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

| **AUDIT REPORT** |
|---|
| **ISSUE DATE:** |
| **AUGUST 17, 2001** |
| **REPORT NUMBER: 1-16** |

**TO:** Jeanne M. Sclater, Acting Associate Deputy Administrator for Capital Access

Robert G. Seabrooks

**FROM:** Robert G. Seabrooks, Assistant Inspector General for Auditing

**SUBJECT:** SBA's Follow-Up on SBLC Examinations

Attached is a copy of the subject audit report. The report contains one finding and two recommendations addressed to the Office of Capital Access. We provided you with a copy of the draft report for review and comment. Your comments indicate that you generally agree with the audit results and recommendations. Your comments are summarized in the report and included, in their entirety, at Appendix A.

The findings in this report are the conclusions of the Office of Inspector General's Auditing Division. The findings and recommendations are subject to review and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide your management response to the recommendations within 30 days from the date of this report on the attached SBA Forms 1824, Recommendation and Action Sheet. Any questions you may have regarding this report may be directed to Garry Duncan, Director, Credit Programs Group, at 202-205-7732.

Attachment

# SBA's Follow-up on SBLC Examinations

# AUDIT REPORT NUMBER 1-16

# August 17, 2001

The findings in this report are 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

## SBA's Follow-up on SBLC Examinations

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**SUMMARY**

In September 1998, the Small Business Administration (SBA) implemented a program to improve its oversight of the Small Business Lending Companies (SBLC) by requiring annual safety and soundness examinations of the 14 SBLCs that participate in the program. The first two annual examinations were performed in FY 1999 and FY 2000 by the Farm Credit Administration (FCA) under a contract with SBA.

The objective of our audit was to determine whether the actions taken by SBA in response to the 14 FY 1999 examination reports were sufficient to assure that the SBLCs corrected problems identified in the examination reports. SBA had taken several actions to improve its oversight of the examination process, however, additional actions are needed to fully ensure that timely corrective actions are taken by SBLCs in response to the FCA examinations.

The initial safety and soundness examinations performed in FY 1999 were intended to provide program oversight and assist SBA in establishing standards for the SBLC program. Because this was the first time the SBLCs had been subject to the examination process, SBA decided to delay following up on all but two of the examination findings and recommendations until the second round of examinations were performed during FY 2000.

During the FY 2000 examination cycle, SBA required FCA to follow-up on the FY 1999 examination findings and recommendations. Based on a sample review of four SBLCs examination reports with a combined total of 30 findings and recommendations, we determined that the SBLCs adequately addressed 11 of the findings and recommendations. The remaining 19 were either partially addressed or not addressed at all.

One reason the SBLCs did not take all the actions necessary to address the FY 1999 examinations reports was because there was little guidance available to the SBLCs as to what actions were required by SBA. Most non-SBLC lenders subject to examination by financial institution regulators are required to have certain internal controls in place. SBA is solely responsible for oversight of the SBLCs and had not established internal control standards for the SBLCs. Another reason was because SBA did not require the SBLC to provide a written plan of action in response to the FY 1999 examination reports.

During the FY 2000 examination cycle, SBA began to issue notification letters to each SBLC advising them of what actions were needed to address the FY 2000 examination reports. As of January 23, 2001, notification letters had been issued to 8 of the 14 SBLCs and 6 responses had been received. The SBLCs that responded either did not fully respond or indicated they would not comply with about 80 percent of the findings and recommendations. SBA did not pursue additional follow-up action beyond the initial responses from the SBLCs.

We recommend that the Acting Associate Deputy Administrator for Capital Access: (1) formalize and implement follow-up procedures for the SBLC examination process to ensure that the examination findings and recommendations are adequately addressed by the SBLC in a timely manner: and (2) develop and promulgate internal control standards for the SBLC program similar to those required for non-SBLC lenders subject to financial institution regulators.

The Office of Capital Access (OCA) generally agreed with the report findings but disagreed with the audit report regarding the risk created by not actively pursuing corrective actions on the SBLC examination findings. The OCA agreed to take action on the two audit recommendations.

# INTRODUCTION

## Background

The Small Business Lending Company (SBLC) program was established in 1975 to provide financial assistance to eligible small business concerns in the form of SBA guaranteed loans as authorized under section 7(a) of the Small Business Act. Unlike other SBA lenders that are regulated by financial institution regulators, SBLCs are non-depository lending institutions that are licensed and regulated by the SBA. Currently, there are 14 SBLCs that participate in the SBLC program. All of the SBLCs are designated as preferred lenders under SBA's Preferred Lenders Program (PLP) and, as such, are authorized to make SBA guaranteed loans, subject only to an eligibility review by SBA. The SBLCs originated approximately 24 percent of the $10.4 billion in 7(a) loans approved by the SBA during FY 1999.

The Office of Capital Access (OCA) is responsible for lender oversight, which is carried out by the Office of Lender Oversight (OLO). In September 1998, the OCA contracted with the Farm Credit Administration (FCA) to perform the first round of annual safety and soundness examinations on each of the 14 SBLCs that participate in the program. According to OCA, the purpose of the initial examinations was to establish a baseline for future examinations in terms of capital adequacy, asset quality, management, earnings and liquidity. Therefore, OCA did not require the SBLCs to formally respond to the findings and recommendations contained in the FY 1999 examination reports, except for two findings involving capital issues. During the FY 2000 examinations, OCA began to implement a follow-up system to formally notify each SBLC what corrective actions were needed to address the findings and recommendations contained in the examination reports.

On September 30, 1999, the FCA issued a comprehensive summary report for the first round of examinations. SBA presented the U. S. Senate Committee on Small Business with a written response to the FCA's comprehensive summary report in June 2000. At the request of the U. S. Senate Committee on Small Business, the General Accounting Office (GAO) initiated a review in April 2000 of the SBLC examination process, which included an assessment of OCA's response to the FCA's Comprehensive Summary Report. Accordingly, our audit was limited to actions taken by SBLCs and SBA in response to the individual examination reports issued for each SBLC.

## Objective and Scope

The audit objective was to determine if SBA had adequate control processes to assure that the SBLCs took sufficient actions to correct the problems identified in the initial safety and soundness examinations performed in FY 1999.

We assessed SBA's follow-up process by reviewing pertinent documentation related to the SBLC program and met with SBA and FCA officials. We also selected a sample of four SBLCs to test SBA's follow-up on the findings and recommendations from the first round of examinations performed in FY 1999. This test sample consisted of the two largest SBLCs in terms of volume of SBA loans generated during fiscal year 1999, the SBLC with the most severe findings, and a fourth SBLC selected to provide geographical diversification. For each SBLC, we reviewed the FY 1999 and FY 2000 examination reports, the workpapers for the FY 2000 examinations, and held discussions with OCA and FCA officials as well as management from some of the SBLCs. We also performed an on-site observation of one SBLC examination and participated in the exit conference of another SBLC examination. Both of these SBLC examinations were included in our audit sample.

## RESULTS OF THE AUDIT

### Finding The Office of Capital Access Needs to Improve Follow-up Procedures for the SBLC Program

The Office of Capital Access (OCA) did not take timely follow up actions to address the findings and recommendations contained in the FY 1999 SBLC examination reports. The OCA considered the FY 1999 examinations to be a baseline for future examinations and therefore, did not require the SBLC to respond to the findings and recommendations, with the exception of two findings. The OCA also delayed follow-up on the FY 1999 examinations until the FY 2000 examination cycle. As a result, the SBLC program was placed at unnecessary risk because OCA did not actively pursue corrective actions to address the examination findings and recommendations.

### Follow-up on FY 1999 Examination Reports

The initial SBLC safety and soundness examinations were performed by FCA during FY 1999. Since this was the first time the SBLCs were subject to this type of examination, a primary purpose was to establish a baseline for future examinations in terms of evaluating capital adequacy, asset quality, management, earnings, and liquidity. Therefore, with the exception of two SBLCs that were required to take immediate corrective action due to the critical nature of two findings, OCA did not require the SBLCs to respond in writing to the findings and recommendations contained in the FY 1999 examination reports.

During the second round of examinations performed in FY 2000, OCA relied on the FCA to perform follow-up procedures on the majority of the FY 1999 examination findings and recommendations. We tested the adequacy of FCA's follow-up procedures by reviewing four SBLC examinations performed during FY 2000. Based on a review of the supporting working papers, a site visit of one examination in process, and discussions with SBLC and FCA officials, we found FCA's follow-up procedures to be sufficient to evaluate the adequacy of the corrective actions taken by the SBLC. We also found that 20 of the 30 findings and recommendations contained in the four examination reports we reviewed were either fully or partially addressed by three of the SBLCs. The fourth SBLC took no action on the findings and recommendations. Since OCA did not require the SBLCs to respond to the FY 1999 examination reports, all but the two corrective actions mentioned above were taken voluntarily by the SBLCs.

The following table shows the number and adequacy of the corrective actions taken by the four SBLCs in response to the FY 1999 examination reports.

| SBLC | Total FY 1999 Findings and Recommendations | Corrective Actions taken by the SBLCs | | |
|---|---|---|---|---|
| | | Adequate | Needs Additional Actions | Non Responsive |
| #1 | 7 | 0 | 0 | 7 |
| #2 | 7 | 3 | 4 | 0 |
| #3 | 9 | 5 | 1 | 3 |
| #4 | 7 | 3 | 4 | 0 |
| TOTAL | 30 | 11 | 9 | 10 |

The 11 findings and recommendations that were adequately addressed by the SBLCs involved deficiencies such as the need for additional capital, improvements in lending policies and procedures, and improvements to information systems. The remaining 19 findings and recommendations that were partially addressed or not addressed at all involved recommendations to implement or improve internal controls, such as credit underwriting, credit review and classification and supporting analysis for allowances for loan losses. The apparent reason most of the findings and recommendations were not addressed fully by the SBLCs was due to the lack of guidance from OCA as to what actions were needed to address the recommendations.

Most SBA lenders are subject to examination by financial institution regulators and required to have certain internal control procedures in place. These include procedures to perform reviews to identify problem loans, classify loans according to risk, and establish allowance accounts that reasonably reflect the potential for loan losses. None of these internal control procedures were required for the SBLCs. The only SBA guidance available to the SBLCs was a draft of the SBLC Examination Handbook issued in September 1988, but OCA officials stated that the handbook did not include standards for operating the SBLCs. According to OCA, such standards would be developed and formalized based on the results of the initial round of examinations. As of January 23, 2001, OCA had not established a uniform set of standards for operating the SBLCs.

**Follow-up on FY 2000 Examinations**

During the FY 2000 examination cycle, OCA implemented a procedure designed to improve the SBLC examination follow-up process. The OCA began to formally notify each of the 14 SBLCs as to what actions were needed to address the FY 2000 examination findings and recommendations. As of January 23, 2001, only eight notification letters had been issued and six responses received. The notification letters sent to the six SBLCs that responded contained a total of 29 findings and recommendations, but OCA required written responses to only 20 of the 29 findings. Furthermore, the SBLCs either did not respond or indicated that they did not plan to comply with the corrective action sought by OCA for 8 of the 20 findings and recommendations. For a ninth finding, the SBLC agreed to take action on a questionable underwriting practice, but did not provide OCA with the list of loans involved with the questionable underwriting practice as requested in the notification letter. As a result, approximately 45 percent (9/20) of the findings that required responses were unanswered or challenged by the SBLCs. As of January 23, 2001, OCA had taken no further action to follow-up with the SBLCs that did not fully respond to the notification letters.

The OCA also did not follow-up on responses to 7 of the 20 findings (35 percent) for which responses were received to ensure that the actions proposed by the SBLCs were sufficient to correct the problems identified in the examination reports. Several SBLC responses included policies designed to address the recommendations, but OCA did not review the proposed policies. One SBLC indicated in its response that a newly adopted policy was in place, but did not include a copy of the policy for OCA to review. Another SBLC disagreed that corrective actions were necessary because it claimed that adequate procedures were in place at the time of the examination. Without additional follow-up by OCA, the responses alone were not sufficient to determine if the actions proposed or taken by the SBLCs were adequate to address the findings and recommendations.

Another action taken by OCA during FY 2000 to improve the examination follow-up process was to modify the format of the examination report. In the initial examination reports issued in FY 1999, most of the findings and recommendations were not separately identified. Also, the descriptions used for similar findings frequently varied between reports. This made it difficult to readily identify and understand the findings and recommendations. The FY 2000 examination reports were redesigned to include schedules in the appendices that specifically identified corrective actions taken in response to previous examination reports and gave a summary of the current findings and recommendations.

**Future Follow-up Procedures**

During FY 1999 and FY 2000, FCA performed annual examinations on all 14 SBLCs. However, due in part to limited resources, OCA began to stagger its SBLC examinations in FY 2001 based on the degree of risk each SBLC represent to SBA. SBLCs that exhibited less risk were placed on an examination schedule of between 18 to 24 months and the high-risk SBLCs will be examined annually. The OCA indicated that the determination of risk was based on factors such as an SBLC's size (SBA loan volume), the timing of the last examination, SBLC responses to past examination findings, and the stability of an SBLC's management team. As of January 23, 2001, OCA had not developed a formal policy or established standard criteria for making these determinations.

Under the staggered review process, seven SBLCs will be examined in FY 2001 and the remaining seven will be reviewed within the next 18 to 24 months. As a consequence, because of OCA's past practice to delay follow-up until the subsequent examinations, findings and recommendations may go unchecked for up to two years. Such a delay, whether or not an SBLC is considered by OCA to be of low risk, is not prudent oversight and places SBA and the SBLCs at unnecessary risk.

## Recommendations

To improve the effectiveness of OCA's oversight of the SBLC examination process, we recommend that the Associate Deputy Administrator for Capital Access take the following actions:

1.A. Develop and implement formal procedures for the SBLC examination follow-up process and ensure that appropriate corrective actions are taken in a timely manner.

1.B. Develop and promulgate internal control standards for the SBLC program similar to those required for non-SBLC lenders subject to financial institution regulators. These standards should address at a minimum the following areas:

- identifying problem loans,
- classifying loans according to risk, and
- establishing allowance accounts that reasonably reflect the potential for loan losses.

## Management Response

The Office of Capital Access agreed with both recommendations and plans to (1) initiate a more systematic follow-up process on examination findings and SBLC responses and (2) develop internal control standards for the SBLCs.

## Evaluation of Management Response

Implementation of the proposed actions should satisfy the intent of our recommendations.

**Appendix A**

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

**DATE:** August 3, 2001

**TO:** Robert G. Seabrooks
Assistant Inspector General for Auditing

**FROM:** Jeanne Sclater Robert J. Moffitt
Acting Associate Deputy Administrator for Capital Access

**SUBJECT:** Office of Capital Access Response to the Draft Audit Report -- SBA's Procedures to Assure the Adequacy of the SBLCs' Response to the FY 1999 Examination Reports

Thank you for the opportunity to respond to the Draft Audit Report on "SBA's Procedures to Assure the Adequacy of the SBLC's Response to the FY 1999 Examination Reports."

Overall, we find the report fairly and accurately states the facts of the Office of Capital Access's (OCA's) approach to regulation of the SBLCs since assuming responsibility for oversight of the SBLCs from the Office of Inspector General beginning in FY 1999. However, we disagree with the report with regard to the finding that the SBLC program was placed at unnecessary risk because the OCA did not actively pursue corrective actions to address the examination findings and recommendations.

Prior to FY 1999, oversight of the SBLCs was more limited and there was no examination process in place. By initiating SBLC safety and soundness examinations in FY 1999, the OCA significantly improved the process of identifying and assessing the risk posed by the SBLCs to the Agency. The OCA views the examination process as progressive with FY 1999 examinations establishing a baseline from which to evaluate progress and results in future years. The SBLCs had not been subject to safety and soundness examinations prior to FY 1999. Accordingly, most SBLCs were unfamiliar with the concept. Furthermore, the OCA believed that an education process for both the SBLCs and SBA was the best approach with the initiation of examinations. However, as noted in the draft audit report, in those cases where examination findings had significant implications for the Agency, the OCA took immediate action. The OCA believes the approach adopted with regard to the FY 1999 examinations was both prudent and reasonable.

OCA agrees with the recommendations included in the draft audit report and provides the following comments:

> _Recommendation 1.A._: *Develop and implement formal procedures for the SBLC examination follow-up process and ensure that appropriate corrective actions are taken in a timely manner.*
>
> With the FY 2000 cycle of examinations, the OCA began providing the SBLCs with specific guidance on actions to be taken as a result of the examinations. The same practice will continue with the FY 2001 cycle of examinations. In addition, a more systematic follow-up process on examination findings and SBLC responses will be initiated. While these processes are being put in place, the OCA agrees with the need for formal procedures that specifically articulate the SBA's practices in this regard.
>
> As noted in the draft audit report, these practices are essential as the Agency moves to a risk based approach to on-site examinations with the FY 2001 cycle of examinations. At the same time, understand that not all examination findings carry the same weight in terms of materiality. The SBA will make reasonable judgments as to which findings to emphasize and will consider progress made since the initiation of examinations in FY 1999 in evaluating an SBLC's responsiveness in addressing examination findings.
>
> _Recommendation 1.B._: *Develop and promulgate internal control standards for the SBLC program similar to those required for non-SBLC lenders subject to financial institution regulators. These standards should address, at a minimum, the following areas:*
>
> - *Identifying problem loans.*
> - *Classifying loans according to risk.*
> - *Establishing allowance accounts that reasonably reflect the potential for loan losses.*
>
> The OCA agrees with the need for these standards. They provide a means of providing guidance to the SBLCs as to the Agency's expectations. The standards will be developed in connection with a revised SBLC Examination Handbook.
>
> On an administrative note, please include the Associate Administrator for Lender Oversight on the Audit Report Distribution list.
>
> Again, thank you for the opportunity to provide comments on the draft audit report. We look forward to continuing to work with you on these important issues. Please let me know if you have any questions or if you need any additional information.

**Appendix B**

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