



U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

Action Memorandum
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To: Jeanne M. Sclater, Deputy Associate Deputy Administrator
for Capital Access

Jane P. Butler, Associate Administrator
for Financial Assistance

Janet A. Tasker, Associate Administrator
for Lender Oversight

From: Robert G. Seabrooks, Assistant Inspector General
for Auditing

Subject: Improvements are needed in the Small Business Lending Company Oversight Process

The purpose of this memorandum is to alert you to several issues identified during our on-going oversight of the Small Business Lending Company (SBLC) program. The issues involve the following areas:

- FY 2001 SBLC examination reports,
- Coordination of program management and oversight,
- Off-site monitoring,
- Identification of problematic loans, and
- Reporting loans with suspected fraud.

Background

The Small Business Lending Company (SBLC) was established in 1975 to provide financial assistance to eligible small business concerns in the form of SBA guaranteed loans. SBLCs are non-depository lending institutions that are licensed and regulated by the SBA. In September 1998, the SBA contracted with the Farm Credit Administration (FCA) to perform annual safety and soundness examinations on each of the 14 SBLCs that participate in the guaranteed loan program. During FY 2001, FCA performed seven examinations and final reports were issued in February 2002.

Findings

1. SBLC Program Management and Oversight was Adversely Impacted due to Untimely Issuance of FY 2001 SBLC Examination Reports

The Small Business Administration (SBA) requires periodic safety and soundness examinations for all SBLCs that participate in the Guaranteed Loan Program. A primary purpose of the examinations, which are carried out by the Farm Credit Administration (FCA), is to assess the viability of the SBLC on an on-going basis and identify areas in need of improvement or corrective action. As a general rule, SBA waits until final examination reports are issued before taking supervisory or enforcement actions that are subject to appeal. According to SBA, final reports are needed to support these actions in the event of an appeal. Until final reports are issued, SBA relies mainly on the PLP approval and renewal process to hold SBLCs accountable for their actions.

During FY 2001, FCA examiners performed seven SBLC examinations and provided draft reports on all seven to SBA between April and November 2001. Final reports were issued in February 2002; ten months after the first draft report was received. The reason given for the delay was that this was the first full cycle of examinations conducted under the responsibility of the Associate Administrator for Office of Lender Oversight (OLO) and it took longer than expected to review the draft reports. As a result of these delays and SBA's policy to delay enforcement actions until final reports are issued, two SBLCs were allowed to continue to operate in an unsafe and unsound manner despite early identification of material weaknesses during the FY 2001 SBLC examinations.

On July 12, 2001, SBA received a draft examination report on an SBLC that cited management weaknesses as the primary cause for the significant deterioration of loan underwriting and asset quality, insufficient liquidity, inadequate earnings, and a lack of permanent capital. SBA officials became aware of these adverse conditions approximately three months earlier during the examination exit conference held on March 28, 2001. Shortly after the exit conference, SBA considered suspending the lender from the PLP and secondary market, but neither action was taken until after the final report was issued on February 12, 2002. Two days later, SBA informed the lender that its PLP status, which had expired on January 16, 2002, would not be renewed based on the results of the examination, but no action was taken to suspend the lender from participating in the secondary market.

On July 10, 2002, SBA received a draft examination report on another SBLC that showed that the SBLC had been operating below the minimum regulatory capital requirements and under a capital impairment since January 31, 2001. According to one SBA official, the SBLC continued to make guaranteed loans while under a capital impairment until it experienced liquidity problems in June 2001. Pursuant to 13 Code of Federal Regulations (CFR) 20.470 (b)(4), SBLCs with impaired capital "...may not present any loans to the SBA for guarantee." SBA first learned of these adverse conditions during the exit conference held with the

lender on June 27, 2001, but no direct enforcement actions were taken until the final report was issued on February 5, 2002.

SBA did, however, take a less severe action of notifying the lender in April and May 2001, that its requests for PLP expansion and reinstatement would not be approved until audited financial statements were provided. In December 2001, SBA informed the lender that its PLP status, which expired one month earlier, would not be renewed because audited financial statements still had not been provided. As of the February 5, 2002, the only other enforcement action taken by SBA was to issue a notification letter along with the final examination report asking the lender to provide a plan on how it would address the problems cited in the examination report.

Although we did not examine SBA's policy of waiting until final reports are issued before taking appealable enforcement actions, adherence to this policy emphasizes the importance of issuing final reports as soon as possible after the draft examination reports are received by SBA. Delays for up to ten months as was the case in FY 2001 places the Agency at greater risk and allows material weaknesses identified during the examination process to go unchecked.

To assist in resolving these issues, we recommend the following actions:

- *Establish controls and procedures to ensure that final examination reports are issued timely so that appropriate enforcement actions can be taken soon after lender deficiencies are discovered.*
- *Develop a formal policy regarding effective supervisory and enforcement actions.*
- *Flag all loans approved by the SBLC that continued to operate under a capital impairment [FOIA EX. 4], to ensure that appropriate actions are taken in the event purchase requests are received on the loans.*

2. Informal Structure of SBLC Program Management and Oversight Contributed to Delays in Issuing Final Examination Reports for FY 2001

SBA's OLO and Office of Financial Assistance (OFA) are responsible, respectively, for oversight and management of the SBLC program. The OLO was established in FY 1999 to take over SBLC oversight, a function that was previously performed by OFA. Under this new structure, OLO is responsible for SBLC on-site examination and off-site monitoring and OFA handles day to day program management, policymaking, and enforcement of corrective actions. Coordination between the two offices, however, was not formally established and simply evolved over time. This informal structure contributed, in part, to the delays in issuing the FY 2001 examination reports.

This informal structure does not meet the requirements of Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables. Section III.B.3 of the circular requires the agency to submit its written reports of lender reviews to an agency review

board. Section I.4.b.(1) further directs that the agency review board should include among others, the CFO and senior officials for the program offices with credit activities.

In the banking industry, it is a common practice for bank regulators to use a “supervisory committee system” to coordinate supervisory efforts, especially in developing policy, implementing enforcement actions, obtaining legal advice, documenting decisions for planned actions thus insulating individuals from liability for actions that adversely impact the lenders.

We recommend that SBA implement a system similar to that used by bank oversight organizations to assist in establishing lines of authority between OLO and OFA and formalizing the coordination between the two offices. A supervisory committee system could also be used to establish policy and procedures for supervisory and enforcement actions.

3. Off-Site SBLC Monitoring was not Implemented

The OLO did not establish an off-site monitoring process for the SBLC program as described in the OLO strategic plan dated October 26, 2000. Off-site monitoring is needed to identify and assess changes in risk at each SBLC during the period between on-site examinations and justify enforcement of timely and meaningful corrective actions. This is particularly important since the annual safety and soundness examinations have been replaced with periodic examinations performed at intervals of between 18 and 24 months.

We recommend that OLO implement an off-site monitoring process as described in the strategic plan as soon as possible. The monitoring process should include trend analysis of factors such as loan growth, concentrations of industry or market; delinquency rates, default rates, liquidation rates, recovery rates, and guaranty purchase rates.

4. SBA did not Flag Problematic Loans in its Loan Database

Problematic loans identified during the FY 2001 examinations were not specifically identified as such in the Delinquent Loan Collection System (DLCS), as required. SBA policy requires that loans identified with lender errors or omissions during audits, reviews, and examinations should be specifically identified as potentially problematic (flagged) in the DLCS. Flagging these loans alerts the purchase reviewers to the issues involved with these loans so that the adverse conditions are given full consideration during the guarantee purchase review process. Failure to flag problematic loans can result in erroneous guarantee purchase payments.

We recommend that SBA take appropriate measures to ensure that all problematic loans identified during the FY 2001 examinations are properly flagged in the DLCS. We further recommend that SBA review the status of these loans to determine if any were purchased prior to flagging. If they were purchased, SBA should undertake a review to determine if the decisions were appropriate given that the adverse

conditions associated with the loans. If it is found that the purchase decisions were improper, SBA should take the appropriate action, such as a repair or full denial of the guarantee.

We also recommend that SBA implement adequate controls and procedures to ensure that all loans identified during audits, reviews, and examinations with lender issues are properly flagged in the DLCS in a timely manner.

5. SBA did not Report Loans with Suspected Fraud to OIG

Only one of several potentially fraudulent loans identified during the FY 2001 SBLC examinations was referred to the OIG for further investigation as required.

We recommend that OLO take immediate action to refer all potentially fraudulent loans identified during the FY 2001 examination to the OIG for investigation. We also recommend that SBA develop and implement adequate controls to ensure that these loans are promptly reported to the OIG in the future.

We have designated you as the primary action official. Please respond within 60 days from the date of this memorandum what actions, if any, you plan to take. If you have any questions, please contact Garry Duncan at (202) 205-7732.

The findings in this report are the conclusion of the OIG's Auditing Division based on testing of SBA operations. 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.