OVERSIGHT OF SBA SUPERVISED LENDERS

Report Number: 8-12

Date Issued: May 9, 2008

U.S. Small Business Administration
Office Inspector General

Memorandum

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Date: May 9, 2008

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Subject: Oversight of SBA Supervised Lenders
Report No. 8-12

This is the second report resulting from our audit of the Small Business Administration's (SBA) oversight of non-depository lenders that do not receive oversight from other Federal regulatory agencies. These lenders, which SBA refers to as SBA supervised lenders, include Small Business Lending Companies (SBLCs) and non-federally regulated lenders (NFRLs) that are among SBA's highest producing and highest risk lenders. Our initial report[1] focused on SBA's oversight of an SBLC, Business Loan Center (BLX), which was initiated as a result of allegations of fraudulent loans originated through BLX's Troy, Michigan Office. A senior employee of BLX was charged with making at least 76 fraudulent SBA-guaranteed loans totaling about $76 million. This initial report determined that even though SBA's oversight activities identified recurring and material issues related to BLX's performance, SBA allowed BLX to continue making loans without prior SBA approval.

Based on the results of the audit of SBA's oversight of BLX, we expanded our scope to include four other SBA supervised lenders that were considered to be among the highest risk to the Agency. A listing of these lenders is provided in Appendix I. Our audit objective was to determine whether SBA effectively

[1] OIG Report No. 7-28, *SBA's Oversight of Business Loan Center, LLC*, July 11, 2007. OIG reports can be found on our website: www.sba.gov/ig.

addressed performance issues to mitigate the risk presented by these lenders, and to identify opportunities that may exist to improve the oversight process.

To address our audit objective, we reviewed onsite examination reports, lender risk ratings generated by SBA's Loan and Lender Monitoring System (LLMS), information supporting renewal of delegated lender authorities, and Lender Oversight Committee minutes between October 2003 and December 2007. Our review of onsite examination reports focused on credit administration and regulatory compliance issues as opposed to the safety and soundness of lender operations[2] because SBA's risk assessments are based on lender ability to make prudent loan decisions. The overall conclusions relating to safety and soundness of lender operations for the SBA onsite examinations were influenced by whether lenders were financially solvent, even though they may have had recurring performance issues.

A more detailed explanation of our audit scope and methodology is provided in Appendix II. We conducted our audit between May 2007 and January 2008 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

BACKGROUND

SBA is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guaranteed loans. SBA provides these loans through approved lenders who are generally depository institutions that are overseen and examined for safety and soundness by a Federal or state regulator.

Commencing in 1975, SBA allowed lending institutions not supervised by a Federal regulator (SBLCS and NFRLs) to participate in the 7(a) guaranty loan program. SBLCs are non-depository lending institutions that are not subject to oversight by any other Federal or state entity. NFRLs are non-depository business concerns that are regulated by state agencies, but are not subject to oversight by other Federal regulatory agencies. Presently there are 50 active SBA Supervised Lenders, of which 8 have loan portfolios in excess of $100 million and are considered to be among SBA's largest lenders. Currently, SBA's lender portfolio includes 39 NFRLs, of which only one has a loan portfolio in excess of $100 million. As of September 30, 2007, these SBA supervised lenders had a combined

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[2] Onsite examinations are conducted by the Farm Credit Administration (FCA). One of FCA's major functions is evaluating the safety and soundness of Farm Credit lending institutions. This evaluation is primarily based on adequate capital and financial performance.

portfolio of $5.6 billion, which represented about 18 percent of SBA's total 7(a) loan portfolio.

Between calendar years (CY) 2004 and 2007,[3] SBA generally placed the largest non-depository lenders in the two highest risk categories due to their LLMS raw scores. These lenders, like most SBLCs, frequently sold the SBA-guaranteed and non-guaranteed portions of their loans. Because these lenders have delegated lending authority,[4] SBA generally does not determine lender compliance with Agency policies until after the loan defaults and SBA purchases the guaranty from the secondary market. While SBA conducts lender onsite examinations, examiners review only a small sample of loans for compliance. Therefore, the majority of non-defaulted loan files are not reviewed in detail by SBA.

SBA has established a lender oversight process to identify and manage financial risk to the 7(a) program both at the lender and loan levels. This process includes four major activities: lender risk assessments based on data generated by LLMS, delegated lending authority reviews, onsite examinations, and an evaluation of lender compliance during guaranty purchase and liquidation reviews. Responsibility for these activities is shared by several SBA offices:

- The Office of Credit Risk Management (OCRM) manages loan program credit risk, monitors lender performance, assigns lending authority to high-risk lenders, enforces lending program requirements, and takes enforcement actions when warranted.

- The Office of Financial Assistance (OFA) establishes policy and goals for SBA's credit programs, including assigning delegated lending authority to medium- and low-risk lenders. OFA also oversees the operations of the loan processing, servicing and purchase centers.

- The Sacramento Loan Processing Center (Sacramento Center) makes recommendations to OCRM and OFA on delegated lending authority requests based on analyses of lender performance and achievement of performance benchmarks (see Appendix III for the performance benchmarks and their definitions).

- The Herndon, Virginia National Guaranty Purchase Center (NGPC) and the Little Rock, Arkansas and Fresno, California Commercial Loan Service

[3] Although SBA's Loan and Lender Monitoring System became operational in FY 2003, risk ratings were not available until mid CY 2004.

[4] Delegated lending authority is the authority to process, close, service, and liquidate SBA-guaranteed loans with reduced requirements for documentation and without prior SBA approval. This authority has been extended to lenders in the Preferred Lender, SBA*Express*, and Community Express programs.

Centers monitor lender compliance with SBA liquidation requirements and perform purchase reviews of defaulted loans.

Additionally, a Lender Oversight Committee is responsible for reviewing decisions on oversight strategy and approving lender enforcement actions. The Committee's three voting members are the Deputy Administrator, Associate Administrator for Capital Access, and Chief Financial Officer. Non-voting representatives include officials from OCRM, OFA, Office of General Counsel, and Office of Field Operations.

RESULTS IN BRIEF

Although SBA determined that the lenders reviewed posed a higher risk of financial loss than other 7(a) lenders, SBA did not take sufficient enforcement actions to mitigate lender risk. The four lenders were consistently rated as high-risk and had actual loan purchase rates exceeding that of other large lenders. Additionally, several of the lenders consistently did not meet performance benchmarks established by SBA and were reported as having recurring performance and compliance issues during onsite examinations. As of September 2007, SBA had incurred a cumulative net loss from the four lenders of $329 million,[5] and between September 2005 and September 2007, SBA purchased over $239 million in guaranties from the lenders—a cost that is subsidized by fees paid by lenders in the 7(a) program and recoveries through liquidation efforts.

Despite the greater risk and even though lenders missed at least half of the required benchmarks for renewal, SBA continued to renew and expand lender delegated authorities, allowing them to make loans without prior SBA approval. In two cases, SBA expanded lenders' authority to over [FOIA Ex. 4] additional district offices even though a significant percentage of loans reviewed during onsite examinations[6] were criticized. These included loans that were classified as either:

- Other Assets Especially Mentioned – loans that had potential weaknesses that could result in deterioration if uncorrected;

- Substandard – loans that had well defined weaknesses or weaknesses that could hinder normal collection of the debt;

[5] The $329 million constitutes a negative net cash flow to SBA's financing account, or the difference between the receipts in the form of payments of principal, interest, fees, and liquidation recoveries and disbursements in the form of payments to lenders to honor the guaranties.

[6] Both expansions were approved before SBA granted nationwide delegated lending authority to preferred lenders in May 2006.

- Doubtful - loans that had weaknesses similar to substandard loans, but that were also so extreme that significant loss potential exists; and

- Loss - loans that were considered uncollectible and no longer of any value.

The onsite examination process is further described in Appendix IV.

Senior SBA officials reported that they exercised appropriate oversight of these lenders by meeting with their managers and reducing delegated authority periods when renewals were granted. They stated that due to the size of the lenders' portfolios, it takes several quarters for the lenders to show significant improvement in performance. However, we noted that when lender performance did not improve or in some cases deteriorated, as shown by increases in credit administration and compliance issues identified during onsite examinations, SBA did not take progressively more stringent enforcement actions to correct performance.

In September 2006, SBA completed a study of SBLCs to better understand why these lenders were high-risk.[7] While the study focused primarily on SBLCs, it noted that NFRLs had operating traits and purchase rates that were similar to SBLCs. The study found that the primary driver for the higher level of risk was that SBLCs generally had a 12-month purchase rate that was more than double the average purchase rate of SBA's overall 7(a) loan portfolio.

Despite the greater risk presented by these lenders, we concluded that SBA had not taken adequate risk mitigation measures or steps to hold lenders accountable for their performance. This occurred because:

- SBA did not have clear policies describing the circumstances under which it would take enforcement actions against lenders in the event of continued noncompliance;

- There is a conflict between SBA's lender advocacy and oversight roles, and the organizational structure supporting these functions has impacted SBA's treatment of lenders;[8] and

- Loan production goals established by SBA in the past have made it difficult to ensure that a proper balance was maintained between SBA's lender advocacy and oversight roles.

[7] This study was never formally published.

[8] OIG Report No. 7-28, *SBA's Oversight of Business Loan Center, LLC*, July 11, 2007; and GAO-03-90, *Small Business Administration: Progress Made but Improvements Needed in Lender Oversight*, December 2002.

In recent discussions, the Deputy Administrator agreed that definitive criteria for implementing enforcement actions is needed to ensure consistency in managing lender performance, and that progressively stricter actions should be taken when performance issues continue. The Associate Administrator for Capital Access also agreed that criteria to guide enforcement actions would ensure more consistency in lender treatment, and that a part-time Lender Oversight Committee could be effective if it had criteria to use in evaluating enforcement actions taken against poor performing lenders. Further, OCA officials agreed there should be a balance between their advocacy and risk mitigation roles, and believe the current organizational structure provides that balance.

Finally, we identified weaknesses in four major oversight activities that further impacted SBA's supervision of the lenders we reviewed. These included:

- **Timely Purchase Reviews at the National Guaranty Purchase Center**. SBA did not always conduct timely post purchase reviews of the four lenders' defaulted loans due to a processing backlog at its National Guaranty Purchase Center.

- **Better-Timed and Scoped Onsite Examinations.** Onsite examinations were not scheduled to coincide with delegated lending authority decisions, and also were limited in scope.

- **More Consistent Use of Corrective Action Plans**. SBA did not consistently implement corrective action plans for problem lenders.

- **Remediation of Bad Loans Identified during SBA's Lender Risk Assessments**. SBA's Loan and Lender Monitoring System (LLMS), procured under contract with Dun and Bradstreet, identifies specific loans in each lender's portfolio that are projected to have a default within the next 18 to 24 months. However, because the terms of its current agreement with Dun and Bradstreet do not allow SBA to share specific credit scores or loan information with lenders, SBA did not alert lenders to risky loans to ensure they took action to prevent them from defaulting.

SUMMARY OF RECOMMENDATIONS

We made seven recommendations to further strengthen SBA's oversight of its supervised lenders. To eliminate inconsistencies in lender delegated authority approvals, we recommended that SBA establish specific criteria for renewals and expansions of delegated lending authorities. To provide a better balance between OCA's lender advocacy and oversight roles, we recommended that performance goals and measures be established for risk mitigation to complement existing

measures for loan production, and that OCA develop specific criteria for determining the level of enforcement actions that should be taken when dealing with lender performance issues. We also recommended that SBA develop procedures to establish a hierarchy of enforcement actions and criteria for exercising such actions to ensure consistency in SBA's treatment of lenders.

Further, we recommended that onsite examinations be scheduled to coincide with delegated lending authority decisions and that loans reviewed for compliance during onsite examinations be statistically sampled to ensure that examination results are representative of the lender's actual compliance. To alert lenders to risky loans so they can take action to prevent them from defaulting, we recommended that SBA explore the cost/benefit ramifications of providing data to lenders on loans that have a high likelihood of default. Finally, to ensure that purchase review backlogs do not occur in the future, we recommended that SBA fully staff the Herndon Center to the appropriate level.

SBA responded to our report findings and recommendations on April 22, 2008, expressing concern that the OIG downplayed the role that concrete oversight actions by OCA had in improvements to lender risk ratings. The response also indicated that information provided to the OIG to clarify facts, calculations and procedures outlined in the draft report were largely not incorporated into the final report. Management agreed with five recommendations, partially agreed with one, and stated it had already accomplished one recommendation. Management decisions on six of the recommendations will require additional details and target dates for implementation before we can consider them responsive to the findings.

We do not believe the report downplayed the role that SBA's oversight actions had on improvements to lender risk ratings. As discussed in the report, we could not determine (nor do we believe SBA could determine) what caused the risk ratings to improve because the Agency continually revised the range of scores affecting lender placement in the risk categories. This rescaling had the effect of lowering the risk scores of many lenders. We also believe that extraordinary care and time were taken to clarify facts and other information in the report to the extent that the Agency could provide definitive evidence supporting such changes. Where the Agency provided clear and credible evidence to support requested clarifications, we made the appropriate changes to the report. However, SBA was not able to provide sufficient evidence for many of the clarifications it requested.

SBA's comments and our corresponding response are discussed in more detail in the "Agency Comments and Office of Inspector General Response" section of the report. SBA's response is presented in its entirety in Appendix V.

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FINDINGS

Despite High-Risk Ratings and Recurring Performance Issues, SBA Renewed and Expanded Lenders' Delegated Authorities

Over the years, SBA has been aware that its largest supervised lenders have presented a higher risk than other 7(a) lenders. These lenders have significantly higher loan purchase rates than other 7(a) lenders and have been consistently rated as high-risk by SBA. Yet, SBA renewed and expanded the delegated authorities of its supervised lenders, allowing them to make loans without prior approval from SBA. The Agency reported that it took a variety of enforcement actions to manage the performance of these four lenders, but believes it will take considerable time to see measurable improvements in performance given the large size of the lenders' portfolios. We agree that short-term improvements in lender risk rating scores may be difficult given their large portfolios; however, when multiple indicators highlighted deteriorating performance, SBA should have taken progressively more stringent enforcement actions.

Lenders Reviewed Were Rated as High-Risk and Demonstrated Recurring Performance Issues

Based on June 2004 to September 2007 performance data generated by LLMS, the four lenders reviewed generally were rated as high-risk. The four lenders also had purchase rates exceeding that of other large lenders. As of September 2007, SBA had incurred a cumulative net loss from the four lenders of $329 million, and between September 2005 and September 2007, SBA purchased over $239 million in guaranties from the lenders—a cost that is subsidized by fees paid by lenders in the 7(a) program and recoveries through liquidation efforts.

Further, onsite examinations of these lenders that were conducted between October 2003 and September 2007 identified recurring performance issues. During the examination, the quality of each lender's portfolio was also evaluated and its loans classified as acceptable or placed in one of four at-risk categories. The at-risk loans included those in both the "criticized" and the "adversely classified" categories. The last three risk categories are the "adversely classified." (The examination process is further explained in Appendix IV). The at-risk categories included:

- **Other Assets Especially Mentioned (OAEM)** – loans that had potential weaknesses that could result in deterioration if uncorrected and all loans that were less than 12-months old;

- **Substandard** – loans that had well defined weaknesses or weaknesses that could hinder normal collection of the debt;

- **Doubtful** – loans that had weaknesses similar to substandard loans, but that were also so extreme that significant loss potential exists; and

- **Loss** – loans that were considered uncollectible and no longer of any value.

Onsite examinations of three of the four lenders reported a decline in the quality of the lenders' assets. A description of each lender's performance is summarized below:

- For 10 of the 14 rating quarters since June 2004, Lender A was rated either a 4 or 5 (high- or highest-risk). In the most recent three quarters, the rating improved to either a 3 (moderate-risk) or a 2 (low-risk). FCA examinations in [FOIA Ex. 4] and [FOIA Ex. 4] identified increasing percentages of loans with compliance and credit administration issues. For example, of the loans reviewed, credit administration weaknesses increased from 14 to 17 percent, and loans classified as OAEM, substandard, doubtful or loss increased from 31 to 34 percent. Based on a judgmental sample, the percentage of loans reviewed that had compliance issues increased from 20 to 35 percent.

- From June 2004 to March 2007, Lender B's quarterly risk rating was either a 4 or a 5. In the two most recent quarters, the lender's rating improved to a 3. Between [FOIA Ex. 4] and [FOIA Ex. 4], FCA examinations documented increasing performance issues. For example, of the loans reviewed, credit administration issues increased from 19 to 30 percent and loans classified as OAEM, substandard, doubtful, or loss increased from 70 to 82 percent during the same period. Based on a judgmental sample in [FOIA Ex. 4], 40 percent of the loans reviewed had compliance issues.

- Lender C was rated either 4 or 5 for 9 of the 14 rating quarters reviewed. Since May 2005, onsite examinations documented improvements in the lender's credit administration practices, compliance with SBA regulations, and the percentage of the lender's SBA portfolio that was classified as OAEM, substandard, doubtful or loss. However, despite these improvements, as of November 2006, 24 percent of the loans reviewed were classified as OAEM, substandard, doubtful, or loss.

- SBA rated Lender D a 5 for 9 of the 14 rating quarters and a 3 in the most recent two quarters. [FOIA Ex. 4] and [FOIA Ex. 4], onsite examinations determined that compliance issues remained constant while

credit administration issues in the loans reviewed increased from 6 to 11 percent, and loans classified as OAEM, substandard, doubtful, or loss increased from 32 to 63 percent.

In an effort to better understand why non-depository lenders posed a greater financial risk than other lenders, in September 2006 OCRM completed a comprehensive study of SBLCs and NFRLs. While the study focused primarily on SBLCs, it determined that NFRLs had similar operating traits and purchase rates. The study concluded that the primary driver behind the higher risk levels was an elevated average 12-month purchase rate that was more than twice that of the average purchase rate for the total 7(a) loan portfolio.[9] As described below, the study also found that in virtually all performance areas the SBA-supervised lenders incurred greater losses than other lenders, but did not mitigate those losses through higher recovery rates. Specifically:

- Purchase rates for SBA supervised lenders with delegated lending authority were twice that of other lenders regardless of delivery method.[10]

- Charge-off rates (defined in Appendix III) for SBLC secondary market loans were more than twice the rates for non-SBLC loans.

- From FY 1996 to FY 2004, SBLC loans had negative net cash flow[11] rates that were on average two to three times higher than those of non-SBLC loans.

- From FY 1988 to FY 2005, the cumulative recovery rate for defaulted SBLC loans sold in the secondary market was roughly comparable to that of non-SBLC lenders—38 percent for SBLCs compared to 43 percent for non-SBLCs.

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[9] The study compared the average 12-month purchase rate of non-depository lenders with the average for the total 7(a) portfolio as of June 2006.

[10] Delivery methods include the Preferred Lending Program (PLP), Certified Lending Program, and standard 7(a) loan processing.

[11] Net cash flow is the difference between the receipts in the form of payments of principal, interest, fees, and liquidation recoveries and disbursements in the form of payments to lenders to honor the guaranties.

SBA Took Limited Enforcement Actions and Continued to Renew Lender Delegated Authorities

In dealing with problem lenders, SBA can take a number of enforcement actions, including:

- Requiring lender management to meet with SBA headquarters staff;
- Directing the lender to correct specific deficiencies;
- Requiring the lender to implement a corrective action plan;
- Requiring the lender to provide periodic reports of lending activity;
- Conducting more frequent onsite examinations;
- Reducing renewal periods, suspending or revoking delegated lending authorities; and
- Suspending or terminating the lender from participating in the 7(a) program(s).

SBA was not consistent in applying enforcement actions, and did not take more stringent enforcement actions to improve lender performance. SBA's corrective actions consisted of meeting with lender management, directing that lenders correct specific deficiencies, and reducing renewal periods for delegated authority. As shown in Table 3, the renewal periods were reduced to 6 months for some lenders and to 1 year for others. When lender performance did not improve, SBA did not always conduct more frequent examinations or suspend or revoke delegated lender authorities when lenders failed to meet key performance benchmarks for loan currency, default, losses and liquidation. These benchmarks are explained in Appendix III.

Moreover, on at least three occasions, SBA expanded the geographical area of lenders' delegated authority, increasing SBA's risk even though the lenders did not have acceptable performance. When some lenders did not meet all of the benchmarks for renewal, SBA reduced the renewal periods. SBA continued to make subsequent renewals even though significant improvements had not occurred in lender performance.[12]

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[12] SBA's handling of the four lenders was similar to how it addressed another high-risk lender (BLX). SBA's oversight of BLX is discussed in OIG Report No. 7-28, *SBA's Oversight of Business Loan Center, LLC*, July 11, 2007.

The specific actions SBA took for each of the four lenders reviewed is summarized below:

Lender A

- [FOIA Ex. 4], SBA renewed Lender A's delegated lending authority for 2 years, [FOIA Ex. 5]. At that time, the lender was rated as high-risk (a rating of 4) and did not meet two of the four performance benchmarks. To improve the performance of Lender A, SBA conducted several meetings with lender management, and required specific corrective actions be taken.

- [FOIA Ex. 4], when the lender's performance deteriorated and it was placed in the highest risk category (a rating of 5), SBA again renewed the lender's authority, but reduced the renewal period to 6 months. SBA did not require the lender to prepare a corrective action plan or implement other enforcement actions.

- [FOIA Ex. 4], the lender was renewed for a 1-year period, when its risk rating was elevated to a 3 (moderate-risk).

- [FOIA Ex. 4], SBA purchased over $163 million in guaranties on loans made by the lender. While this amount is significant when compared to purchases for other SBLCs in the same rating peer group, which averaged about $42.6 million, [FOIA Ex. 4].

Lender B

- Lender B's delegated lending authority was consistently renewed for four 1-year periods between [FOIA Ex. 5], and despite risk ratings of 5 during three renewal periods. Also, in three of the four renewal periods, the lender did not meet three of the four performance benchmarks for renewal. During two of these renewal periods, an onsite examination classified 70 percent of the loans reviewed as OAEM, substandard, doubtful, or loss, and reported that 19 percent of the loans reviewed had credit administration issues. Despite recurring performance issues and high risk ratings, in [FOIA Ex. 4] the lender's delegated lending authority was expanded to allow it to operate in a total of [FOIA Ex. 4] additional district offices. This expansion occurred prior to May 2006, when SBA granted nationwide delegated authority to preferred lenders.

- [FOIA Ex 4], SBA reduced the lender's renewal period to 6 months and met with the lender's management due to the lender's deteriorating performance, but took no other enforcement actions. At that time, an onsite examination reported that of the loans reviewed, those classified as OAEM, substandard, doubtful, or loss had increased to 82 percent, while loans with credit administration issues had increased to 30 percent.

- Between [FOIA Ex. 4], SBA purchased over $29 million in guaranties on loans made by this lender.

Lender C

- [FOIA Ex. 4], Lender C's delegated lending status was renewed for 2 years even though the lender did not meet three benchmarks established for renewal, [FOIA Ex. 5]. No lender risk ratings were available at that time.

- [FOIA Ex. 4] (8 months later), SBA expanded the lender's delegated authority, increasing the number of districts from [FOIA Ex. 4] in which the lender could make loans with limited oversight. While the lender was rated as being moderate-risk (rating of 3), it did not have a current onsite examination. Its last examination occurred 16 months previously in [FOIA Ex. 4].

- Six months after the lender's delegated lending authority was expanded, an onsite examination classified 39 percent of the loans reviewed as OAEM, substandard, doubtful, or loss, 27 percent as exhibiting compliance issues, and 32 percent with credit administration weaknesses. After the onsite examination results were reported, the lender was allowed to continue to operate under its expanded authority until [FOIA Ex. 4].

- [FOIA Ex. 4], SBA renewed the lender's delegated lending authority for only 6 months based on its placement in the highest-risk category and its failure to meet two performance benchmarks, but allowed it to retain its expanded authority. In April 2006, SBA asked the lender to develop a corrective action plan that identified goals and timeframes for accomplishing the corrective actions. Although the lender's plan set targets below the required performance benchmarks, SBA accepted the plan. In [FOIA Ex. 4], the lender also did not meet two benchmarks and had a risk rating of 5, and was renewed for 6 months.

- [FOIA Ex. 4], SBA purchased over $17 million in guaranties on loans made by this lender.

Lender D

- SBA rescinded the lender's preferred lending status in [FOIA Ex. 4], but [FOIA Ex. 4], SBA reinstated the lender's preferred lending status in [FOIA Ex. 4]. For most of calendar year 2005, the lender was rated a 5 (high-risk). [FOIA Ex. 4], SBA expanded the lender's delegated lending authority from [FOIA Ex. 4] district offices.

- [FOIA Ex. 4], SBA renewed the lender's preferred status for 1 year and expanded the lender's delegated lending authority as part of SBA's program to provide all PLP lenders with nationwide lending authority. This was done [FOIA Ex. 5] and even though the lender had a risk rating of 5. The lender also did not meet three of the four performance benchmarks for renewal.

- The lender's delegated authority was renewed again in [FOIA Ex. 4] for 1 year. At that time, the lender's risk rating was a 5, and the lender did not meet three of the four performance benchmarks for renewal.

- [FOIA Ex. 4], SBA purchased over $28 million in guaranties on loans made by this lender.

Senior officials responsible for lender oversight stated that they took appropriate steps to mitigate risk, as three lenders had recently shown improvement, two of which demonstrated significant improvements in their 12-month purchase rates and risk ratings since June 2007. They also indicated that they held various telephone discussions and meetings with lender management, as well as performed in-depth portfolio analyses that were not always documented in the files provided to the OIG. They stated that due to the size of the lenders' portfolios, it took several quarters for the lender to show significant improvement in performance.

While we understand the large size of the lenders' portfolios precluded measurable improvements in lender risk ratings from occurring over the short-term, we noted SBA had other sources of information, which indicated lender performance was actually deteriorating in some instances. Onsite examinations of two lenders highlighted increases in credit and compliance issues in loans reviewed that merited progressively more stringent enforcement actions.

We are also concerned about whether improvements in lender purchase rates and risk ratings were due to actual improvements in lender performance. A recent

OIG audit[13] determined that lenders were not timely submitting guarantee purchase requests, and SBA was not timely purchasing guarantees from the secondary market—both of which could have impacted the 12-month purchase rate. These delays were occurring around the time that the 12-month purchase rates declined for these four lenders. This may have caused purchase rates to decline for a period of time and risk ratings to be lowered.

Further, SBA reset the quarterly range of scores comprising the LLMS risk categories, which generally resulted in lenders' risk ratings being lowered more than had it used the old range of scores. LLMS produces a raw risk score from 0 to 999 for each lender, with 999 representing the highest risk. In assigning risk ratings quarterly up until September 2007, SBA determined which lenders would be rated a 1, 2, 3, 4, or 5, based on the percent of lenders it wanted to place in each risk category. In September 2007, OCRM began segmenting risk categories based on natural breaks in lender raw risk scores and actual 12-month purchase rates on defaulted loans.

As shown in Table 1, the rescaling generally allowed lenders to be placed in lower risk categories with each subsequent revision of the risk categories.

Table 1. LLMS Raw Score Ranges and Risk Ratings from September 2006 to June 2007

	3 Risk Rating		4 Risk Rating		5 Risk Rating	
Risk Rating	**Low**	**High**	**Low**	**High**	**Low**	**High**
September 2006	357	482	510	533	538	931
December 2006	367	513	518	551	555	953
March 2007	375	563	565	591	606	691
June 2007	362	602	605	611	635	707
September 2007	459	498	516	684	750	750

Source: Information provided SBA's Office of Credit Risk Management

To illustrate the effects of rescaling:

- In September 2006, Lender A had a raw score of 602 and was rated a 5. In September 2007, when its raw score dropped to 413, the lender's risk rating was elevated to a 2. However, if SBA had used the same rating scale as it had in September 2006, the lender's rating would have been a 3.
- In September 2006, lender B had a raw score of 586, and a 5 risk rating. In September 2007, the lender's score decreased to 495, and it was assigned a risk rating of 3. Under the September 2006 rating scale, the 495 score would have most likely placed the lender in the 4 category.

[13] OIG Report No. 8-09, *Loan Classifications and Overpayments on Secondary Market Loans*, March 26, 2008.

- In September 2006, Lender C was rated a 5 with a raw score of 735. In September 2007, the lender's rating was elevated to a 4 when its raw score decreased to 548. However, if SBA had used the September 2006 rating scale, the lender's rating would have remained a 5.
- Lender D had a raw score of 981 and was rated a 5 in September 2006. In September 2007, its rating was a 3 based on a raw score of 459. That same raw score would also have placed it in the rating 3 category in September 2006.

Finally, as shown in Table 2, the September 2007 rescaling of the risk categories had the effect of placing considerably more lenders in the two lowest risk categories (an increase from 43 to 72 percent), and moving all but one of the highest-risk lenders from a 5 to a 4 rating.

Table 2. Risk Rating Distribution

Risk Ratings	No. of Lenders June 2007	Percent*	No. of Lenders September 2007	Percent*
1 and 2	26	43	43	72
3	26	43	9	15
4	3	5	7	12
5	5	8	1	2
TOTALS	60		60	

Source: Information provided SBA's Office of Credit Risk Management

*Percentages do not add to 100 due to rounding.

Unclear Enforcement Policies and Conflicts between SBA's Lender Advocacy and Oversight Roles Impacted SBA's Treatment of Lenders

While SBA had the authority to take a number of enforcement actions, it did not have criteria for guiding how enforcement actions should be implemented to ensure that enforcement was progressively and consistently applied. Further, the Lender Oversight Committee, which was supposed to play a critical role in SBA's oversight and enforcement process to mitigate the conflict of having OCRM report to OCA, did not approve most of the enforcement actions to be taken. As a result, OCRM took only limited enforcement actions.

SBA Did Not Have Uniform Criteria for Enforcement Actions

SBA did not take more stringent and progressive enforcement actions because it lacked clear enforcement policies describing the circumstances under which it would suspend or revoke delegated lending authority. This authority allows lenders to originate, service, and liquidate loans with limited oversight from SBA. Consequently, SBA was inconsistent in how it dealt with lender performance

issues. For example, in some instances SBA renewed lender delegated authority for shorter periods [FOIA Ex. 5], and in other instances it approved longer periods [FOIA Ex. 5]. Extending and expanding lender delegated authorities when performance benchmarks are not achieved and risk ratings are unacceptable conveys to lenders that there are little consequences for performing poorly. Table 3 provides examples illustrating the inconsistencies in enforcement actions taken by SBA in dealing with the four lenders reviewed during calendar years 2006 and 2007.

Table 3. Comparison of Reduced Renewal Periods and Other Enforcement Actions SBA Approved for the Four Lenders Reviewed

Lender	Year	Sacramento Recommendation	Benchmarks Failed	Risk Rating	Renewal Period	Other Enforcement Action Taken
A	[Ex. 5]	[FOIA Ex. 5]	1	5	6 months	Meeting with lender management
	[Ex. 5]	[FOIA Ex. 5]	1	3	1 year	None
B	[Ex. 5]	[FOIA Ex. 5]	2	5	1 year	None
	[Ex. 5]	[FOIA Ex. 5]	1	3	6 months	Meeting with lender management
C	[Ex. 5]	[FOIA Ex. 5]	2	5	6 months	Corrective Action Plan (CAP)
	[Ex. 5]	[FOIA Ex. 5]	2	5	6 months	Continued CAP
	[Ex. 5]	[FOIA Ex. 5]	3	3	6 months	Continued CAP
D	[Ex. 5]	[FOIA Ex. 5]	3	5	1 year	None
	[Ex. 5]	[FOIA Ex. 5]	3	5	1 year	None

Source: Data from SBA's Sacramento Loan Processing Center, and Office of Credit Risk Management

Moreover, SBA's favorable treatment of large lenders who are high-risk is unfair to smaller lenders who were rated as high-risk, but were denied delegated lending authority. In a prior audit report[14] we noted that SBA denied 91 (8 percent) of 1,142 applications for new or renewed delegated lending authority during the first 6 months of FY 2007. There were no denials of large lenders whose SBA-guaranteed loan portfolios were in excess of $100 million. Consequently, SBA should establish better criteria for approving lender delegated authorities so that more consistent decisions are made.

Previous OIG reports on *SBA's Oversight of Business Loan Center*[15] and *SBA's Use of the Loan and Lender Monitoring System,*[16] recommended that SBA issue policy that establishes risk tolerance levels and a hierarchy of enforcement actions with specific criteria for implementing each enforcement action when tolerance levels are exceeded. Such policy should be sufficiently detailed to describe the appropriate enforcement action to be taken, but not be overly prescriptive so as to prevent SBA from exercising judgment when mitigating circumstances exist. SBA should also document its justification for any deviations from the policy. Further, SBA will need to clarify the role of the Lender Oversight Committee,

[14] OIG Report No. 7-28, *SBA's Oversight of Business Loan Center, LLC,* July 11, 2007.

[15] OIG Report No. 7-28, *SBA's Oversight of Business Loan Center, LLC,* July 11, 2007.

[16] OIG Report No. 7-21, *SBA's Use of the Loan and Lender Monitoring System*, May 2, 2007.

including what decisions will be made by the Committee and how it will oversee actions taken by OCRM to ensure that SBA's lender enforcement policy is being consistently applied. Developing clearer policy to guide enforcement actions would allow SBA to make more consistent decisions about actions that should be taken against lenders in the event of continued noncompliance.

SBA is in the process of implementing regulations to establish a range and hierarchy of enforcement actions it may take against problem lenders, but the regulations do not identify the circumstances that would trigger specific enforcement actions. Alternatively, SBA has agreed to establish criteria for implementing each enforcement action, [FOIA Ex. 5
].

The OIG believes that lenders should be fully informed about enforcement actions that SBA will take to address specific performance issues so that they can be proactive in improving their performance. Preferably this guidance should be incorporated into a Standard Operating Procedure (SOP) so that it can more easily be enforced.

The Lender Oversight Committee Did Not Have a Sufficient Role in Enforcement Decisions to Mitigate Conflicts between SBA Advocacy and Oversight Roles

In July 2007, the OIG's report on *SBA's Oversight of Business Loan Center* stated that OCRM's placement under the Office of Capital Access presented a potential conflict between the desire to encourage lender participation in SBA loan programs and the need to evaluate lender performance and take enforcement action. Although OCA and OCRM serve many roles, specifically, OCA's role of promoting delegated lending authorities was in conflict with OCRM's role of taking enforcement actions against problem lenders.

A prior GAO report[17] also noted that the presence of both OFA and the Office of Lender Oversight (now OCRM) within OCA does not afford the oversight function an arm's length position from the promotion function. GAO reported that the organizational arrangement presented a potential conflict, or at least the appearance of a conflict, between the desire to encourage lender participation in PLP and the need to evaluate lender performance. GAO recommended that SBA separate lender oversight functions and responsibilities, such as revoking preferred lender status from OCA, and establish clear authority and guidance for the Office of Lender Oversight or its successor office.

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[17] GAO-03-90, *Small Business Administration: Progress Made but Improvements Needed in Lender Oversight*, December 2002.

SBA believes that this potential conflict was mitigated when it established the Lender Oversight Committee in FY 2004. The Committee was designed to:

- Serve as an important control in the lending process and to mitigate the inherent conflict presented by OCRM's placement within OCA;
- Review reports on lender oversight activities, including determinations on delegated authority, the status of problem lenders subject to enforcement actions, and the status of debarment activities, etc.; and
- Approve and modify enforcement actions recommended by OCRM, and review OCRM's budget, staffing, and operating plans.

The Committee was not operating as envisioned, but rather generally acted in an advisory capacity. Between January 2005 and December 2007, the Committee met 13 times. Based on documents that OCRM provided to the OIG, the Committee directed OCRM to take action regarding lenders in only three instances. [FOIA Ex. 5

]. The Committee also did not address the study's recommendations and no final decisions were made. Consequently, we do not believe that an oversight Committee, which is only advisory and does not review all enforcement actions, can adequately provide independent oversight of the 4,900 lenders in SBA's 7(a) program.

In recent discussions, the Deputy Administrator agreed that definitive criteria for implementing enforcement actions is needed to ensure consistency in managing lender performance, and that progressively stricter actions should be taken when performance issues continue. The Associate Administrator for Capital Access also agreed that criteria for guiding enforcement actions would ensure more consistency in lender treatment, and that a part-time Lender Oversight Committee would be effective if there were criteria for determining enforcement actions to take in dealing with poor performing lenders. He stated that the criteria should not be overly prescriptive to allow the Committee some flexibility to consider mitigating circumstances. He indicated that OCA would develop criteria to provide the Committee a basis for evaluating whether enforcement actions taken by OCRM are consistently applied and a charter for the Committee that would better define how it will work with OCRM on enforcements actions.

Further, OCA officials agreed there should be a balance between providing capital and minimizing the financial risk posed by lenders, and indicated that in addition to performance measures for loan production, OCA also had informal risk mitigation goals. Current and prior audits have shown that OCA's performance plans have not contained specific lender risk mitigation performance measures. Instead, the performance measures focused on meeting goals for increasing the size of the Agency's loan portfolio. Therefore, OCA was not held accountable for managing lender risk to ensure that an appropriate balance between risk mitigation and loan production goals is maintained. Because SBA's FY 2009 budget request reports goals for growing the Agency's loan portfolio (e.g., 99,494 7(a) loans for FY 2008 and 104,469 loans for FY 2009), SBA will need to ensure that a proper balance is maintained between its competing roles by establishing goals for the performance of its lender oversight function.

Other Weaknesses in Major Oversight Activities Impacted SBA's Supervision of Lenders

In addition to the above, weaknesses in four major oversight activities further impacted SBA's supervision of the lenders reviewed. These activities involved purchase reviews, onsite examinations, the use of corrective action plans to address lender deficiencies and the LLMS process. Specifically:

- **Timely Purchase Reviews at the National Guaranty Purchase Center**. SBA did not always conduct timely post purchase reviews of the four lenders' defaulted loans due to a processing backlog. As a result, the Agency did not have complete information on lender compliance issues.

- **Better-Timed and Scoped Onsite Examinations.** Onsite examinations were not scheduled to coincide with delegated lending authority decisions, and the findings may not have been representative of the lenders' actual compliance due to judgmental sampling.

- **More Consistent Use of Corrective Action Plans**. SBA did not consistently require corrective action plans for problem lenders.

- **Remediation of Bad Loans Identified during SBA's Lender Risk Assessments**. Under the terms of SBA's contract with Dun and Bradstreet for LLMS, the Agency was not able to share specific credit scores or loan information with lenders to alert lenders to risky loans so that steps could be taken to prevent them from defaulting.

Post-Purchase Reviews Were Not Performed on a Significant Number of Loans, Depriving SBA of Critical Data Needed for Renewal Decisions

Purchase reviews are a key oversight function because, in many cases, these reviews are the first time SBA assesses compliance with its lending requirements.[18] However, SBA did not always conduct timely post-purchase reviews of the four lenders' defaulted loans due to a processing backlog at its National Guaranty Purchase Center. Approximately 1,014, or 27 percent, of the 3,786 purchased loans in the backlog as of October 2007 were from the four lenders we reviewed. Many of the backlogged loans had been purchased over 6 years ago.

Because SBA had not conducted post-purchase reviews, the Agency did not have current or complete information on lender compliance issues and lacked critical data to determine whether corrective action was warranted to address lender deficiencies. For example, because loans cannot be charged off until after post-purchase reviews are completed, which did not occur timely for many of the loans purchased from the four lenders, the actual loss rates (defined in Appendix III) of these lenders may be significantly higher than the loss rates SBA used in making delegated lending authority decisions. We believe that subsequent reviews of these loans may disclose compliance problems beyond those identified in the onsite examinations.

A previous OIG audit[19] reported that staffing shortages at SBA's National Guaranty Purchase Center had prevented the Agency from conducting effective and timely purchase reviews of all defaulted loans. Since October 2004 the OIG has reported the shortage of staff at the center as a major management challenge confronting the Agency. For almost 3 years, SBA did not take sufficient steps to adequately staff the National Guaranty Purchase Center. However, in August 2007, SBA began using contractors to eliminate the backlog of loans requiring purchase reviews, and in September 2007, completed a major reengineering study of the Herndon Center that analyzed the tasks performed, skills required, and time standards for each of the major functions at the Center to determine the appropriate staffing level for optimal operational effectiveness. Since that time, SBA has worked aggressively to increase center staffing. However, as of January 24, 2008, the Herndon Center still had 20 vacancies, or 20 percent of its approved positions unfilled. In order to ensure that purchase review backlogs do not occur in the future, SBA should develop a strategy for staffing the Herndon Center at the appropriate level.

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[18] Lender compliance is also evaluated in onsite examinations, but only a small sample of loans are examined for compliance.

[19] OIG Report No. 4-39, *Management Advisory Report on the Transfer of Operations to the National Guaranty Purchase Center*, August 31, 2004.

The Timing and Content of the Onsite Examinations Can Be Improved to Better Meet SBA's Oversight Needs

SBA requires that onsite examinations be conducted for its largest SBA-supervised lenders to assess lender operations and processes for SBA-guaranteed loans, including determining whether the lender exercises prudent risk management. The examinations evaluate: (1) capital (as allowed by statute); (2) asset quality; (3) management; (4) earnings; (5); liquidity; and (6) compliance with SBA requirements. OCRM determines the examination schedule, plan, scope, resources and evaluation criteria.

Because SBA does not require that the scheduled examinations coincide with delegated lending authority reviews, in many cases the examinations of the four lenders occurred either after the renewal decision or a year or more before the next decision was made. For example, Lender B was evaluated for renewal in [FOIA Ex. 4] and its last examination occurred 35 months earlier in [FOIA Ex. 4]. Consequently, SBA frequently made delegated lending authority decisions without current compliance information.

To illustrate the time lag between onsite examinations and delegated lending authority decisions, Table 4 highlights those instances where SBA relied on examination data that was more than 90 days old when evaluating lenders for renewal.

Table 4. Time Lapse between Onsite Examinations and Lending Authority Decisions

Lender	Examination Date	Delegated Lending Evaluation Date	Elapsed Months
Lender A	[FOIA Ex. 4]	[FOIA Ex. 4]	6
	[FOIA Ex. 4]	[FOIA Ex. 4]	10
	[FOIA Ex. 4]	[FOIA Ex. 4]	16
	[FOIA Ex. 4]	[FOIA Ex. 4]	0
Lender B	[FOIA Ex. 4]	[FOIA Ex. 4]	23
	[FOIA Ex. 4]	[FOIA Ex. 4]	35
	[FOIA Ex. 4]	[FOIA Ex. 4]	3
	[FOIA Ex. 4]	[FOIA Ex. 4]	15
	[FOIA Ex. 4]	[FOIA Ex. 4]	7
Lender C	[FOIA Ex. 4]	[FOIA Ex. 4]	8
	[FOIA Ex. 4]	[FOIA Ex. 4]	9
	[FOIA Ex. 4]	[FOIA Ex. 4]	15
	[FOIA Ex. 4]	[FOIA Ex. 4]	9
Lender D	[FOIA Ex. 4]	[FOIA Ex. 4]	12
	[FOIA Ex. 4]	[FOIA Ex. 4]	1
	[FOIA Ex. 4]	[FOIA Ex. 4]	13
	[FOIA Ex. 4]	[FOIA Ex. 4]	2

Source: Reports of Examinations conducted by the Farm Credit Administration and data from SBA's Sacramento Loan Processing Center

OCA officials told us that prior to FY 2007, budgetary constraints prevented them from conducting onsite examinations for all large lenders. As a result of regulatory changes allowing SBA to charge lenders for the cost of the examinations, SBA plans to examine all lenders with guaranteed loan portfolios in excess of $10 million at least every 24 months. However, it is unclear whether the timing of these examinations will coincide with lender renewal periods. Because these examinations provide assessments of lender compliance with SBA policies as well as performance, we believe the examinations should be appropriately timed to provide current compliance information for renewal decisions.

Further, our review of 10 examination reports for the four lenders that were issued between April 2004 and July 2007 disclosed that conclusions about lender compliance were based on judgmental samples of a small percentage of the lenders' portfolios. The judgmental samples were taken from a statistical sample of reviewed loans, but could not be projected to other loans in the lenders' portfolios. As shown in Table 5, for three of the reports in which the portfolio size was 5,380 loans or greater, the loans examined represented less than 1 percent of the loans and no more than 1.1 percent of the dollars. According to examiners, this occurred because the examination methodology approved by SBA limited the number of loans to be sampled to between 15 and 25 loans, regardless of the size of the lender's loan portfolio. Because the sample size was small and the loans were judgmentally sampled, conclusions reached about lender compliance on sampled loans may not be representative of other loans in the lender's portfolio.

Table 5. Comparison of Portfolio Size to Loans Reviewed

Report Date	Portfolio Size	Loans Reviewed	Percent of Loans Reviewed	Percent of Dollars Reviewed
[FOIA Ex. 4]	345	25	7.3	14.2
[FOIA Ex. 4]	5,380	25	0.5	1.0
[FOIA Ex. 4]	307	25	8.1	17.1
[FOIA Ex. 4]	468	15	3.2	4. 9
[FOIA Ex. 4]	782	25	3.2	8.4
[FOIA Ex. 4]	5,964	20	0.3	0.7
[FOIA Ex. 4]	533	20	3.8	9.4
[FOIA Ex. 4]	346	20	5.8	15.6
[FOIA Ex. 4]	904	20	2.2	3.7
[FOIA Ex. 4]	6,054	20	0.3	1.1

Source: Reports of Examinations conducted by the Farm Credit Administration for the four lenders reviewed

Additionally, regulatory compliance determinations were based on the number of compliance questions that were satisfactorily answered per loan and not the number of loans with deficiencies. For example, if 20 loans were reviewed and examiners reported satisfactory answers to all but a few compliance questions for each loan, the lender's overall rating would have been reported as "substantially in compliance," even though all 20 loans did not fully comply with SBA requirements and some of the deficiencies identified may have been material.[20] For example, examiners identified material weaknesses in 40 percent of the loans examined for one lender regarding the assessment of repayment, capitalization, and management, but classified the lender as "acceptable, with improvements needed." Table 6 summarizes the percentage of deficiencies noted in loans reviewed during examinations conducted of the four lenders between April 2004 and July 2007.

Table 6. Comparison of Compliance Ratings to Review Results

Number of Loans Reviewed	Loans with Deficiencies	Percent of Loans Reviewed with Deficiencies	Rating Provided
25	8	32	Substantially in compliance
25	5	20	Substantially in compliance
25	2	8	Substantially in compliance
15	3	20	Substantially in compliance
25	12	48	In compliance
20	7	35	Substantially in compliance
20	4	20	Acceptable with improvements
20	4	20	Acceptable with conditions
20	8	40	Acceptable with improvements
20	7	35	Acceptable with conditions

Source: Reports of Examinations conducted between April 2004 and July 2007 by the Farm Credit Administration for the four lenders reviewed

Finally, although the normal practice of examiners and instructions in SBA's *Examination Handbook for SBLCs* provide that the safety and soundness of lenders should be rated on a scale from 1 to 5, SBA did not approve the use of numeric safety and soundness ratings. The rating levels were drafted by OCRM and were based on a modified version of the Uniform Financial Institution Rating System. Because the rating levels were not used, all of the lenders reviewed were

[20] Farm Credit Examination reports classify weaknesses as material, but do not define what constitutes material.

determined to be safe and sound when they would have been rated in the 2 to 4 range,[21] indicating that modest to unsatisfactory weaknesses were identified. When asked why the Handbook ratings were not used, an OCRM representative stated that the Handbook ratings were not reflective of what SBA was trying to accomplish, and SBA wanted to use an alternative lender rating system—LLMS—to assess lender risk.

Effective September 28, 2006, OCRM issued SOP 51 00, which established a new rating system for onsite reviews and examinations, including those of SBA supervised lenders. The new system includes specific criteria to be used when rating lenders and requires lenders to receive an overall rating of acceptable, acceptable with corrective action required, or unacceptable with corrective action required. While the new system is an improvement, SBA will need to address inconsistencies in how compliance issues are handled in the purchase review and onsite examination processes.

Criteria is Needed for Determining When Corrective Action Plans Will Be Required and How Performance Targets Will Be Established

When a lender has systemic performance problems, OCRM may request that the lender prepare and implement a corrective action plan to restore its performance to levels acceptable to SBA. SBA must review and approve the plan prior to implementation. While the corrective action plan process can be an effective method for improving lender performance, we noted that only one of the four lenders was required to prepare and implement a plan, even though the remaining three lenders were performing at unacceptable levels. The plan submitted by this lender contained performance goals, which if achieved, would be below performance standards considered acceptable by SBA. We believe that SBA needs to develop criteria establishing when corrective action plans will be required and take steps to ensure that plans specify performance targets and time frames for accomplishing them.

Information on Loans with a High Potential for Defaulting Was Not Shared with Lenders

The LLMS, which was procured from Dun and Bradstreet, allows SBA to identify specific loans in each lender's portfolio that have a high probability of default within 18 to 24 months. Each loan is assigned a Small Business Portfolio Score, where the lowest score has the highest probability of default. Loans scored below 140 are considered to be at highest risk of default.

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[21] According to an FCA senior examiner, one of the lenders potentially would have been rated a 4. The remaining lenders would have been rated a 2 or 3.

The portfolio scores are calculated quarterly and are shared with lenders in the aggregate, but not by individual loans. Because lenders are not told which loans have a high probability of default, SBA has no assurance that the lenders will identify these loans using their own procedures so that action can be taken to prevent the loans from defaulting. SBA needs to share the information with the lenders in the event the lenders' systems do not identify the high risk loans. We believe that sharing this information with lenders would allow them to intensify their servicing efforts to possibly mitigate the risks posed by some of these loans in the event that lender monitoring systems do not identify these high-risk loans.

However, under the current terms of SBA's contract with Dun and Bradstreet, SBA cannot share the scores for individual loans with the lenders or tell the lenders which loans in the portfolio are at risk of default. This contract is scheduled to end in FY 2008, and SBA is in the process of re-bidding the contract. Therefore, prior to the contract award, SBA has the opportunity to consider the cost/benefit ramifications of sharing information on high risk loans with lenders.

RECOMMENDATIONS

We recommend that the Associate Administrator for Capital Access:

1. Establish risk mitigation goals applicable to each loan program and the entire lending portfolio, and performance measures to indicate the progress in achieving the goals.

We recommend the Director, Office of Credit Risk Management:

2. Develop standard operating procedures that will establish a hierarchy of enforcement actions addressing when and under what circumstances specific enforcement actions will be implemented, and require that any deviations from the procedures be justified in writing.

3. Issue guidance requiring that onsite examinations be conducted no earlier than 90 days prior to the delegated lending authority renewal period; and that lender compliance be determined based on a review of a statistical sample of loans.

4. Develop guidance addressing when corrective action plans should be required and ensure that the plans include performance goals and milestones to be achieved by the lenders.

5. Explore the cost ramifications of providing LLMS data to lenders for loans that have a high likelihood of severe delinquency or default; and if cost-effective, include a provision in future LLMS contracts to share the data.

We recommend that the Director, Office of Financial Assistance:

6. Improve the delegated lending authority process by revising SOP 50 10 to include specific criteria for renewals of delegated lending authorities. The criteria should address both the normal 24-month renewal periods, any abbreviated renewal periods, and the performance benchmarks used in the process.

7. Fully staff the National Guaranty Purchase Center at the appropriate level.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

The Associate Administrator for Capital Access provided formal written comments to the report expressing concern that the OIG downplayed the role that concrete oversight actions by his office had in improvements to lender risk ratings. He also commented that information provided to the OIG to clarify facts, calculations and procedures outlined in the draft report were largely not incorporated into the final report. For example, the purchase figures cited in the report do not accurately portray the Agency's ultimate losses as they do not include offsetting fees paid by lenders and recoveries through liquidation efforts. In addition, the net loss figures for each lender are misleading and are not comparable to other information in the report as they represent losses incurred long before the audit period.

We do not agree with the Associate Administrator's assessment of our treatment of the Agency's request to clarify information in the report. The *Government Auditing Standards*, which the OIG follows, requires that we obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions. Where the Agency provided sufficient evidence to support requested changes, we made the appropriate revisions to the report. However, SBA was not able to provide sufficient evidence for many of the clarifications it requested.

For example, management was unable to support its claim that oversight actions were responsible for recent improvements in lender ratings. SBA provided no additional information beyond what was already contained in the report to support its claim. As discussed in the report, we could not determine (nor do we believe SBA can determine) what caused the risk ratings to improve because the Agency

continually revised the range of scores affecting lender placement in the risk categories. This rescaling had the effect of lowering the risk scores of many lenders. For example, in September 2007 one lender's raw risk score improved by only 9 points; however, his rating was reduced from a 5 (highest-risk) to a 3. Had SBA used the same rating scale as it had used during the previous quarter, the lender would have been rated a 4. With such adjustments to the rating categories, it was not possible to determine whether the changes in scores were attributable to the rescaling of categories versus actual improvements in lender performance.

Further, we believe we took the best and only available approach to portray SBA's actual losses from defaulted loans approved by the four lenders, and that it is unreasonable to expect the OIG to develop statistics that the Agency itself cannot provide. SBA's loan accounting system captures purchase costs and recoveries realized during a given period; however, those costs and recoveries are associated with loan defaults that both occurred before and during the audit period. Consequently, we could not easily distinguish losses and recoveries associated loan defaults that occurred during the audit period from those that occurred prior to the audit period. Therefore, to accommodate SBA's request that we report offsetting fees, we reported the cumulative net losses that SBA experienced from each lender since it entered the 7(a) program. Such losses represent the negative net cash flow to SBA's financing account, or the difference between receipts from payments of principal, interest, fees, and liquidation recoveries and disbursements made to lenders to honor the guaranties. The aggregate net loss of $329 million for these four lenders demonstrates their long-term performance as 7(a) lenders and the ultimate cost of not managing their performance.

The Agency concurred with five recommendations, partially concurred with one recommendation, and stated it had already accomplished one recommendation. Proposed actions on six of the recommendations will require additional details and target dates for implementing proposed actions before we can consider them responsive to the findings. A summary of the Agency's responses to the individual recommendations and evaluation of those responses is provided below.

Recommendations 1, 4, 5, and 6

Management concurred with recommendations 1, 4, and 5, and 6 and proposed actions that will be responsive to the findings once target dates for implementing those actions are provided. For example, the Agency plans to create risk mitigation objectives for the loan programs, develop guidance concerning corrective action plans, assess success under such plans, and explore the cost ramifications of sharing LLMS data with lenders. However, target dates for implementing the proposed actions need to be provided to be considered fully responsive to the report findings.

Recommendation 2

Regarding recommendation 2, the Agency stated that once regulations are in place, standard operating procedures will be developed that will build on the lender oversight framework. However, the response did not indicate whether or not the new procedures would include a hierarchy of enforcement actions addressing when and under what circumstances specific enforcement actions would be implemented. As shown in the report, enforcement actions were not progressively and consistently applied. Without uniform criteria to guide when progressive enforcement actions should be implemented, the Agency will continue to have inconsistent application of its enforcement actions. SBA also needs to specify a time frame for implementing the recommendation. Therefore, we do not consider the Agency's proposed action to be fully responsive to recommendation 2.

Recommendation 3

Management agreed that having current information to make determinations about delegated lending authority is important, but stated that the complexities of scheduling, analyzing information, and preparing reports from the examinations makes the 90 days requirements an unrealistic timeframe. It indicated that to the extent practicable it will consider the timing of delegated lending authority renewal decisions when scheduling onsite examinations. Also, regarding using statistical sampling for compliance determinations, the Agency believes the OIG report is incorrect concerning the methodology currently used to analyze compliance.

As discussed in the report, onsite examination results used in delegated lending renewal decisions were sometimes more than a year old, and may not have reflected the lender's current performance. While we recognize that it may not be possible to schedule every examination within 90 days of the delegated lending authority renewal, SBA should make the effort to meet this goal or propose an alternative that will reasonably address the finding. Therefore, we consider the proposed action to be vague, and therefore, non-responsive.

Further, we disagree with SBA's assertion that our report incorrectly described the methodology used to analyze compliance during onsite examinations. We accurately stated that the compliance determination was based on a judgmental sample that could not be extrapolated to the lender's entire portfolio. OIG auditors met several times with Farm Credit examiners to gain an understanding of their compliance methodology. As an added measure, an advance draft of the report language describing the methodology was provided to the Farm Credit Administration for their review to ensure that the report language was accurate.

Farm Credit examiners responded that the report's description of their methodology accurately detailed their process.

Recommendation 6

The Agency stated that it will develop further guidance for renewal of delegated lending authorities, but did not indicate whether the guidance will address both 24-month and shorter renewal periods, and the performance benchmarks used in the renewal process. Therefore, we cannot consider the Agency's comments to be responsive until additional details are provided.

Recommendation 7

Finally, the Agency indicated it had already accomplished recommendation 7, stating that current staffing levels exceed that which is required for the Herndon Center. While we consider management's comments to be responsive, we will evaluate the Agency's staffing levels and pursue closure of the recommendation with SBA at a later date.

ACTIONS REQUIRED

Because your proposed actions do not provide target dates or sufficient details to be considered fully responsive to all of recommendations, we request that you provide a written response by May 19, 2008, clarifying your management decision on the recommendations below and the time frames you propose for implementing the six recommendations requiring action. Specifically, we request that your response indicate whether:

- The new procedures will include a hierarchy of enforcement actions addressing when and under what circumstances specific enforcement actions would be implemented (recommendation 2);
- A goal will be established for scheduling onsite examinations within 90 days of delegated lending authority decisions, or an alternative goal/action will be proposed to fully address the recommendation (recommendation 3); and
- The guidance being developed for renewal of delegated lending authorities will address both the 24-month and shorter renewal periods and will outline performance benchmarks that are to be used in the process (recommendation 6).

We appreciate the courtesies and cooperation of the Office of Capital Access representatives during this audit. If you have any questions concerning this report, please call me at (202) 205-[FOIA Ex. 2].

APPENDIX I. LENDERS REVIEWED

[FOIA Ex. 4]

[FOIA Ex. 4]

[FOIA Ex. 4]

[FOIA Ex. 4]

APPENDIX II. SCOPE AND METHODOLOGY

The audit objective was to determine whether SBA effectively addressed performance issues to mitigate the risk presented by SBA supervised lenders, and to identify opportunities that may exist to improve the oversight process. To address our audit objective, we judgmentally selected a sample of four SBA supervised lenders based on the size of their SBA-guaranteed loan portfolios at June 2007. At that time each of the lenders had Loan and Lender Monitoring System (LLMS) risk ratings which were in the high- or highest-risk categories.

To determine the extent of performance and compliance issues for each lender, we reviewed the:

- LLMS components and risk ratings for each lender for each quarter from December 2005 to September 2007, and compared the components to each lender's peer group averages and SBA portfolio averages.

- Performance data, performance benchmarks for renewal, and recommendations made by the Sacramento Loan Processing Center for delegated lending authority decisions made between October 1, 2003 and September 30, 2007. We also reviewed evaluations of lender performance made by SBA's field for the same period.

- Farm Credit Administration (FCA) examination reports for each of the four lenders for the period, October 2003 to September 2007.

We also followed up on Agency actions to implement two prior lender oversight recommendations, reviewed the minutes of the Lender Oversight Committee meetings to determine their role in approving enforcement actions taken by Office of Credit Risk Management (OCRM) and the extent to which that role has mitigated organizational conflicts of having the Office of Financial Assistance and OCRM report to the Office of Capital Access.

We interviewed staff at SBA headquarters and the various loan processing centers, and FCA examiners. We also interviewed a representative from a state agency regarding their oversight examinations of one of the lenders in our review. We conducted our audit between May 2007 and January 2008 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

APPENDIX III. PERFORMANCE BENCHMARK DEFINITIONS

The Sacramento Loan Processing Center uses four performance benchmarks in recommending to SBA headquarters the suitability of lenders for renewal or expansion of their delegated lending authority. The four benchmarks are currency rate, default (purchase) rate, liquidation rate, and charge-off rate (also known as loss rate), and generally, are based on a 3-year average. There is no requirement concerning the number of benchmarks a lender must achieve, and the lender's performance against each individual benchmark is weighed against the lender's performance as a whole. The following definitions explain the four rates that SBA uses as benchmarks:

Currency — Percentage of loans that are 0 to 30 days current in scheduled payments based upon total outstanding (active) loan portfolio. Paid-in-full and charged-off loans are excluded, while loans in delinquent or liquidation status are included.

Default — Percentage of loans purchased compared with the total loans disbursed by a lender. The total loans disbursed include the outstanding (active) portfolio, paid-in-full and charged-off loans.

Liquidation — 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.

Charge-off (Loss Rate) — Percentage of loans charged-off compared with total loans disbursed by a lender. The total loans disbursed included the outstanding (active) portfolio plus paid-in-full and charged-off loans.

APPENDIX IV. ONSITE EXAMINATION PROCESS

SBA's Standard Operating Procedure 51 00, *Onsite Lender Reviews and Examinations*, requires all SBA supervised lenders with SBA-guaranteed loan portfolios in excess of $10 million to have an onsite examination every 2 years. Examinations of SBA supervised lenders are conducted by Farm Credit Administration examiners (FCA) under contract with SBA. The examinations, which are patterned after the examinations employed by bank regulators, determine the safety and soundness of the lending institution and allow SBA to make an informed assessment of the lender's SBA lending operations and processes, including whether the lender employs prudent risk management practices.

A safe and sound institution is defined as one with adequate capital and financial performance, and that also operates in accordance with applicable laws, regulations, guidelines and other appropriate business practices. To ascertain whether a lender is safe or sound, the examiners review the lender's management, financial condition and performance, loan portfolio management, asset quality, and regulatory compliance. To assess asset quality, examiners review a statistical sample of loans in the lender's SBA portfolio to project the credit quality for the lender's entire SBA guaranteed loan portfolio. The sample of loans is classified into five categories to identify the risk residing in the lender's portfolio:

Acceptable	No deficiencies noted.
Other Assets	Loans are generally profitable but exhibit potential
Especially Mentioned	Weaknesses that could result in deterioration if uncorrected.
Substandard	Loans have well defined weaknesses or weaknesses that could hinder normal collection of the debt. While no loss potential may be identified to an individual substandard loan, SBA does expect that some losses will result from the total volume of substandard loans.
Doubtful	Loans have weaknesses similar to those of a substandard loan but are so extreme that significant loss potential exists. There is an element of doubt as to the full collection of the loan.

Loss Loans are considered uncollectible and no longer of any value. While there may be a partial recovery sometime in the future, there is no opportunity at present.

Loans in the last four categories are considered to be a credit or collection risk, and the last three categories are considered to be "adversely classified."

To assess regulatory compliance, examiners judgmentally select loans that were part of the statistical sample and review them for compliance with SBA's regulations and guidelines. Examiners generally limit the number of loans selected for a compliance review from 15 to 25 loans, regardless of the size of the lender's loan portfolio or lending activity.

APPENDIX V. AGENCY COMMENTS

DATE: April 22, 2008

TO: Debra Ritt
Assistant Inspector General for Auditing

FROM: Eric Zarnikow
Associate Administrator for Capital Access

SUBJECT: Response to the Office of Inspector General's Draft Report
Titled "Oversight of SBA Supervised Lenders"

Thank you for this opportunity to respond to the Office of Inspector General (OIG) concerning the draft audit report (Report) on Oversight of SBA Supervised Lenders. OCA is committed to maintaining appropriate lender oversight standards that balance the need for oversight with the ability to ensure that SBA can adapt to market changes and conditions. This flexibility is necessary in order to achieve our mission of providing critical assistance to the nation's small businesses and underserved markets.

COMMENTS ON REPORT FINDINGS:

Overall, the Report's findings are similar to those outlined in Report 7-28, *SBA's Oversight of Business Loan Center, LLC,* issued last year.

Though generally not discussed in this Report, OCRM has taken initiative to improve SBA's oversight efforts. We are disappointed to note that the Report continues to downplay the role concrete SBA oversight actions had in improvements to the lenders' risk ratings. SBA took appropriate oversight actions with these lenders, without suspending the lenders from the program; and as a result the raw LLMS risk scores for all four lenders improved. We believe the improvements are largely due to oversight efforts, though the final Report dismisses this conclusion.

Last month OCA met with you to clarify facts, calculations and procedures outlined in your draft Report. We appreciated the chance to speak with you about these issues. However, we felt that the information we discussed was largely not incorporated into the final report.

For example, OCA pointed out that the purchase cost figures cited in the report do not accurately portray the agency's ultimate losses, as they do not consider offsetting fees paid by the lenders and recoveries on loans purchased by SBA. This information was not revised in the final report. Instead, an additional figure was added indicating the net loss from these four lenders; however, the figure included losses incurred long before the

audit period, and included periods during which the program operated with subsidy. OCA believes this figure is misleading and not comparable to the other information described in the Report.

OCA has already provided extensive and detailed clarifications in an earlier meeting with you. Accordingly, this written response is limited to a formal response to the report recommendations. In addition, necessary redactions to the report will be provided by Friday, April 25th.

It is important to reiterate the Agency's strong commitment to balancing an effective oversight process with a flexible system that takes into account SBA's mission. The following responses are provided in that context.

RESPONSES TO RECOMMENDATIONS:

1. **Establish risk mitigation goals applicable to each loan program and the entire lending portfolio, and performance measures to indicate the progress in achieving the goals.**

   OCA will create risk mitigation objectives for the loan programs that would be reassessed periodically consistent with and balanced by the agency's mission.

2. **Develop standard operating procedures that will establish a hierarchy of enforcement actions addressing when and under what circumstances specific enforcement actions will be implemented, and require that any deviations from the procedures be justified in writing.**

   Once oversight regulations are in place, OCRM will develop standard operating procedures that will build on SBA's lender oversight enforcement framework and outline guidelines for applying specific actions to lenders.

3. **Issue guidance requiring that onsite examinations be conducted no earlier than 90 days prior to the delegated lending authority renewal period; and that lender compliance be determined based on a review of a statistical sample of loans.**

   Having current information to make determinations about delegated lending authority is important. Current information becomes even more important for lenders with significant risk characteristics. To the extent practicable, OCRM will consider the timing of delegated authority renewals as one factor in scheduling on-

site examinations particularly as it relates to those lenders with high risk ratings. However, given the complexities of scheduling, analyzing information and preparing reports from these examinations, OCA believes 90 days would not be a realistic timeframe.

As discussed with OIG in earlier meetings, OCRM believes the findings presented in your Report are based on a misunderstanding of the current methodology used to analyze compliance. However, OCRM will review its current process to determine the benefits and drawbacks of alternative methodologies.

4. **Develop guidance addressing when corrective action plans should be required and ensure that the plans include performance goals and milestones to be achieved by the lenders.**

   As contemplated by the response to Recommendation 2, once regulations are in place, OCRM will develop guidance around corrective action plans and assessing success under such plans.

5. **Explore the cost ramifications of providing LLMS data to lenders for loans that have a high likelihood of severe delinquency or default; and if cost-effective, include a provision in future LLMS contracts to share the data.**

   As part of the LLMS re-procurement process begun in January, OCRM asked for cost options around sharing LLMS data with lenders. Once this information is available, OCRM will consider the pros and cons of such data sharing.

6. **Improve the delegated lending authority process by revising SOP 50 10 to include specific criteria for renewals of delegated lending authorities. The criteria should address both the normal 24-month renewal periods, any abbreviated renewal periods, and the performance benchmarks used in the process.**

   OCA will develop further guidance for renewal of delegated lending authorities.

7. **Fully staff the National Guaranty Purchase Center at the Appropriate Level.**

   The staffing level at the NGPC currently exceeds the full complement needed to maintain operations at a steady state. In addition, surge capacity has been added both in Herndon and in Ft. Worth. Together, that staffing level exceeds what is recommended in the report.