AUDIT OF THE OFFICE OF LENDER OVERSIGHT CORRECTIVE ACTION PROCESS

Report Number: 7-18

Date Issued: March 14, 2007

Memorandum

U.S. Small Business Administration
Office of Inspector General

To: Bryan Hooper
Director, Office of Lender Oversight

Janet A. Tasker
Acting Director, Office of Financial Assistance

Date: March 14, 2007

From: /S/ original signed
Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of the Office of Lender Oversight Corrective Action Process
Report No. 7-18

This report presents the results of our audit of the Office of Lender Oversight (OLO) corrective action process. The corrective action process was established in fiscal year (FY) 2005 to ensure that lenders implement appropriate corrective actions for weaknesses identified either during on-site reviews and examinations or from other measures. Currently, OLO's focus is on large lenders.[1] The objective of the audit was to determine whether OLO had fully implemented the corrective action process and ensured that identified deficiencies were addressed timely.

To address our objective, we: (1) determined the extent to which on-site reviews and examinations were completed; (2) assessed SBA's timeliness in notifying lenders of deficiencies noted in the reviews and examinations; (3) determined whether SBA conducted follow-up of corrective actions taken by lenders; and (4) determined the extent to which deficiencies were recorded in the Delinquent Loan Collection System (DLCS). Because lenders were just beginning to submit their corrective action plans at the time of our audit, we were not able to evaluate the extent to which their deficiencies were corrected.

[1] Section 7(a) lenders with $10 million or more in outstanding SBA loan guarantees.

To determine SBA's timeliness in notifying lenders, we reviewed correspondence between SBA and lenders for the 33 on-site review reports issued between May 2005 and February 2006. To determine the extent of SBA's follow-up efforts, we reviewed 14 of the 38 on-site reviews and examinations completed in FY 2006. We also interviewed OLO and lender personnel, reviewed minutes of the Lender Oversight Committee meetings, and reviewed existing and draft operating procedures. Finally, we examined the DLCS for evidence that SBA recorded deficiencies identified during nine reviews and examinations.

We conducted our audit between November 2005 and December 2006 in accordance with generally accepted Government Auditing Standards.

BACKGROUND

As SBA has delegated more authority to lenders, a greater need for lender oversight has resulted. SBA established the OLO in 1999 to ensure consistent and appropriate oversight of SBA's lending partners. OLO is primarily responsible for evaluating lender risks and ensuring appropriate corrective actions are implemented to mitigate those risks. A key component of OLO's current oversight process is on-site reviews of large lenders. SBA's standard operating procedures require that OLO conduct on-site reviews on a 12- to 24-month cycle based on the level of risk posed by the lender. There are approximately 350 large 7(a) lenders whose lending activities comprise about 59 percent of SBA's guaranteed dollars. Based on the review cycle and the current number of lenders, OLO should review about 175 lenders per year.

The scope of the review or examination is determined prior to the start of the review, but generally includes a review of the lender's credit administration, management and operations, portfolio performance and compliance with SBA policy and procedures. At the conclusion of the review or examination, a written report is prepared identifying any findings and classifying the lender's risk as either "Acceptable," "Acceptable with Corrective Actions Required," or "Less than Acceptable with Corrective Action Plan Required." SBA's goal is to provide the lender with a written report within 60 days of completing the on-site review or examination.[2] Beginning in FY 2005, SBA initiated the requirement for a lender to submit a corrective action plan addressing the exceptions and findings in the report. SBA reviews the lender's response for acceptability. In addition, SBA may require the lender to provide monthly or quarterly status reports. Any material deficiencies related to loans identified in the reports are to be recorded in DLCS to alert SBA personnel of the deficiency in the event the loan is transferred to liquidation.

The DLCS is a screen-oriented application which merges loan data from existing systems with data collected within the DLCS for the purpose of automating the servicing of delinquent loans. In addition, the application provides a mechanism for recording servicing activity, and allows users to obtain additional information about a loan or enter

[2] This became a formal goal with the issuance of SOP 51 00 in September 28, 2006. Prior to that date, it was an informal goal.

servicing information, including information derived from on-site reviews and examinations.

RESULTS IN BRIEF

The audit disclosed that OLO has strengthened its oversight process by expanding the scope of lenders reviewed, providing more detailed reports to lenders, and requiring corrective action plans when deficiencies are identified. The audit also disclosed that OLO was beginning to assess the adequacy of lenders' proposed corrective actions to resolve the deficiencies. However, we determined that OLO has not fully implemented the corrective action process. Specifically, OLO has not:

- Conducted on-site reviews of all large lenders. Of the approximately 350 lenders eligible for on-site reviews in FY 2005 and 2006, SBA reviewed only 125. Of this amount, 70 reviews were completed in FY 2005 while only 55 were completed in FY 2006. According to management, it did not review all large lenders due to budget constraints.

- Timely notified lenders of the results of on-site reviews and examinations. On average SBA transmitted review results to lenders 6 months, and in some cases, up to 12 months after the end of the reviews. According to recently issued operating procedures,[3] SBA's goal is to provide results to lenders within 60 days of completing the on-site review or examination.

- Documented deficiencies noted during on-site reviews and examinations in the DLCS timely. SBA either did not record 113 loans with deficiencies in DLCS or recorded them 9 months after on-site reviews were completed. The recording of the deficiencies may not have happened due to confusion over who was responsible for making the entry. As the deficiencies may have warranted a repair or denial of the guaranty, SBA may have inappropriately honored guarantees totaling $734,676 for these loans.

On December 19, 2006, we discussed with OLO our audit results. OLO officials indicated they have taken steps to address the issues we identified. Management stated that they are in the process of finalizing a regulation that will allow them to collect fees from lenders to finance additional on-site reviews. They have also reduced lender notification times to an average of 50 days following report issuance. Finally, OLO told us in the future that DLCS entries will be required as part of SBA's review of the final on-site review or examination report.

SBA Performed On-Site Reviews of Only a Small Percentage of Large Lenders

On-site reviews and examinations are the primary mechanisms OLO uses to ensure that large lenders are prudently originating and managing their SBA loan portfolios and

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[3] SOP 51 00, *On-Site Reviews/Examinations*, September 28, 2006.

complying with all SBA requirements. Under a policy memorandum officially establishing OLO's responsibilities, and more recently SOP 51 00, these reviews and examinations are required every 12 to 24 months. Despite this requirement, we found that SBA reviewed only 125 (36 percent) of the 350 large lenders during FYs 2005 and 2006. Of this number, 70 lenders were reviewed in FY 2005 and 55 were reviewed in FY 2006. By not conducting all planned lender reviews, SBA is unable to identify the extent of financial and compliance risks posed by large lenders in its loan portfolio. For example, 62 or 50 percent of the 125 lender reviews identified material deficiencies, thereby demonstrating the need for on-site reviews.

Management stated that all intended reviews were not performed because budget constraints limited the amount of funds available for contracting. Congress passed legislation in FY 2005 that authorized SBA to charge lenders fees for the cost of the lender monitoring system and the on-site reviews. SBA made minor changes to its proposed rule for assessing fees for lender reviews and examinations based on comments received from the public, and has put the rule into the clearance process.

Notification of Review Results Was Inconsistent

The elapsed time for notifying lenders of the results of on-site reviews completed between November 2004 and December 2005 was not consistent. For 33 of the lenders reviewed, only 2 received notification of their review results within the desired 60-day reporting goal. Seventy-percent of the remaining lenders received notification 6 months or more after the reviews were completed.

OLO acknowledged that there were significant delays in notifying lenders of their review results and stated it has taken action to improve its timeliness. Based on statistics provided by OLO, from January 2006 to September 2006, it reduced the elapsed time for reporting on-site review and examination results to an average of about 50 days. OLO stated that the improvement can be attributed to increased resources and greater diligence in reporting review results.

OLO Did Not Record All Loan Deficiencies in DLCS

OLO did not ensure that material deficiencies cited during the review and examination process were promptly recorded in the DLCS. We noted that during 9 on-site reviews, 113 loans were examined and found to have 262 material deficiencies. The number of deficiencies per loan varied, with some loans having as few as 1 deficiency and others having as many as 14. SBA did not record deficiencies for 71 or 63 percent of the loans in the DLCS. Deficiencies for the remaining 42 loans were recorded 3 to 12 months after the reports were issued. As of September 2006, SBA had purchased the guarantees for 8 of the 113 loans. Because the deficiencies were not recorded in DLCS, SBA officials making the purchase decisions were not aware of them when they decided to honor the guarantees. Consequently, because this information was not used to obtain repairs or to deny the guarantees, SBA may have inappropriately paid $734,676 in guarantees for the 8 loans (see Appendix I).

The material deficiencies may not have been recorded due to confusion over who is responsible for making the recordings. Standard Operating Procedure 50 50 4B, *Loan Servicing*, requires a review team to notify the appropriate servicing office of any deficiencies identified at the time it submits its report, and requires the servicing office to annotate the DLCS database. This is further supported by SBA Procedural Notice 5000-700, *Guaranty Repair Tracking System*, which states the SBA servicing loan officer must indicate the problem in the DLCS.

After we notified OLO of the unrecorded deficiencies, it entered the missing information into the system. These actions were in line with draft SOP 51 00, *On-site Lender Reviews/Examinations*, which was pending at the time of our review. This SOP, which was issued in September 2006, requires OLO financial analysts to record lender deficiencies in the DLCS. It appears that the intent of the SOP was implemented on an inconsistent basis before it was issued.

RECOMMENDATIONS

We recommend that the Director, Office of Lender Oversight:

1. Develop a plan that ensures all large lenders receive on-site reviews and examinations every 12 to 24 months.

2. Develop procedures for recording deficiencies identified during on-site reviews and examinations in the DLCS in a timely manner.

We recommend that the Acting Director, Office of Financial Assistance:

3. Determine the significance of deficiencies associated with the eight loans described in Appendix I, and seek recovery through repairs or denials of the $734,676 in guarantees paid to the respective lenders, as warranted.

SBA COMMENTS

SBA provided written comments to our draft report indicating that actions are being taken to satisfactorily address the three report recommendations. The Director of OLO stated that in anticipation of the new lender review fee rule, OLO has developed a plan to review all large lenders, while maintaining flexibility to review higher risk lenders more frequently.

OLO has also implemented a new internal procedure in June 2006 to ensure that any loan deficiencies discovered during on-site reviews and examinations are timely recorded in DLCS. The procedure requires the OLO analyst leading the on-site review to record any deficiencies in DLCS as part of the review report drafting process. OLO will further ensure that the DLCS notification process is completed through an internal tracking document that monitors the status of all reviews.

The Acting Director for OFA stated that the eight loans described in Appendix I will be reviewed to determine whether recoveries should be sought related to the guarantees paid to the affected lenders. SBA's comments are included in their entirety in Appendix II.

OFFICE OF INSPECTOR GENERAL RESPONSE

The actions being taken by SBA are responsive to our recommendations. However, we believe the Agency should set a target date for completing the review of the eight loans and recovering any guarantees paid to the affected lenders when appropriate. Therefore, we are requesting that the Acting Director for OFA provide the Office of Inspector General a target date for implementing recommendation 3 no later than March 23, 2007.

We appreciate the courtesies and cooperation of the Small Business Administration representatives during this audit. If you have any questions concerning this report, please call me at (202) 205-**[Exemption 2]**or Robert Hultberg, Director, Credit Programs Group, at (202) 205-**[Exemption 2]**.

APPENDIX I. SUMMARY OF DEFICIENCIES CITED ON EIGHT LOANS WITH PURCHASED GUARANTEES

	LOAN NUMBER	DEFICIENCIES NOTED	SBA AMOUNT TO LIQUIDATION	GUARANTEE PURCHASE AMOUNT	LOAN DISPOSITION
1	[Exemption 2]	Inadequate Repayment Ability Analysis Inadequate Verification of Equity Injection	$ 86,789	$ 43,178	Charged Off
2	[Exemption 2]	Inadequate Management Ability Assessment Inadequate Lender Assessment	$ 842,065	$ 92,979	Charged Off
3	[Exemption 2]	Inadequate Repayment Ability Analysis Inadequate Verification of Equity Injection	$ 193,934	$ 189,261	Liquidation
4	[Exemption 2]	Inadequate Verification of Equity Injection	$ 60,057	$ 61,887	Charged Off
5	[Exemption 2]	Inadequate Repayment Ability Analysis Inadequate Capitalization/Lender Assessment	$ 7,122	$ 3,650	Charged Off
6	[Exemption 2]	Inadequate Repayment Ability Analysis Inadequate Verification of Equity Injection	$ 164,118	$ 160,137	Charged Off
7	[Exemption 2]	Inadequate Verification of Borrower Injection Prior Loss to Government Lack of Personal Resources Test	$ 73,282	$ 70,564	Charged Off
8	[Exemption 2]	Lack of Management Ability Assessment Lack of Franchise Eligibility Analysis	$ 107,100	$ 113,020	Charged Off
		Total	**$ 1,534,467**	**$ 734,676**	

APPENDIX II. SBA COMMENTS

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: March 5, 2007

TO: Debra Ritt
Assistant Inspector General for Auditing

FROM: Bryan Hooper [Exemption 6]
Director, Office of Lender Oversight

Janet A. Tasker [Exemption 6]
Acting Director, Office of Financial Assistance

SUBJECT: Response to Draft Survey Report – Oversight Corrective Action Process

The purpose of this memorandum is to provide the Office of Lender Oversight's (OLO) and the Office of Financial Assistance's (OFA) response to the Office of Inspector General's (OIG) draft audit titled Oversight Corrective Action Process.

First, we would like to thank OIG for the opportunity to respond to the issues raised in the audit report, and for the chance to outline the improvements OLO has made to address OIG's recommendations relating to OLO's corrective action process. OLO believes that the actions it has taken in response to the findings in the audit have satisfactorily addressed the two audit recommendations directed at OLO.

The audit report contained three recommendations. Two of the recommendations were intended for OLO, and one for OFA. The recommendations for OLO called for OLO to: 1) develop a plan to ensure that all large lenders are subject to on-site review or examination every 12 to 24 months, and 2) develop procedures to record loan deficiencies, identified during on-site reviews or examinations, in DLCS in a timely manner. Finally, OIG recommended that OFA determine the significance of deficiencies associated with eight loans, to establish whether SBA should seek recovery through repairs or denials of guarantees paid to lenders.

As noted in the audit report, it is OLO's objective to review or examine all large lenders and Small Business Lending Companies with a frequency that corresponds with the risk characteristics of the individual lenders, generally every 12 to 24 months. Currently, the cost of performing these reviews and examinations is absorbed by SBA; funding for the reviews comes from appropriated funds. Due to budgetary constraints, OLO has not had sufficient funding to perform reviews of all large lenders in the cycle noted above.

SBA is in the process of implementing a final rule implementing statutory authority to charge 7(a) lenders for the cost of on-site reviews or examinations. We expect the final rule to be issued during the spring of 2007. Implementation of the rule will eliminate the need to rely on appropriated funds for on-site 7(a) lender reviews. The rule will also allow OLO to significantly increase the number of on-site reviews of 7(a) lenders, and we expect that the increased resources will help OLO accomplish our objective regarding the frequency of on-site reviews.

In anticipation of the new lender review fee rule, OLO has developed a plan to review all large lenders, while maintaining the flexibility to review higher risk lenders more frequently to minimize SBA's risk from those high-risk lenders. OLO's highest priority is to review all large lenders over a 24 month cycle. However, we also consider other, risk-related factors to ensure appropriate on-site monitoring of high-risk lenders. These factors include: lenders' risk ratings, their outstanding 7(a) portfolio as measured in SBA-guaranteed dollars, results of previous on-site reviews (if applicable), and any exceptional factors that may come to our attention.

OLO has also taken steps to address the second finding. In June 2006, OLO implemented a new internal procedure to ensure that any loan deficiencies, discovered during an on-site lender review, are recorded in the Delinquent Loan Collection System (DLCS). The procedure requires the OLO analyst leading the on-site review to record the deficiency in DLCS as part of the review report drafting process. The analyst is required to send an email to the manager of the review process, confirming that all deficiencies have been noted in DLCS. The manager cannot forward the review report to the Director of the Office of Lender Oversight, for signature and release of the report, until the email has been submitted. Since it is OLO's goal to complete the review report within 60 days of completion of the on-site review, this procedure will ensure that DLCS is updated in a timely manner. We further ensure that the DLCS notification process is completed through an internal tracking document that monitors the status of all reviews.

With respect to the recommendation for OFA, we will review the loans included in the report's appendix to determine whether recoveries should be sought related to the guarantees paid to the affected lenders.

Once again, thank you for the opportunity to respond to this audit. We believe that the actions being taken satisfactorily address the recommendations outlined in the audit report. However, we stand ready to work with OIG to work out any issues that might prevent the final resolution of this audit.

APPENDIX III. AUDIT REPORT DISTRIBUTION

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