SBA’S USE OF THE LOAN AND LENDER MONITORING SYSTEM

Report Number: 7-21
Date Issued: May 2, 2007

U.S. Small Business Administration
Office Inspector General

Memorandum

To: Bryan Hooper
Director, Office of Lender Oversight

Date: May 2, 2007

/S/ original signed

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Subject: Audit of SBA's Use of the Loan and Lender Monitoring System
Report No. 7-21

This report presents the results of our audit of the Office of Lender Oversight's (OLO) Loan and Lender Monitoring System (L/LMS). The Small Business Programs Improvement Act of 1996[1] required SBA to establish a risk management database that would provide timely and accurate information to identify underwriting, collections, recovery and liquidation problems with 7(a) and 504 loans. To respond to this mandate, in fiscal year (FY) 2003 SBA contracted with Dun & Bradstreet for loan and lender monitoring services. These services, collectively referred to as L/LMS, comprise commercial off-the-shelf risk scoring models developed by Fair Isaac and data managed by Dun and Bradstreet, and is used by SBA to generate lender risk ratings.

We conducted an audit to determine (1) whether L/LMS generates lender ratings that correspond to actual lender performance, and (2) the extent to which SBA uses lender ratings to manage the risk in the section 7(a) program. To determine whether L/LMS generates reliable lender ratings, we reviewed system documentation and test results and interviewed officials from SBA and Dun & Bradstreet. We performed tests to evaluate whether using loan volumes, financial stress scores, and recovery dollars as additional variables in L/LMS would result in more predictive risk ratings.

To assess how SBA uses L/LMS for lender oversight, we reviewed relevant SBA operating procedures and interviewed SBA officials in OLO and at the National

[1] Public Law No. 104-208, Div. D, 110 Stat. 3009-724, 15 U.S.C. Section 633, as amended.

Guaranty Purchase Center. We also reviewed prior Government Accountability Office (GAO) and Office of Inspector General (OIG) audit reports, Office of Management and Budget (OMB) Circular A-129, and Public Law 104-208. Our audit was conducted at SBA headquarters between February 2006 and March 2007 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

BACKGROUND

SBA provides small businesses with access to credit, primarily by guaranteeing loans through its 7(a) and 504 loan programs. As of September 2006, SBA's total credit portfolio was more than $67.2 billion, the majority of which consisted of 7(a) and 504 loans. The SBA-guarantee portion of the portfolio is valued at more than $54.6 billion. As SBA's reliance on lenders to originate 7(a) and 504 loans has grown, so has SBA's need for an efficient method to monitor its portfolio and the performance of its lenders.

In 1996, Congress passed the Small Business Programs Improvement Act requiring SBA to establish a risk management database that would provide timely and accurate information to identify loan underwriting, collections, recovery and liquidation problems.[2] In addition, in November 2000 OMB revised Circular A-129, encouraging agencies to develop a lender classification system to establish priorities for on-site reviews and monitoring corrective actions.

Consequently, in FY 2003 SBA contracted with Dun & Bradstreet for L/LMS to provide the Agency with the information necessary to assess and manage risk in its loan portfolio. SBA uses predictive financial models to develop composite ratings that reflect SBA's assessment of the potential risk to the government from lenders' SBA portfolio performance. The models are commercial off-the-shelf products that use Dun & Bradstreet business bureau data, Fair Isaac consumer bureau data on the businesses' principals, and SBA loan data to predict the probability of a loan becoming severely delinquent in 18 to 24 months after loan disbursement.

Based on the predictive data, and other variables,[3] lenders are scored from 1 to 999, (with 1 representing the lowest risk and 999 representing the highest risk) and then segregated into peer groups based on the size of lenders' loan portfolios, as shown in Table 1.

[2] Public Law 104-208.
[3] Other rating factors include the past 12-month actual purchase rate, problem loan rate and projected purchase rate.

Table 1: Lender Peer Groups

SBA-Guaranteed Portion Outstanding	
7(a) Peer Groups	**504 Peer Groups**
Over $100 million	Over $100 million
$10 million to $100 million	$30 million to $100 million
$4 million to $10 million	$10 million to $30 million
$1 million to $4 million	$5million to $10 million
Less than $1 million	Less than $5 million
Less than $1 million (inactive)	

Source: Information obtained from SBA's Office of Lender Oversight

Based on the scores, lenders are placed into one of five risk categories within the peer group. Risk category "1" indicates the lowest risk to SBA while "5" represents the highest risk. The lender's risk rating is a measure of how each lender's loan performance compares to its peer group's loan performance. Because lenders are rated relative to other lenders in their peer group, a lender's risk rating in one peer group will not be comparable to that of another lender in a different peer group who has the same raw score.

SBA uses the risk ratings to identify those lenders whose financial performance indicates unacceptable risk, establish priorities for on-site reviews, evaluate the lending programs, and determine whether to grant or renew a lender's expedited loan processing status. As of September 30, 2006, there were about 4,900 participating 7(a) lenders, of which 350 were classified as large[4] and 4,550 were considered small. There were also about 265,504 participating 504 lenders, of which 115 were classified as large and 150 were considered small. The large lenders in both programs comprised about 84 percent of SBA's guarantee loan portfolio.

RESULTS IN BRIEF

The Dun & Bradstreet service provides SBA with the capability to conduct the type of monitoring and analyses typical among major lenders and recommended by financial regulators. The L/LMS rating system is also both on par with industry best practices and based on sound financial models. Although the rating system generates the information needed by SBA to assess lender risk, the Agency's method of assigning risk based on L/LMS scores is inadequate for conducting effective portfolio and lender oversight. Because SBA arbitrarily limits the number of lenders that can be considered "high-risk" to no more than 10 percent of the lenders in each peer group, it excludes large groups of lenders with poor historical performance from being considered a priority for oversight attention.

[4] Large 7(a) lenders are those with guaranteed loan portfolios of $10 million or more and large 504 lenders are those with portfolios of $30 million or more.

Further, although SBA acquired L/LMS in FY 2003, it has made limited use of lender risk ratings to guide its oversight activities. For example, the Agency conducts on-site reviews of only those lenders with guaranteed loan portfolios of $10 million or more, regardless of their risk ratings. Consequently, smaller lenders with high-risk ratings are not reviewed on-site. While we recognize that some of the smaller lenders may not have a sufficient number of loans in their portfolio to warrant an on-site review; others may. SBA officials believe that by focusing on only the largest lenders it is managing the bulk of the loan dollars at risk. However, as we reported in February 2007, SBA has not been able to review all of the large lenders. In FYs 2005 and 2006, SBA reviewed only 125 of the approximately 350 7(a) lenders that were eligible for on-site reviews.[5]

Reviewing only large lenders regardless of the risk they pose to SBA's portfolio takes on added importance with SBA's proposed final rule requiring lenders to reimburse SBA for the cost of the on-site reviews. Since lenders will be bearing the cost of the on-site reviews, SBA should not require lenders with consistently low risk ratings to pay for reviews which may be unnecessary. Doing so would also contradict representations made to Congress that the new loan monitoring would allow the Agency to deploy resources where it has the most exposure, while being less intrusive to lenders.

Additionally, SBA has not shared lender risk ratings with SBA offices responsible for purchasing loan guarantees. The ratings would help purchase officials identify those lenders with above-average default rates and high-risk lending practices whose purchase requests require closer scrutiny. SBA has not made wider use of lender risk ratings because it has not developed comprehensive policies regarding risk tolerance and lender performance, or directed how L/LMS data is to be used in exercising lender oversight activities. Consequently, although L/LMS was acquired in FY 2003, SBA has not fully realized the benefits of the system or used the data to drive risk-based decisions.

[5] Audit of the Office of Lender Oversight Corrective Action Process, Report No. #7-18, March 14, 2007.

RESULTS

Lender Scoring is Sound, but SBA's Method of Assigning Risk Ratings Does Not Allow for Effective Portfolio and Lender Oversight

SBA has, through the Dun & Bradstreet service, an internal rating system that GAO reported in 2004 is on par with industry best practices and based on sound financial models.[6] Dun &Bradstreet scores and ranks lenders according to their projected guarantee purchase rate (i.e., the likelihood that the lender will default on each loan in its portfolio and that SBA will purchase the guarantees) against the guaranteed value at risk.

While the lender scoring used by SBA to rank lenders is based on sound methodology, the risk categories that SBA ultimately places lenders in are not representative of the actual risks they represent to SBA's loan portfolio. Based on rankings, SBA assigns lenders to one of five risk categories—categories "4" and "5" are considered high risk, and categories "1" to "3" are considered low to moderate risk. SBA establishes different cut-off scores or breaking points for the high-risk categories in each peer group to ensure that no more than 10 percent of the lenders in each group are rated as high-risk. Consequently, 90 percent of lenders within each peer group are rated moderate to lowest risk, regardless of their score or ranking in their group.

For example, Table 2 compares the risk ratings of six lenders in the same peer group with that of each lender's performance data as of March 31, 2006. The table shows that two lenders in the highest risk categories (categories 4 and 5) passed more performance benchmarks than the four lenders in the lower risk categories (categories 2 and 3). This demonstrates that the ranking process results in lenders being rated as high-risk even though their actual performance is better than lenders in lower risk categories. Conversely, poor performing lenders who should be considered high-risk are rated as moderate or low risk.

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[6] *New Service for Lender Oversight Reflects Some Best Practices, but Strategy for Use Lags Behind,* GAO-04-610*,* June 2004.

Table 2: Comparison of Risk Ratings to Performance Benchmarks

Lender	Risk Rating	BENCHMARKS				Number not met
		Currency rate	Default rate	Liquidation rate	Charge-off rate	
		90%	**10%**	**8%**	**5%**	
[Exemption 4]	3	86.8	17.8	8.7	15.3	4
[Exemption 4]	3	88.6	10.3	9.8	5.5	4
[Exemption 4]	2	84.7	15.9	13.0	12.7	4
[Exemption 4]	3	72.5	14.3	22.3	11.0	4
[Exemption 4]	5	91.3	10.0	6.5	8.7	1
[Exemption 4]	4	90.9	12.0	6.5	8.1	2

Source: SBA's Office of Lender Oversight and the Sacramento Loan Processing Center

Further, SBA's segmentation of the risk categories does not occur at logical breaking points, resulting in lenders whose scores are 1 point or less apart being placed in different risk categories. Table 3 shows the ratings, raw scores, and Small Business Predictive Scores (SBPS) (predictor of likely default within the next 18 to 24 months) for four lenders as of March 31, 2006. Two of these lenders were rated 3 (moderate risk) and two were rated 4 (high risk). Only eight points separate the raw scores and only four points separate the SBP scores of these lenders. One of the lenders rated 3 had the same or higher SBP score, indicating greater risk than the two lenders rated 4.

Table 3: Risk Indicators for Four Lenders

Lender	Risk Rating	Raw Score	Small Business Predictive Score
[Exemption 4]	3	407	175
[Exemption 4]	3	412	179
[Exemption 4]	4	413	177
[Exemption 4]	4	415	179

Source: SBA's Office of Lender Oversight

The segmentation of rating categories should be based on a determination of what are the unacceptable risk levels or raw scores. For example, if SBA determined that lenders with raw scores in excess of 700 represented an unacceptable level of risk, then SBA could establish a score of 700 as the cut-off level for the highest risk category.

Lender comments submitted to SBA in response to the Agency's Lender Risk Rating System Notification suggested that the Agency establish performance benchmarks either in lieu of or in conjunction with the risk ratings. SBA rejected this suggestion because developing performance benchmarks would be time-consuming, and the benchmarks would have to continually be monitored and replaced as program and economic conditions changed. Also, SBA had concerns about using benchmarks in conjunction with the risk rating system because the system had not been available for an entire economic cycle.

SBA Does Not Use Lender Risk Ratings to Direct All of Its Lender Oversight Activities

Although SBA received the first L/LMS lender rankings from Dun & Bradstreet in September 2003, the Agency has not used them to direct all of its lender oversight activities. For example, SBA does not use lender rankings to identify all lenders who should receive on-site reviews. Instead, SBA conducts on-site reviews of only large lenders regardless of their risk ratings. SBA officials believe that by focusing on only the largest lenders, it is managing the bulk of the loan dollars at risk as the large lenders hold about 84 percent of the outstanding SBA guarantee loan portfolio. However, as we reported in February 2007, SBA has not been able to review all of the large 7(a) lenders. In FYs 2005 and 2006 combined, SBA reviewed only 125 of the approximately 350 7(a) lenders eligible for on-site reviews,[7] and it expects to review only about 70 7(a) lenders in FY 2007.

Further, SBA is not requiring all high-risk lenders to take corrective actions to mitigate the risk of loan defaults. In its initial Lender Risk Rating System Notification, and the subsequent Final Notice, SBA stated that lenders rated 4 and 5 would be subject to extensive SBA oversight, which could include additional reviews or assessments, requests for corrective action plans, and/or removal from delegated loan programs. While SBA has required some large lenders to submit corrective action plans, with one exception, it has not performed additional reviews or removed lenders from delegated loan programs.

Because SBA's oversight has primarily focused on large lenders, smaller lenders with high risk ratings have been allowed to participate in SBA's loan programs with little or no oversight and with no enforcement actions for noncompliance. For example, as of September 30, 2006, there were about 323 section 7(a) lenders in the $4 million to $9.9 million peer group. Of these, 49 received a rating of 4 or 5 for at least one quarter in FY 2006, and 15 were rated a 4 or 5 for three or more quarters in FY 2006. Despite recurring high-risk ratings, the 15 lenders neither received on-site reviews in FY 2006 nor were scheduled for on-site reviews in FY 2007.

While we recognize that some of the smaller lenders may not have a sufficient number of loans in their portfolio to warrant on-site reviews; others may. SBA officials told us it would not be cost effective to review all smaller lenders with high risk ratings, but acknowledged that lenders in the $4 million to $9.9 million peer group may need to be reviewed. Accordingly SBA is considering requiring lenders in the $4 million to $9.9 million peer group, on a selective basis, to

[7] OIG Report No. #7-18, March 14, 2007.

undergo agreed-upon-procedures reviews. We believe this would be an improvement over the current policy and should include all lenders rated as high risk for more than one rating period.

Finally, our audit disclosed that OLO has shared lender risk ratings with other SBA offices, but according to officials at the National Guaranty Purchase Center and the Little Rock and Fresno Commercial Loan Centers, has not provided lender ratings to offices responsible for purchasing loan guarantees. Because lender risk ratings are based, in part, on actual and predicted guarantee purchase rates, such information would be instrumental in determining which lender's defaulted loans should be more closely reviewed for potential problems.

SBA Does Not Have Policies and Procedures to Guide the Use of L/LMS Data Agency-wide

SBA's FY 2005 Performance Plan states that the Agency will continue to use and enhance its new loan monitoring capability to improve financial accountability and management. To this end, OLO has issued operating procedures for lender reviews and is finalizing lender fee and enforcement regulations. While these are positive steps, the Agency has not yet developed or implemented comprehensive loan-monitoring policies and procedures that:

- define acceptable lender performance and risk tolerance levels that require corrective actions be taken by the lenders;
- identify enforcement actions that the Agency will be taken when risk tolerance limits are violated; or
- describe how data generated by L/LMS will be incorporated into mission activities agency-wide and reflected in credit models used by the Agency for financial reporting.

RECOMMENDATIONS

We recommend that the Director, Office of Lender Oversight:

1. Establish a method, based on a specific standard or other metrics, for assigning risk ratings that more accurately reflect the risk profiles of lenders.

2. Develop an on-site review plan or agreed-upon-procedures for all high-risk 7(a) lenders with guaranteed loan portfolios in excess of $4 million.

3. Distribute L/LMS data to SBA offices involved in purchasing loan guarantees.

4. Share lender risk ratings with SBA offices that make guarantee purchase decisions.

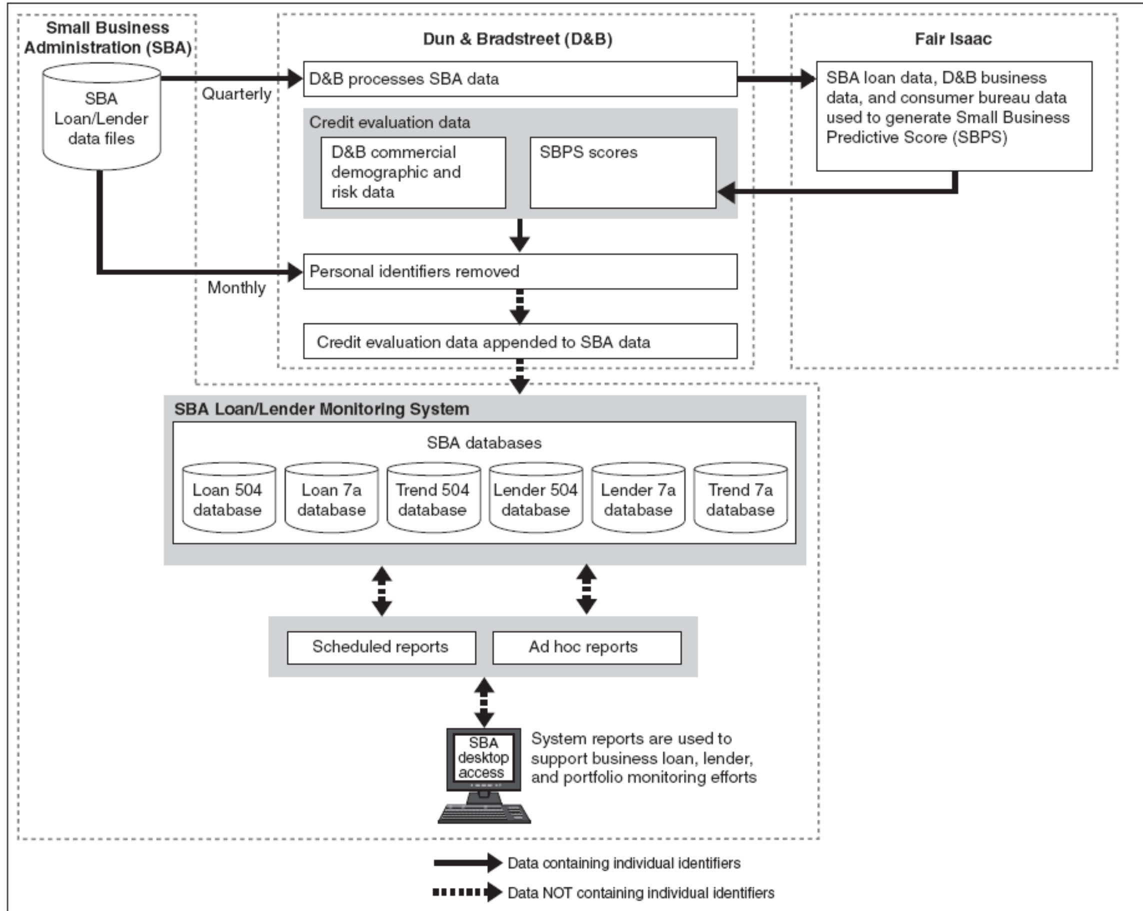
5. Develop and implement comprehensive loan-monitoring policies and procedures that define acceptable lender performance and risk tolerance levels; enforcement actions that the Agency will be taken when risk tolerance limits are violated; and how L/LMS data will be incorporated into mission activities agency-wide and Agency credit models.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

A draft report was provided to SBA on March 14, 2007, with a request for a response within 30 days. SBA subsequently requested, and was granted, an extension of the comment period to April 16, 2007. When comments were not provided by the revised deadline, the OIG requested that the Agency provide comments no later that April 29, 2007, and notified management that the report would be issued on May 1, 2007. As the OIG was finalizing its report on May 1, the Director of OLO provided a draft response that had not been cleared by senior management within the Office of Capital Access. Because he could not provide assurance of when the response would be cleared, we elected to issue the audit report without comments and to obtain a management decision on the recommendations through the audit resolution process.

APPENDIX I. OVERVIEW OF THE LOAN AND LENDER MONITORING SYSTEM

Figure 6: An Overview of the Loan/Lender Monitoring System



Source: GAO analysis of agency data.

Credit Evaluation Data: The L/LMS uses several sources of commercial data, including Dun & Bradstreet demographic and risk data from its global business database, consumer bureau Data on the business principals (e.g. information relating to recent delinquencies), and predictive risk scores.

APPENDIX II

SOP 50 50 4(b), Appendix 30 established performance benchmarks for measuring lender performance. The benchmarks were later revised by the Sacramento Loan Processing Center. These benchmarks are based on historical information.		
BENCHMARKS (RATES)	**PERCENTAGES**	**DEFINITIONS**
CURRENCY	90	Percentage of loans that are 0 to 30 days current in schedule payments based upon total outstanding (active) loan portfolio. Paid-In-Full (PIF) and charged-off loans are excluded, while loans in delinquent or liquidation status are included.
DEFAULT	10	Percentage of loans purchased compared with the total loans disbursed by a lender. The total loans disbursed include the outstanding (active) portfolio, PIFs and charged-off loans.
LIQUIDATION	8	Percentage of loans in liquidation status compared to the lender's total outstanding loans (active portfolio). Loans are generally classified as being in liquidation when workout attempts have ceased and a lender begins enforced procedures to obtain recovery.
LOSS	5	Percentage of the total loans disbursed, including the outstanding (active) portfolio, plus PIF and charged-off loans. Losses are initially tracked on a cumulative basis and subsequently on an annual basis by loan fiscal year.
CHARGE-OFF	5	Percentage of loans charged-off compared with total loans disbursed by a lender. The total loans disbursed includes the outstanding (active) portfolio plus PIF and charged-off loans.

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