U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

MANAGEMENT ADVISORY REPORT

POLICIES AND PROCEDURES FOR THE SBA*EXPRESS* AND COMMUNITY*EXPRESS* LOAN PROGRAMS

REPORT NUMBER 6-34
SEPTEMBER 29, 2006

WASHINGTON, DC

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

MANAGEMENT ADVISORY REPORT
Issue Date: September 29, 2006
Report Number: 6-34

To: Michael W. Hager
Associate Deputy Administrator for Capital Access

From: Glenn P. Harris
Counsel to Inspector General

Subject: Policies and Procedures for the SBA*Express* and Community*Express* Loan Programs

Attached is a copy of the subject management advisory report. The report contains five concerns and sixteen recommendations addressed to you. Your response has been synopsized and included in the report.

The recommendations in this report are subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for Office of Inspector General report follow-up. Please provide your management decision for the recommendations to our office within 30 days of the date of this report using the attached SBA Form 1824, Recommendation Action Sheets.

Should you or your staff have any questions, please contact me, at 202-205-6862.

Attachment

MANAGEMENT ADVISORY REPORT POLICIES AND PROCEDURES FOR THE SBA*EXPRESS* AND COMMUNITY*EXPRESS* LOAN PROGRAMS

This Management Advisory Report contains concerns of the Small Business Administration (SBA) Office of Inspector General (OIG) based solely upon its review of policies and procedures for the SBA*Express* Program and the Community*Express* Program. This is not intended as an audit and, therefore, was not conducted in accordance with Federal Government Auditing Standards.

Of the OIG concerns discussed in this report, the following are the most significant:

(1) Although the SBA*Express* Program has been in existence for over 11 years and was made permanent in 2004 by Congress, SBA has not issued any regulations to govern the Program.

(2) The Agency's Guide for the Program contains credit requirements for lenders that may conflict with the Small Business Act, and contains provisions that conflict with SBA regulations.

(3) The criteria for lenders seeking admission to the Program in the Guide may not provide SBA with sufficient information to identify whether the applicant lender presents an undue risk to the Agency, and appears to impose more stringent criteria upon lenders who have previously participated in SBA loan guarantee programs than for lenders with no SBA program experience.

(4) Certain provisions in the Agency's Guide are ambiguous, or conflict with other agency policies, and do not provide meaningful guidance to lenders or guidance that SBA could rely upon to use enforcement to correct lender noncompliance.

(5) The Agency is relying on a Guide for the Community*Express* Program that has never officially been cleared or issued by SBA, contrary to agency procedures.

Background

1. SBA*Express* Program

SBA initiated the SBA*Express* Program as a pilot program in 1995, and continued the program as a pilot through a series of notices in the Federal Register until Congress made the program permanent in December, 2004. The initial version of the Program limited participation to lenders with considerable experience in SBA's loan guarantee program, which is known as the "7(a) Program."[1] In 2002, SBA opened the program up to lenders with no prior experience in SBA loan programs. Currently, the Program accounts for more than 70 percent of 7(a) Program loans.

[1] Section 7(a) of the Small Business Act, 15 U.S.C. § 636(a), authorizes the SBA to provide guarantees on loans to small businesses made by private sector lenders.

SBA implemented what was originally called the FA$TRAK program in 1995 to streamline and expedite the processing of loan guarantee applications from lenders for small dollar loans and to increase the number of smaller loans. The Program was designed to permit certain lenders approved by the Agency to make SBA-guaranteed loans, using many of their own documents and lending procedures, instead of SBA forms and procedures. (60 Fed. Reg. 12268, March 6, 1995.) The Federal Register notice announcing the program contemplated that the Program would be effective for two years, and included a Guide setting forth policies and procedures for the FA$TRAK Program.

The FA$TRAK Program was initially limited to loans of $100,000 or less and provided only a 50% guarantee to lenders instead of the typical SBA guarantee, which is 75% to 80% of the loan, depending on loan size. The Program was also initially limited to lenders that had been admitted to the SBA's Preferred Lender Program (PLP), under which certain lenders with extensive 7(a) Program experience and a good loan performance history obtain delegated authority to approve loans with an SBA guarantee. As in the PLP Program, FA$TRAK lenders also were delegated the authority to approve loans and obligate an SBA guarantee upon the submission of limited documentation for SBA review. Under paragraph VI.D of the FA$TRAK Program Guide, lenders were only required to submit to SBA a Form 1920, FA$TRAK Authorization and Loan Request, to make an SBA-guaranteed loan. This is in contrast to applications for SBA loan-guarantees for lenders that were not admitted to the PLP or FA$TRAK Program, which were required to include much more extensive information regarding the lender's credit analysis, the business history of the borrower, and the borrower's eligibility under SBA rules and procedures.

In 1997, the SBA issued a notice announcing that it would hold a hearing to determine whether to make the FA$TRAK Program permanent. (62 Fed. Reg. 44741, August 22, 1997.) The notice advised that since the Program's inception, 18 banks or bank holding companies (comprising 60 lenders, counting affiliates and subsidiaries) had participated in the Program, making 5,824 loans for $243 million. SBA did not, however, make the program permanent at that time.

On October 1, 1998, the Program, which SBA had renamed as the SBA*Express* Program, was extended as a pilot into Fiscal Year (FY) 2002, and expanded to include additional lenders.[2] In 2001, the Agency issued a Federal Register notice extending the Program as a pilot until July 1, 2002. (66 Fed. Reg. 54319, Oct. 26, 2001.)

In FY 2001, 11,802 SBA*Express* loans were approved, totaling approximately $646 million. Although the Program had been, as of the end of that fiscal year, in existence for over five years, SBA did not make the program permanent. Instead, in June, 2002, SBA issued another Federal Register notice extending the SBA*Express* Program as a pilot until September 30, 2005. (67 Fed. Reg. 40766, June 13, 2002.) The notice stated that the volume of SBA*Express* loans had grown to represent 29 percent of SBA's loan volume. Nevertheless, the

[2] This is according to the SBA*Express* Program Guide that the Agency issued in October of 2002. Despite extensive research, however, we were not able to find any Federal Register notice or internal agency notice officially extending the Program as a pilot from 1997 to 2001.

Agency stated that the three-year extension of the Program as a pilot was needed so that SBA could implement changes and enhancements that would make the Program more attractive to its lending partners and better meet the needs of small businesses.

SBA issued Procedural Notice 5000-812 on July 10, 2002, announcing several significant revisions to the SBA*Express* Program. The Notice advised that the Program was being expanded to allow participation not only by non-PLP lenders that met certain program admission criteria, but also to other lenders that had no prior 7(a) Program experience as long as those lenders met separate admission criteria. Further, the cap on loans under the Program was raised to $250,000.

In October, 2002, the Agency issued Procedural Notice 5000-830 announcing the issuance of an SBA*Express* Program Guide, which revised the policies and procedures in the 1995 Guide for the FA$TRAK Program. As under the FA$TRAK Program, the SBA*Express* Program Guide provided that lenders were only required to submit limited documentation to SBA for review prior to being able to obligate an SBA guarantee on a loan. (Pars. 6.B., 6.C.).[3]

Congress amended the Small Business Act in December, 2004, adding a new section, 15 U.S.C. § 636(a)(31), which established the SBA*Express* Program as a permanent SBA program. (Consolidated Appropriations Act of 2005, P.L. 108-447, Div. K.) In that legislation, Congress also raised the ceiling on SBA*Express* loans to $350,000.

In FY 2005, lenders approved 58,664 SBA*Express* loans (totaling approximately $2.9 billion), which was approximately 72% of the 80,642 loans (totaling approximately $5 billion) approved under the entire 7(a) Program. From FY 1999 to FY 2005, a total of 182,208 SBA*Express* loans were approved, totaling over $9.1 billion.

2. Community*Express* Program

SBA initiated the Community*Express* Program as a pilot program in 1999, and has continued the program as a pilot through a series of notices in the Federal Register. The most recent notice extends the pilot until December of 2006. The program is similar to the SBA*Express* Program except that lenders obtain a higher SBA guarantee on loans in exchange for providing technical assistance to economically or otherwise disadvantaged borrowers. Program loans in FY 2005 exceeded $125 million.

On May 14, 1999, SBA initiated the Community*Express* pilot program through Procedural Notice 5000-605. The Notice advised that the Community*Express* Program would be similar to the SBA*Express* Program in that lenders would be permitted to make loans up to $250,000 using many of their own forms and procedures and to obligate an SBA guarantee with minimal prior review by SBA. According to the Notice, however, the Community*Express* Program was only available to borrowers that are considered "New Markets," i.e., "small businesses owned by minorities, women, and veterans, who are underrepresented in the population of business owners compared to their representation in the overall population, and

[3] The Guide required lenders to submit to SBA a request for a loan number and, other than lenders with delegated eligibility authority, an eligibility checklist certifying to the borrower's eligibility. Pars. 5.C(2), 6.B., 6.C.

businesses located or locating in Low and Moderate Income urban and rural areas." In order to assist these borrowers, Notice 5000-605 provided that lenders were required to arrange and pay for technical and management assistance to borrowers. To offset some of the additional cost to lenders for providing technical assistance, the SBA would extend a guarantee on Community*Express* loans that was similar to 7(a) Program loans, i.e., up to 80 percent for loans of $100,000 or less, and up to 75 percent for loans over $100,000.

Notice 5000-605 provided that nine lenders would be permitted to participate in the initial version of this Program. On July 28, 2000, SBA issued Procedural Notice 5000-676, announcing that the Community*Express* Program was being opened up to all lenders that met the criteria to be an SBA*Express* lender. Both Notice 5000-605 and Notice 5000-676 expired within one year of their issuance as required by SBA standard operating procedures (SOPs).

The Community*Express* Program was originally set to expire at the end of September 2005, as set forth in Notice 5000-605. However, through a series of Federal Register notices, SBA has extended the Program as a pilot until December, 2006.[4]

The Program began modestly with only 23 loans approved in Fiscal Year 1999, totaling slightly more than $2 million. In FY 2005, lenders approved 6,210 Community*Express* loans, totaling approximately $125 million. Since the beginning of the Program, lenders have approved over 14,000 loans worth in excess of $387 million.

Concerns

Concern 1: The SBA*Express* Program lacks regulations, and program guidance may be inconsistent with the "credit elsewhere test" in the Small Business Act and conflicts with SBA regulations.

The SBA*Express* Program began over 11 years ago, and became a permanent SBA program through amendments to the Small Business Act in December, 2004. Nevertheless, the Agency has not issued any regulations governing this Program. Further, the SBA*Express* Program Guide (Guide) contains directions for lender credit analysis which may be inconsistent with the Small Business Act and contains policies and procedures that conflict with existing SBA regulations. (The Guide is available on SBA's Electronic Lending web-page, http://www.sba.gov/banking/enhance.html#commexp.)

Absence of Regulations.

In the 1995 Federal Register notice announcing the origin of the SBA*Express* Program, SBA advised that the Program would be run as a pilot for two years, and that "[p]rior to the termination date, SBA will review the experience with the program and determine if final rules and regulations will be developed." (60 Fed. Reg. 12268, March 6, 1995.) However, this did not occur. Instead, as discussed in the Background section, the Agency extended the Program as a pilot program through repeated notices in the Federal Register until Congress made the Program

[4] 70 Fed. Reg. 56962 (Sept. 29, 2005); 70 Fed. Reg. 71363 (Nov. 28, 2005); 71 Fed. Reg. 29703 (May 23, 2006).

permanent in December, 2004 amendments to the Small Business Act. We note that congressional interest in seeing the Agency issue regulations is indicated in the following statement from Senator Olympia Snowe, the Chair of the Senate Committee on Small Business and Entrepreneurship: "Congress expects that the Administrator will establish by rule the standards needed to qualify as an Express lender." (150 Cong. Rec. S11740-05.) As the Program is now permanent, the Agency should issue regulations so that the public is adequately informed about the existence and nature of this Program and so that SBA has legally enforceable rules to manage this Program.

Potential Conflict Between the Guide and the Small Business Act.

The credit analysis provisions in the Guide could be interpreted as being in conflict with the "credit elsewhere" test in the Small Business Act. Under the statute, a guaranteed loan under the 7(a) Program can only be made if a borrower is unable to obtain credit from lenders under their standard lending practices. This may conflict with the Guide, however, which requires that lenders use the same credit analysis procedures for SBA*Express* loans as they would for their non-SBA-Guaranteed loans.

The Guide contains limited guidance on determining the credit-worthiness of SBA*Express* borrowers. Paragraph 5.D provides:

> The SBA*Express* credit analysis and credit decision processes are delegated to the lender. However, the lender is required to use appropriate and generally accepted credit analysis processes and procedures, and these procedures must be consistent with those used for its non-SBA guaranteed commercial loans. Acceptable analytical processes include "credit scoring," if the lender uses credit scoring for non-SBA guaranteed commercial loans. The credit analysis technique must be documented, must be kept in the loan file, and is subject to SBA review (emphasis added).

The guidance in the Guide that lender credit analysis procedures "must be consistent with those used for its non-SBA guaranteed commercial loans" could be interpreted in different ways. On the one hand, the Guide could be read to mean only that lenders must use their own loan-making procedures when making SBA*Express* loans. Alternatively, the Guide could be construed as requiring SBA*Express* lenders to use the same credit analysis as they would for their own loans made without a Federal guarantee. Such an interpretation would conflict with the "credit elsewhere" test in the Small Business Act and agency policies, which provide that financial assistance under the 7(a) Program can only be made available if the lender could not make the loan under its own terms without the benefit of the SBA guarantee.

The Small Business Act provides as follows:

(A) Credit elsewhere

> No financial assistance shall be extended pursuant to this subsection if the applicant can obtain credit elsewhere. No immediate participation may be purchased unless it is shown

> that a deferred participation is not available; and no direct financing may be made unless it is shown that a participation is not available.

15 U.S.C. § 636(a)(1)(A). SBA has interpreted what is known as the statutory "credit elsewhere test" as follows in its regulations:

> SBA provides business loan assistance only to applicants for whom the desired credit is not otherwise available on reasonable terms from non-Federal sources. SBA requires the Lender or [Certified Development Company (CDC)] to certify or otherwise show that the desired credit is unavailable to the applicant on reasonable terms and conditions from non-Federal sources without SBA assistance, taking into consideration the prevailing rates and terms in the community in or near where the applicant conducts business, for similar purposes and periods of time.

13 C.F.R. § 120.101. SBA's SOP 50 10 4(E) further interprets the "credit elsewhere" test to mean that "[i]f a lending institution will provide the credit to the small business applicant, on reasonable terms, without SBA support, the requested financing is not eligible for SBA consideration." (Subpart A, Ch. 2, Par. 3.)

To avoid lender confusion, it would appear to be prudent for SBA to revise the SBA*Express* Program Guide to make it clear that the "credit elsewhere" test does apply to the Program. Such a change would also assist SBA's efforts to enforce compliance with the "credit elsewhere" test if it was found that the lender had violated this test. Under the current language, an SBA*Express* lender could rely on the language in the Guide to claim that its loan was acceptable.

Absence of Meaningful Guidance To Lenders Regarding Credit Analysis.

As noted in the quote from paragraph 5.D of the Guide above, the Guide provides little explanation as to the credit analysis that lenders should employ when making SBA*Express* loans. The Guide merely provides that lenders should use their own credit analysis procedures and may use credit scoring. This guidance appears to be sufficiently vague that it may not provide meaningful guidance to lenders and SBA employees reviewing lender compliance with program requirements. Moreover, although the Guide does not provide any other guidance on the use of credit scores, in paragraph 7.B(1), which relates to Internal Revenue Service (IRS) verification of borrower financial information (discussed and quoted in Concern 4 below), the Guide suggests that it is permissible to rely solely on credit scores in making an SBA*Express* loan. The guidance on the use of credit scores also appears to be sufficiently vague that it may not provide meaningful guidance either to lenders that participate in the Program or to SBA employees that are reviewing lender compliance. In order to reduce lender confusion and implement enforceable requirements, SBA should clarify the credit analysis standards in the Guide and the use of credit scores by lenders.

Conflict Between the Guide and Other Regulatory Provisions.

Certain provisions of the Guide appear to be inconsistent with SBA regulations governing

the 7(a) Program. The apparent conflicts are as follows:

(1) Par. 5.b(3) of the Guide permits SBA*Express* lenders to make revolving lines of credit. SBA regulations, however, provide that 7(a) loans may not be made for "floor plan financing or other revolving lines of credit, except under § 120.390." 13 C.F.R. § 120.130. Section 120.390 only permits revolving lines of credit under the SBA CapLines Program, which is a subprogram of the 7(a) Program limited to construction loans. (As discussed below, in 1995, SBA issued a "temporary" suspension of the regulatory restriction on revolving lines of credit for the FA$TRAK Program.)

(2) Par. 5.b(5) of the Guide allows lenders to charge variable interest rates on loans under the SBA*Express* Program. According to the Guide, lenders could charge 4.5 to 6.5 percentage points above prime depending upon loan amount. However, under 13 C.F.R. § 120.214, lenders can only charge 2.25 to 2.75 percentage points above prime depending upon loan amount and maturity.

(3) Par. 5.b(7) of the Guide permits lenders to charge the same "fees for SBA*Express* as it charges for its non-SBA guaranteed commercial loans." However, 13 C.F.R. § 120.222 specifically prohibits lenders from charging certain types of fees to borrowers on 7(a) loans. In addition, 13 C.F.R. § 120.221(b) provides that lenders on 7(a) loans may only charge fees for "extraordinary servicing" with SBA's prior written approval and that such fees may not exceed 2 percent per year on the outstanding balance of the portion of the loan requiring extraordinary servicing. Further, 13 C.F.R. § 120.221(a) provides that lenders may only charge packaging fees to an applicant if the lender advises "the applicant in writing that the applicant is not required to obtain or pay for unwanted services" and that "the applicant is responsible for deciding whether fees are reasonable."

(4) Paragraph 5.D of the Guide states that "[t]he credit decision, including ... whether to require an equity injection, is left to the business judgment of the lender." 13 C.F.R. § 120.102, however, requires that 20 percent or greater owners of the applicant business inject equity into the business if their personal assets exceed certain thresholds.

With respect to the Guide's authorization of revolving lines of credit, we note that SBA issued a "temporary" suspension of this regulation in 1995, when it implemented the FA$TRAK Program, the predecessor to the SBA*Express* Program. In the 1995 Federal Register notice announcing the origin of the Program, SBA stated that it was suspending the applicability of 13 C.F.R. § 120.102-2 (1995), which limited the use of revolving lines of credit (this regulation was subsequently renumbered as 13 C.F.R. § 120.130(c)). This suspension was consistent with 13 C.F.R. § 120.1-2 (1995), which authorized SBA to "publish a notice in the Federal Register that certain rules will be suspended or modified for a limited period of time" in order to test new programs or ideas for the 7(a) Program (emphasis added).[5] Although it is not clear what the

[5] This regulation has since been reworded and renumbered as 13 C.F.R. § 120.3.

phrase "a limited period of time" was intended to mean, SBA appears to have exceeded its limited authority to suspend regulations for new programs given the fact that eleven years have elapsed since it suspended the revolving line of credit regulation for the SBA*Express* Program. SBA should either revise its regulations to permit revolving lines of credit for SBA*Express* loans or revise the Guide.

With respect to the remaining conflicts between the Guide and agency regulations, regulations have the force and effect of law and cannot be contradicted by other agency guidance which has not been issued for public notice and comment. Thus, SBA should revise the regulations to exempt the SBA*Express* Program or revise the Guide so that it is consistent with the regulations.

Recommendations:

We recommend that the Office of Capital Access:

1.A Promulgate regulations to govern the SBA*Express* Program in order to ensure that the Agency has sufficient legal authority to manage the Program and that the public is put on adequate public notice of this Program.

1.B Revise the SBA*Express* Program Guide to clarify the credit analysis for lenders in the Program so that these provisions do not conflict with the "credit elsewhere" provision in the Small Business Act, and with SBA's regulations and procedures interpreting that provision.

1.C Revise the Guide to establish criteria as to when lenders are permitted to use credit scores, when they can use credit scores as the sole means of determining the creditworthiness of borrowers, and what range of credit scores SBA would consider to be acceptable.

1.D Revise the Guide to identify acceptable credit analysis methods so that lenders have a clear understanding of what is expected of them and SBA employees have a basis for reviewing lender underwriting.

1.E Promulgate regulations to exempt the SBA*Express* Program from existing regulations that conflict with the SBA*Express* Program Guide or revise the Guide to be consistent with agency regulations.

Management Response:

1.A. The Office of Capital Access (OCA) agreed that regulations were needed for the SBA*Express* Program.

1.B. The OCA disagreed that clarification was needed in the SBA*Express* Program Guide (Guide) to clarify SBA's credit analysis requirements because lenders execute other forms that contain a statement that credit is not available. Nevertheless, the OCA agreed to emphasize the credit elsewhere requirement in an updated Guide.

1.C. The OCA also disagreed that the Guide should establish criteria for when and how lenders may use credit scores to determine the creditworthiness of borrowers. The office stated that since the Program is designed to delegate authority to lenders, it would be inappropriate for the Agency to dictate specific credit scoring requirements. Further, the OCA noted the difficulties in establishing uniform credit scoring guidance since many lenders utilize disparate credit scoring methodologies. However, the OCA agreed to require lenders to document credit scoring methodologies and include regular validations of the predictiveness of the models, and to review this documentation during on-site lender reviews.

1.D. Although the OCA disagreed that the Guide needed to identify acceptable credit analysis methods, it stated that the Office will consider providing guidance to staff for use in reviewing credit aspects of purchase requests for SBA*Express* loans.

1.E. The OCA agreed that regulations are needed to address the SBA*Express* deviations from the standard 7(a) regulations.

OIG Evaluation of Management's Response

The OCA agreed to implement recommendations 1.A and 1.E. Although not entirely responsive, we consider the response to recommendation 1.B to be adequate.

As to Recommendation 1.C and 1.D, we do not agree with the OCA that the existing Guide provides clear and enforceable guidance for lenders on the permissible use of credit scoring and credit analysis methods or for guarantee purchase reviewers to review the adequacy of lender underwriting. It is not enough to provide guidance to the reviewers if the guidance to the lenders is vague and unclear because such provisions are incapable of enforcement. Additional protective measures should be put in place to more fully protect SBA's interests. OIG will pursue these recommendations through the resolution process.

Concern 2: The SBA*Express* Program Guide contains inadequate criteria for the admission of lenders to the Program.

As discussed in the Background section above, lenders that are admitted to participate in the SBA*Express* Program are given broad authority to obligate SBA guarantees on loans they make with very little prior review by SBA. The Guide, however, does not appear to establish sufficient criteria for Program admission because many criteria are vague and focus only on present responsibility problems rather than whether the lender has experienced problems in the past. Further, although the Guide requires lenders to demonstrate an adequate performance history if they have previously participated in the 7(a) Program, no performance history is required for lenders with no prior program experience.

The SBA*Express* Program Guide contains separate criteria for lenders seeking admission to the Program depending upon whether the lender is currently participating in the 7(a) Program (hereinafter referred to as "Experienced 7(a) Lenders") or has no prior 7(a) Program experience (hereinafter referred to as "New Lenders"). Under the Guide, to be admitted to the SBA*Express* Program, Experienced 7(a) Lenders must:

(1) Be able to process, make, close, service, and liquidate SBA loans;
(2) Demonstrate a satisfactory performance history with SBA, including acceptable currency and default rates;
(3) Be in compliance with applicable SBA statutes, regulations, and policies;
(4) If reviewed by SBA, have received an acceptable rating in its last review, as determined by SBA in its sole discretion. (As circumstances warrant, the Agency may require a lender review and an acceptable rating before a lender can participate in SBA*Express*.);
(5) Be current in filing SBA required 1502 reports;
(6) Be current in remitting required guaranty and servicing fees;
(7) Have at least an 85 percent currency rate on its SBA 7(a) portfolio (excluding Community*Express* loans) for the last 3 complete fiscal years plus the elapsed portion of the current fiscal year (lenders achieving at least an 85 percent currency rate may be approved for up to a 1 year term, while lenders achieving a 90 percent currency rate may be approved for up to a 2 year term). (For SBA lenders with less than 3 years of SBA lending experience/data, the Agency may consider data over a lesser period of time.);
(8) For lenders regulated by one of the federal/state oversight authorities, be in good standing with their primary regulator and currently have no enforcement actions or agreements that are unacceptable to SBA; and
(9) Have received no major substantive objections from its Lead SBA Office. (The Lead SBA Office is that SBA district office where the headquarters of the lender is located.)

(SBA*Express* Program Guide, Par. 2.A). Experienced 7(a) Lenders that SBA admits to the SBA*Express* Program are permitted to participate in the Program for a two-year term before SBA will consider renewing them for another two years. (Par. 4.)

The Guide provides that, to gain admission to the Program, New Lenders must:

(1) Have significant experience processing smaller size business loans;
(2) Be in good standing with its primary federal/state regulator and currently have no enforcement actions or agreements that are unacceptable to SBA;
(3) If a bank, thrift institution or other lender, show at least 20 commercial or business loans for $50,000 or less outstanding at its most recent fiscal year end;
(4) If an institution other than a bank or thrift, show at least 20 commercial or business loans for $50,000 or less outstanding at its most recent fiscal year end statements;
(5) Have received appropriate training on SBA's policies and procedures; and
(6) Have no major substantive objections from the Lead SBA Office.

(SBA*Express* Program Guide, Par. 2.B). The Guide provides that New Lenders are limited to a one-year term and may make no more than $25 million of loans under the Program in their initial years of participation.

Our review of the admission criteria for the SBA*Express* Program has identified the following concerns:

Program Admission Criteria for New Lenders.

As noted above, the Program admission criteria require that Experienced 7(a) Lenders have a satisfactory rate of loan defaults and at least an 85% currency rate. These standards relating to the performance of the lenders' 7(a) Program portfolio help SBA determine whether lenders present excessive risks to the Agency and whether it is appropriate to delegate streamlined loan-making authority to these lenders under the SBA*Express* Program. Lenders authorized to obligate an SBA guarantee with limited prior review by the Agency present a risk to SBA if they are not careful in exercising this authority.

Under the Guide, however, the Program admission criteria for New Lenders is less demanding than for Experienced 7(a) Lenders despite the fact that New Lenders have no prior experience in the 7(a) Program. Specifically, the Guide does not require lenders to provide any information regarding the performance of their portfolios either on loans comparable to SBA*Express* Program loans or other types of loans. Instead, lenders need only state that they have at least 20 loans of $50,000 or less outstanding from the past year and have "significant experience processing smaller size business loans." Thus, SBA does not obtain any data regarding the lender's performance to assess whether it would expose the Agency to unacceptable risk to delegate authority to these lenders to obligate an SBA guarantee with only minimal prior agency review. Further, inasmuch as SBA*Express* Program lenders are authorized to make loans of up to $350,000, it is not clear how the $50,000 threshold relates to, or provides sufficient information for SBA to draw any conclusions regarding, the potential risk of loss from lenders improperly making loans seven times that size.

Only after a New Lender is admitted to the Program would SBA be able to examine that lender's performance. By that time, however, imprudent or improper lending practices could have exposed taxpayer dollars to unnecessary losses.

Another matter of concern with the admission criteria for New Lenders is that the Guide merely provides that "applicants for SBA*Express* Program authority must ... have received appropriate training on SBA's policies and procedures." The Guide does not explain what type of training would be considered appropriate. Further, the criteria only require the lender to obtain training, and does not mandate that all of a New Lender's loan officers receive training on SBA policies and procedures. The lack of definition as to what would constitute acceptable training, and the absence of any requirement that all relevant lender personnel be trained, may put SBA at unnecessary risk of loss.

Given the broad delegated authority to obligate taxpayer funds in the form of loan-guarantees with little prior review by SBA, there should be adequate procedures to verify the qualifications of lenders that are admitted to the Program. Verification of lender qualifications is especially important for New Lenders, which have no prior experience making loans under the 7(a) Program, and which, therefore, may represent a larger risk to the Agency.

Absence of Information Regarding Lender Policies.

Many provisions in the Guide require lenders to process and administer loans in compliance with their own procedures. Examples include:

(1) Paragraph 5.A(4) (verification of use of proceeds);

(2) Paragraph 5.B(6) (collateral policies, which SBA expects will be "commercially reasonable and prudent");

(3) Paragraph 5.B(7) (charging fees to borrowers);

(4) Paragraph 5.D (credit analysis; SBA expects lenders to use "appropriate and generally accepted credit analysis processes and procedures ... consistent with those used for its non-SBA guaranteed commercial loans");

(5) 5.D (verification of equity injections by borrowers); and

(6) Paragraph 7 (closing, servicing and liquidation of loans, which "must be reasonable and prudent commercial lending practices").

As indicated, SBA requires that many of the lenders' own procedures be "commercially reasonable and prudent" or "appropriate and generally accepted." The Guide, however, does not require lenders to provide a copy of their underwriting, closing, servicing or liquidation procedures to SBA at the time that they seek admission to the SBA*Express* Program to determine whether these procedures are commercially reasonable, prudent or generally accepted practices. Without this information, it is not clear how the Agency can determine whether the lender's internal lending practices are acceptable.

Absence of Information Regarding Historical Lender Performance Problems.

Many of the Program admission criteria in the Guide, listed above, only require lenders to provide information about current problems in complying with SBA requirements and with their regulatory agencies, not whether they have experienced problems in the past. This includes for Experienced 7(a) Lenders, the following admission criteria (as listed above): #3 -- "is in compliance with applicable SBA statutes, regulations, and policies;" #4 -- "received an acceptable rating in its last review;" #5 -- "is current in filing SBA required 1502 reports;" #6 -- "is current in remitting required guarantee and servicing fees;" #7 -- "has at least an 85 percent currency rate;" and #8 -- "is in good standing with their primary regulator." For New Lenders, this includes criteria: #2 -- "is in good standing with their primary regulator." It would seem to be highly relevant to determine whether lenders applying for the expanded delegated authority under the SBA*Express* Program have had past problems with regulators or complying with SBA requirements. Past violations, that are not too remote in time, would provide SBA with additional information to determine whether delegating streamlined loan-making authority represents an acceptable risk. Thus, it is unclear why SBA does not ask for information regarding past compliance in the admission criteria.

Recommendations:

We recommend that the Office of Capital Access:

2.A Amend the Guide to require lenders to provide SBA with a copy of their loan administration procedures at the time they apply for admission to the Program. Also, when lenders seek a renewal of program authority, they should indicate if changes have been made. Alternatively, the Agency should develop other procedures for the review of lender policies and procedures.

2.B Amend the Guide to provide that lenders must provide information about past compliance problems with their regulator or in complying with SBA requirements, within a specified period of time (i.e., 5 or 10 years), and that violations that are not too remote in time will be considered in determining program admission.

2.C Amend the Guide to set forth loan portfolio performance standards for lenders with no 7(a) Program lending experience that seek admission to the SBA*Express* Program, ensuring that such standards provide data that is comparable to the size and types of loans which are eligible for the SBA*Express* Program.

2.D Amend the Guide to identify what training in SBA's policies and procedures is "appropriate" for New Lenders, and to require lender certification that all of the lender's loan officers that make SBA*Express* loans have taken the training.

2.E Consider whether it would be appropriate to assess the rates of default and losses and compliance with SBA requirements on SBA*Express* loans made by New Lenders versus loans made by Experienced 7(a) Lenders to determine whether additional measures are needed for program admission criteria for New Lenders.

Management Response:

2.A. The response of the Office of Capital Access (OCA) stated that it "would consider requiring new SBAExpress lenders to submit their loan administration procedures to the Agency at the time of their application for SBAExpress status." As to renewals of SBAExpress Program agreements, OCA stated that the on-site lender review program examines lender administration procedures and the findings from these reviews were taken into consideration when determining whether to renew an SBAExpress lender's term.

2.B. OCA's response to this recommendation stated that that lenders must certify that they are currently in good standing and must provide details as to any current supervisory action. With respect to the recommendation that past regulatory problems be identified, OCA stated that it "will consider integrating this specific information into the SBAExpress Guide."

2.C. OCA disagreed with this recommendation, stating that they already review "Bank Call data and other analyses" to "assess a lender's asset quality measures" and performance on

smaller loans. Thus OCA stated that it had "adequate processes in place to address new lender performance."

2.D. OCA agreed to revise the Program Guide to provide additional guidance on the training that lenders need to take and require lender certification that their SBAExpress loan officers have taken the training when they seek program recertification.

2.E. OCA's response stated that it "agrees that it may be beneficial to compare the performance of new SBA lenders under Express versus lenders that have substantial experience."

OIG Evaluation of Management's Response

2.A. The OCA response was not clear enough to determine whether it agrees or disagrees with the recommendation. Therefore, the OIG does not view this response to be adequate. In addition to the vagueness of the response, on-site reviews will only be performed on the larger lenders (lenders with portfolios in excess of $10 million). This oversight will not capture any information about loan administration policies for other lenders. OIG will pursue this recommendation through the resolution process.

2.B. The OCA response was also non-committal, therefore, the OIG does not view this response to be adequate. OIG will pursue this recommendation through the resolution process.

2.C. The OIG will evaluate the data that OCA states is being reviewed to determine the performance of lenders that have not previously participated in the program. The OIG will also evaluate whether OCA has written procedures regarding the review of these procedures and, if so, the adequacy of these procedures. OCA's response, however, does not state whether this data is actually reviewed in connection with a lender's application for the program. OIG would be concerned if the data is only reviewed after lenders had already been admitted to the program, but will evaluate OCA's practices through the resolution process.

2.D. OCA agreed with the recommendation.

2.E. The OCA response was non-committal, therefore, the OIG does not view this response to be adequate. OIG will pursue this recommendation through the resolution process.

Concern 3: The SBA*Express* Program Guide could provide clearer guidance to lenders regarding regulatory and procedural requirements.

Although the SBA*Express* Program Guide requires lenders to comply with various regulations and agency SOPs, it often does not identify the specific regulatory or procedural provision that lenders must follow. This lack of guidance may contribute to confusion among lenders as to the applicable requirements and a lack of compliance by lenders with these requirements.

Introductory language in the Guide states as follows:

> SBA business loan eligibility, policy, and procedures apply to SBA*Express* loans and the SBA*Express* lender must apply all SBA business loan requirements, including those in the Small Business Act, 13 C.F.R. Parts 120 and 121, and SBA Standard Operating Procedures (SOPs 50 10, 50 50, and 50 51) unless specifically identified as inapplicable by this Guide.

These SOPs collectively consist of over 1,000 pages. (The SOPs are available on SBA's Electronic Lending Web page at http://www.sba.gov/banking/indexregs.html). Many of the provisions in these SOPs only relate to actions by SBA personnel or have no apparent relevance to the SBA*Express* Program. For example, Subpart H of SOP 50-10(4)(E) is 160 pages long, but pertains only to the 504 Program implemented under Title V of the Small Business Investment Act of 1958, 15 U.S.C. §§ 596, et seq. The above-quoted language from the Guide may be too vague to provide meaningful guidance and may confuse SBA*Express* lenders.

In addition, throughout the Guide, there are provisions directing lenders to comply with SBA regulations and/or the procedures in SOP 50-10, which do not reference specific regulations or SOP paragraph(s) so that lenders can readily identify the relevant requirements. Examples include:

(1) (Par. 5.A.(2) of the Guide) "SBA*Express* loans also must meet regular SBA eligibility requirements as to type of business, which are stated in 13 C.F.R. Part 120 and SOP 50-10(4), and which currently include such restrictions as non-profit businesses, businesses engaged in lending, passive holders of real estate/personal property, life insurance companies, pyramid businesses, businesses engaged in gambling, illegal businesses, businesses that restrict patronage, government-owned entities, cooperatives, businesses engaged in loan packaging, businesses engaged in political or lobbying activities, and speculative businesses."

(2) (Par. 5.A(3)) of the Guide) "Under SBA*Express,* a lender may refinance an existing non-SBA guaranteed loan or borrower debt if ... (2) The new loan meets the SBA's 20 percent increase in cashflow requirement, as applicable (see SOP 50 10(4)); ...."

(3) (Par. 5.A(5)(d)) of the Guide) "Generally, loans under SBA*Express* may be made only if questions 1, 2, and 3 on SBA Form 1919 are all answered 'No.' However, if one or more such questions is answered 'Yes,' the lender may elect to process, submit, and disburse the loan under SBA*Express*, when the subject's affirmative activity meets the following situations (as further defined in SOP 50-10)."

(4) (Par. 5.A(5)(f) of the Guide) "A loan is not eligible for SBA*Express* if there is any question of possible violation of any of SBA's ethical requirements, as described in 13 C.F.R. Part 120.140 and SOP 50-10(4)."

(5) (Par. 8.C of the Guide) "For SBA to process the guaranty purchase, the lender must submit to SBA a liquidation wrap-up report with all the information required by SBA

SOPs along with copies of required loan documentation to the appropriate SBA Loan Servicing Center in Little Rock or Fresno."

These are merely examples of provisions that refer lenders to SBA regulations and SOPs, without clearly identifying the applicable regulation or SOP provision. Additional occurrences are found in paragraphs 5.A(5)(g), (h), (i), 5.B(4), 5.C, 6.A(4), 6.B (multiple provisions), and 8.B of the Guide.

The lack of specific guidance as to which provisions of the Agency's SOPs apply to the SBA*Express* Program raises questions about ensuring lender compliance and may promote confusion among lenders and members of the public. This problem is exacerbated by the fact that, as discussed in Concern 2 above, the Agency opened up the SBA*Express* Program in 2002 to lenders that had never previously participated in the 7(a) Program, and which may not be familiar with the applicable requirements for the Program.

Recommendations:

We recommend that the Office of Capital Access:

3.A Identify in the Guide the specific SOP and regulatory provisions that provide the applicable procedures and requirements.

3.B Consider whether it would be appropriate to revise the web-page containing the Guide on the Agency's Electronic Lending Web-Page so that it contains links that a lender could click to be directed to the relevant provision of the SOP.

Management Response:

3.A. OCA's reponses stated as follows: "CA agrees that a cross index between the Express Program Guide and SBA's regulations and SOPs would be potentially helpful and will consider it."

3.B. OCA agreed with the recommendation.

OIG Evaluation of Management's Response

3.A. The OCA appeared to agree with this recommendation, but the response is sufficiently vague that this is unclear. OIG will pursue this recommendation through the resolution process.

3.B. OCA agreed with the recommendation.

Concern 4: Program tax verification procedures may not adequately protect SBA from loss.

SBA procedures require that lenders verify with the Internal Revenue Service (IRS) financial information that borrowers submit to obtain an SBA-guaranteed loan. SOP 50 10 4(E) provides:

> It is SBA's policy to require historical financial statements on all applications from existing businesses.
>
> The financial information submitted will be relied upon for the credit analysis of the application. Whether the type of financial statements submitted are compiled, reviewed, audited, or Federal income tax returns, their accuracy is essential to the quality of analysis provided the application. Therefore, SBA has established policy that the financial statements of the applicant concern shall be verified. The process of conducting this verification is known as the tax verification process. Its purpose is to verify the accuracy of the financial information, not necessarily the tax returns, being submitted with each application.
>
> * * *
>
> Discrepancies between tax returns and financial statements submitted with loan applications led to the establishment of this policy in order to detect and deter the submission of fraudulent financial data. The verification process gives us information on the extent of this problem while allowing us to verify the financial information being submitted.

Subpart A, Ch. 6, par. 4.f. SOP 50 10 4(E) establishes procedures to allow for expeditious verification of financial information by the IRS, with a goal of obtaining an IRS response within ten days.

The Guide, however, states as follows:

> The lender must use IRS tax transcripts to verify financial information used to support the loan credit analysis for all SBA*Express* loan applications. (However, as set forth in SBA Notice 5000-753, SBA*Express* lenders are authorized to close and disburse SBA*Express* loans without waiting for the IRS transcript, although they must follow-up and verify the IRS data when received. Also, if credit scoring is used and does not include business revenues or profits, IRS tax verification is not required.) (Par. 7.B(1)).

SOP 50-10(4)(E), as discussed above, identifies that IRS verification of borrower financial information is an important method of ensuring the accuracy of this information and deters the submission of fraudulent financial data. Accordingly, the directions in the Guide that

lenders may close and disburse SBA-guaranteed loans without first obtaining IRS verification of that information may expose the Agency to fraud and additional risk of loss.[6]

An additional concern is that Procedural Notice 5000-753, which is referenced in the Guide, expired on October 1, 2002. As discussed in Concern 5 below, once temporary directives expire they become obsolete and do not constitute valid agency policy. We also note that, although the Guide indicates that there are no restrictions on permitting a lender to close on a loan without IRS verification, Notice 5000-753 is more restrictive; the Notice only permits a lender to close a loan without IRS verification "if a lender does not receive a response or copy of a tax transcript within 10 business days and the loan is ready for closing ...." The Agency should revise the Guide so that IRS verification is required if the lender's credit analysis has relied upon borrower financial information or, at a minimum, so that it does not rely upon an expired agency Notice.

Recommendations:

We recommend that the Office of Capital Access:

4.A Revise the Guide to eliminate the reference to Notice 5000-753 and implement effective procedures for verification of IRS tax returns by SBA*Express* lenders.

Management Response:

The OCA agreed that the Guide should be updated to reflect the tax verification procedures in Notice 5000-753. OCA disagreed that the procedures should be revised to be consistent with the procedures in SOP 50-10 because it feels that the procedures in notice 5000-753 are effective to prevent significant risk to SBA of fraud or abuse.

OIG Evaluation of Management's Response

The OCA response to recommendation 4.A is responsive. Although we disagree that the Agency's tax verification procedures are adequate, the OCA's response is sufficient to the extent that it resolves the discrepancy between the Guide and the Notice.

Concern 5: The Community*Express* Program Guide being used by the Agency was not cleared and issued in accordance with Agency clearance procedures.

SBA is holding out to the public on its web-site a Community*Express* Program Guide as purporting to establish official agency policies and procedures for the Program. However, this Guide has never been officially issued under agency clearance procedures. The only policies and procedures that SBA has officially issued for the Program are several procedural notices, which expired one year after they were issued.

[6] We recognize that IRS verification may not be necessary if the lender's credit decision is not based on the borrower's financial information, such as would be case if the decision was based solely on credit scoring information obtained from a credit bureau.

SBA's Directives Management System SOP (SOP 00 23 6) requires that the following documents must be issued as agency directives and cleared by various offices within the Agency under the procedures in the SOP: (1) agency policy; (2) procedures for carrying out agency policy; and (3) the assignment of responsibility for duties and implementation of procedures. (Chapter (Ch.) 1, paragraph (par.) 3.) SOPs are to be used to establish long-term policies and procedures relating to agency programs and activities. (Ch. 4, par. 2.) Further, SBA program offices are directed to issue an SOP for all new SBA programs within 10 months of establishment. (Ch. 4, par. 4.) The SOP also provides that draft SOPs "must not be used until formally cleared" under agency clearance procedures. (Ch. 6, par. 1.) In addition, temporary directives, including Policy and Procedural notices, must expire within one year of issuance, and once expired "will become obsolete" and may "not be used as official policy or procedure." (Ch. 12, par 6.)

The SBA Office of Financial Assistance (OFA) posted a Community*Express* Program Guide, dated January 1, 2002, on its Electronic Lending web-page (http://www.sba.gov/banking/enhance.html#commexp). However, our review has determined that this Guide was never officially cleared and issued by the Agency under the requirements of the Directives Management System SOP (or earlier versions of this SOP).[7] However, the Electronic Lending web-page does not contain an advisory that the posted Guide was never officially cleared by the Agency. Thus, it is likely that lenders and members of the public that access this web-page would incorrectly conclude that the Guide constituted official agency policy.

Similarly, the SBA's Electronic Lending web-page also contains a document entitled "CommunityExpress Instructions," which also purports to impose requirements on lenders in the Program. This document also was not officially cleared by the Agency, and could cause additional confusion among SBA employees, lenders and members of the public who are likely to view this document as official agency policy in the absence of any disclaimer to the contrary.

The Community*Express* Program Guide that is posted on-line would appear to fall within the definition of documents that must be issued as directives and cleared by the Agency under SOP 00 23 6 to be considered official agency policy or procedure. Although the Agency did issue Procedural Notices 5000-605 and 5000-676, establishing policies and procedures for the Community*Express* Program, both of these notices have expired.

The Community*Express* Program has now been in existence for over seven years and, as noted above, has a portfolio of over 14,000 loans worth in excess of $387 million. In order to establish enforceable procedures for this Program and limit risk to the Agency, SBA should implement long-term, legally effective policies and procedures for the Community*Express* Program. In addition, although not set forth in any detail here, many of the deficiencies discussed above regarding conflicts with SBA regulations, program admission criteria, and lender credit determinations, also apply to the draft Community*Express* Program Guide posted

[7] It is uncertain when this Guide was posted on the Internet. It is our understanding that, in 2003, the OFA circulated a proposed Community*Express* Program Guide for review and clearance within the Agency, but at least one SBA reviewing office non-concurred with this Guide, and the Guide was never officially cleared and issued.

on the SBA Electronic Lending web-site. SBA should consider whether the Community*Express* Program Guide should be revised to address the Recommendations set forth in Concerns 1-4.[8]

Recommendations:

We recommend that the Office of Capital Access:

5.A Take the Community*Express* Program Guide off the Agency's Electronic Lending Website.

5.B Revise the Community*Express* Program Guide to address the Recommendations set forth in Concerns 1-4, as applicable.

5.C Obtain agency clearance of and issue an official Community*Express* Program Guide.

Management Response:

OCA did not agree with the OIG's determination that a Community*Express* Program Guide had never been cleared by the Agency. It stated that "a CommunityExpress Program Guide was cleared in FY2000, as confirmed by [the Office of General Counsel]." Nevertheless, OCA generally agreed with all three recommendations.

OIG Evaluation of Management's Response

The OIG disagrees with OCA's assertion that the Community*Express* Program Guide was cleared according to Agency clearance procedures in fiscal year 2000. Although the Office of Financial Assistance, which oversees the Community*Express* Program, provided OIG with a copy of the draft Guide, that office was unable to provide a copy of the clearance forms signed by the various parties within the Agency, as needed for an officially cleared document. OIG further contacted the Office of General Counsel, the Executive Secretariat (ES) and the Administrative Information Branch (AIB) to determine whether any of these offices could corroborate the asserted clearance of this Guide. (ES and AIB are the two offices that are responsible for clearing of documents within the Agency.) None of these offices could provide any evidence of clearance forms or corroborate OCA's claim. Finally, our office has rigorously searched both paper and electronic copies of Agency Notices for any Notice communicating to Agency employees and lenders that the Guide had been officially cleared and issued by the Agency. We found no Notices that could verify that this Guide was ever officially issued for use by Community*Express* lenders. Absent any documentation from the Agency that the Guide was ever officially issued, it is our conclusion that it was not.

OCA's responses to recommendations 5.A, 5.B, and 5.C are responsive; however, we are concerned by the Office's projected time tables for implementing these recommendations. Although OCA stated that the existing guide would be removed from the SBA website, as of the

[8] Recent agency correspondence advised of agency plans to issue guidance for the Community*Express* Program regarding the provision of technical assistance by lenders to borrowers and other issues. However, this correspondence did not state that an official Community*Express* Program Guide was planned or provide any timeline on when this guidance would be issued.

date of this report, the Guide has not yet been removed. Furthermore, OCA asserts that the Program is scheduled to expire in 2008, however the most recent Federal Register Notice found by our office indicates that the Program is set to expire in December 2006. Aside from this discrepancy, OCA asserts that it will implement appropriate regulations and an updated Guide once a determination is made about whether to permanently implement the Program. Based on this timetable, OCA may not plan to issue valid Guidance for this Program for at least another two years. In the meantime, the Program would rely upon various policy and procedural notices even though all Agency notices expire after one year. The Agency should take action to properly clear and implement an official Guide for use until the time a decision is made regarding the permanency of the Program. The OIG will pursue this through the resolution process.

Conclusion

The Concerns included in this Report are the conclusions of the Office of Inspector General. The Concerns and Recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for report follow-up and resolution.

The OIG asks that the Agency provide management decision for each Recommendation within 30 days. Management decisions should be recorded on the attached SBA Forms 1824, "Recommendation Action Sheet," and show either the Recommendation and target date for completion, or an explanation of any disagreement with our Recommendations.

Any questions may be directed to Glenn P. Harris, Counsel to the Inspector General at (202) 205-6862.

Attachment

REPORT DISTRIBUTION

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