Increasing Lender Liquidation Responsibility in the Section 7(a) Business Loan Program

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ABBREVIATIONS

CLP	Certified Lenders Program
CFR	Code of Federal Regulations
FDIC	Federal Deposit Insurance Corporation
LIP	Liquidation Improvement Project
NADCO	National Association of Development Companies
NAGGL	National Association of Government Guaranteed Lenders
OFA	Office of Financial Assistance
OIG	Office of Inspector General
OIRM	Office of Information Resource Management
OMB	Office of Management and Budget
PLP	Preferred Lenders Program
SBA	Small Business Administration
SBLC	Small Business Lending Company
SOP	Standard Operating Procedure
UCC	Uniform Commercial Code

EXECUTIVE SUMMARY

Purpose and Background

The Office of Inspector General (OIG) initiated this inspection out of concern that increased loan volume and decreased staffing may diminish SBA's capability to monitor and perform loan liquidations. The inspection's objective was to examine the lenders' role in the liquidation process and explore the potential for increasing their responsibility for liquidating SBA loans.

Under Section 7(a) of the Small Business Act, the Small Business Administration (SBA) guarantees loans made by private lenders, i.e., banks and Small Business Lending Companies (SBLCs), to small business borrowers who cannot obtain credit elsewhere on reasonable terms and conditions. The Section 7(a) program has increased dramatically in recent years. The number of Section 7(a) loans approved each year more than tripled between FY 1990 and FY 1996, from 10,848 to 45,845. Over the same time period, the number of SBA employees decreased from 4,120 to 3,054. The increase in workload combined with the decrease in staff is straining an already overburdened SBA liquidation workforce. Even if default rates for the Agency remain unchanged, the number of loan liquidations can be expected to rise because of the increase in the number of guaranteed loans.

The inspection team examined the lenders' role in the liquidation process and compiled the arguments for and against increasing lender liquidation responsibility. We performed an extensive review of the current legislation, regulations, and standard operating procedures (SOPs) governing the liquidation process. The team conducted interviews with SBA officials at 11 district offices and, with the assistance of Agency officials, identified 17 SBA lenders for our sample. The lenders varied by size, geographic location, small business lending focus, and type (bank or SBLC). We then obtained their views on the respective roles of the Agency and lenders in the liquidation process.

Generally, a loan is transferred to liquidation status when it becomes apparent that the borrower cannot repay or if insolvency proceedings have been initiated. Once a lender has asked SBA to honor its guaranty, it is the Agency's policy to have the lender service and liquidate the loan. If SBA chooses to handle these responsibilities itself, the lender must assign the loan to the Agency. Lenders participating in the Preferred Lenders (PLP), LowDoc, and FA$TRAK programs are required to liquidate all of their 7(a) loans with minimal involvement by SBA. The liquidation activity of lenders in the Certified Lenders Program (CLP) and general loan program is monitored more closely by SBA.

Conclusions

Based on the information gathered during the inspection, the team has reached the following conclusions:

1. **Existing Controls in the Liquidation Process Should Adequately Protect the Interests of the Government, If Consistently and Effectively Applied.** SBA has in place a number of regulations, SOPs, and other controls that encourage lenders to obtain maximum recoveries or allow SBA to take action against lenders for negligent liquidation actions. Controls include the requirement of a lender liquidation plan, a reduced guarantee percentage on 7(a) loans as an incentive for recoveries, the ability to deny or repair SBA's guarantee liability, special requirements for participation in the certified and preferred lender programs, and laws outlined in the Uniform Commercial Code governing the sale of some collateral. The lenders in our sample believe that these measures provide appropriate incentives and disincentives and effectively safeguard SBA's interests when they are objectively and uniformly applied.

2. **SBA Currently Does Not Take Full Advantage of Lender Liquidation Capabilities**. We believe that SBA should no longer be involved in a step-by-step transactional liquidation role for PLPs and CLPs, especially in light of the Agency's reduced resources. Instead, it needs to commit its resources to effective monitoring of their activities. This approach would make more efficient use of SBA resources while also alleviating the pressure from Congress and lender associations to give more authority to lenders to liquidate their SBA loans.

   At the district level, two distinct and equally entrenched points of view exist about how much responsibility lenders should be given to liquidate loans. Some districts give lenders a great deal of latitude, while others have adopted a more conservative approach, often making many of the liquidation decisions themselves. Inconsistencies among district offices often confuse and frustrate lenders seeking guidance on liquidation policies and procedures. SBA recognizes this problem and is addressing it with policy notices intended to encourage greater consistency. SBA is also making an effort to upgrade information systems for monitoring.

   The OIG inspectors also found strong differences of opinion between lenders and SBA officials regarding the ability of lenders to take on more liquidation responsibility and to maximize recoveries. Most agency officials expressed doubt regarding lender liquidation capabilities, while most lenders stressed their advantages. Because of deficiencies in performance data on individual lenders, district officials are seriously hampered in assessing their lenders' ability to handle their liquidation responsibilities.

   There appear to be no compelling reasons for keeping PLP and CLP lenders from assuming full responsibility for liquidating their SBA-guaranteed loans, as mandated by legislation. All credible lenders have procedures for loan liquidation and banks are regulated by Federal and State agencies which require liquidation procedures. Further, PLP and CLP lenders are reviewed by SBA for their ability to liquidate when they apply to the programs.

Recommendations

Based on these conclusions, we recommend that the Associate Administrator for Financial Assistance:

1. **Develop policies to refocus SBA's efforts away from direct involvement in liquidation activities and toward improved monitoring of PLP and CLP performance.**

2. **Use the new decision-making authority given to PLPs and CLPs to conduct a test of a "hands-off" liquidation policy.**

3. **Create a reliable method for collecting data to measure individual lender liquidation performance.**

SBA Comments

The Acting Associate Administrator for Financial Assistance agreed with the report's conclusions and indicated that steps have already been taken to carry out the recommendations. The Office of Financial Assistance (OFA) has begun to implement the requirements of the Small Business Improvement Act of 1996, which gives PLP lenders complete authority to liquidate loans and CLP lenders expedited approval procedures. OFA is also developing courses for SBA liquidation personnel that " . . . will highlight the need to enable lenders to complete their own loan liquidations with minimal SBA involvement . . . ." OFA has also prepared a policy notice that, once issued, should promote greater uniformity in the way district offices handle their relationships with PLP lenders in liquidation matters. The Acting Associate Administrator agreed that OFA needs a better automated system to oversee lender performance in loan liquidations. She indicated that systems modifications for producing performance data will be made to the planned Risk Management Database.

BACKGROUND

SBA guarantees loans to businesses that are unable to obtain other financing on reasonable terms through normal lending channels. The Small Business Act of 1953 requires that all loans be of sound value or be reasonably secured to ensure repayment. To meet the requirements of the law, SBA and its lenders seek to secure as much collateral as necessary for loans, although inadequate collateral cannot be the only reason for denial of a loan request. In guaranteeing loans, SBA also emphasizes that borrowers must show their repayment ability. As a result, its loans involve a degree of risk that must balance providing needed credit assistance with protecting the Government's interest. When a borrower fails to repay a guaranteed loan, SBA or the lender may liquidate pledged collateral to obtain loan repayment. Generally, if collateral proceeds are insufficient, SBA may pursue personal guarantees or obligations provided by business owners or others in support of the loan.

The Section 7(a) business loan program has grown dramatically in recent years. Between FY 1990 and FY 1996, the number of Section 7(a) loans approved each year more than tripled, from 10,848 loans to 45,845. The dollar value of approved loans each year increased from $3 billion in FY 1990 to $7.7 billion in FY 1996. At the end of FY 1996, SBA's share of the outstanding portfolio stood at $21 billion.

While loan volume has grown significantly, the number of SBA employees has decreased 26%, from 4,120 in 1990 to 3,054 in 1996.[1] The increase in loan volume combined with this decrease in staff is straining the SBA liquidation workforce. Even if default rates remain the same, the number of loan liquidations will still rise because of the increase in guaranteed loans. The Office of Management and Budget (OMB) emphasized in its 1997 "budget guidance" letter to the SBA Administrator that "the recent substantial increases in your loan program will likely result in an expanded portfolio of defaulted and repurchased loans in a period where Government resources are declining." Accordingly, OMB requested that SBA management consider all available options to meet the challenges created by such rapid portfolio growth.

According to regulations, "SBA or the lender may liquidate collateral securing a loan if the loan is in default or if there is no reasonable prospect that the loan can be repaid within a reasonable period."[2] Generally, loans are transferred to liquidation status when it becomes apparent that the borrowers cannot repay. Loans must also be placed into liquidation if any type of insolvency proceedings, such as foreclosure, bankruptcy, or receivership, have been initiated or if collateral has been abandoned by the borrower. Once a lender has asked SBA to honor its guaranty, it is the Agency's policy to have the lender service and liquidate the loan. If SBA chooses to handle these responsibilities itself, the lender must assign the loan to the Agency

[1]These figures exclude employees funded by separate disaster assistance appropriations.

[2]Federal Regulations (13 CFR § 120.540(a))

Lenders participating in the Preferred Lenders (PLP), LowDoc, and FA$TRAK programs are required to liquidate all of their 7(a) loans with minimal involvement by SBA. The liquidation activity of lenders in the Certified Lenders Program (CLP) and general loan program is monitored more closely by SBA. As of September 30, 1996, there were approximately 7,000 active SBA lenders, including 387 PLP and 627 CLP lenders.[3] In FY 1996, approved PLP and CLP loans together accounted for 31% of the number and 56% of the value of SBA guaranteed loans.

During the inspection, the Office of Financial Assistance (OFA) began an internal review of SBA's liquidation processes. The Liquidation Improvement Project (LIP) is composed of two working groups tasked with recommending improvements in SBA's internal practices and procedures for liquidating 7(a) loans. One group is focusing on steps that field offices can take to reduce the length of time for completing liquidations while increasing recoveries. The second group is looking into automated systems for improving data collection and reporting. It was not within the scope of this inspection to assess these initiatives; nevertheless, they appear to complement our efforts by focusing on ways to increase efficiency in SBA's internal loan liquidation process.

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[3]Active lenders are defined by the SBA's Office of Financial Asssistance (OFA) as those lenders having originated at least one SBA loan over the past year.

OBJECTIVE, SCOPE AND METHODOLOGY

The Office of Inspector General (OIG) initiated this inspection in June 1996 out of concern that increased loan volume and decreased staffing may diminish SBA's capability to monitor and perform loan liquidations. The inspection's objective was to examine the lenders' role in the liquidation process and explore the potential for increasing their responsibility for liquidating SBA loans. We postulated that by encouraging its best lenders to increase their responsibility, SBA could concentrate its limited resources on resolving more complex cases and on monitoring the lenders' performance in liquidating their SBA loans.

As SBA's loan volume increases, it becomes increasingly important to secure a proper balance between the Agency's role as loan guarantor and the lenders' role in implementing SBA's loan programs. The inspection addresses these concerns in several ways. First, it examines the laws and policies that affect lender liquidations, including recent legislation. Second, it provides an overview of the arguments for and against giving lenders more authority to liquidate their SBA guaranteed loans. Third, it summarizes various options available for increasing lender liquidation responsibility in a manner that is consistent with the goals and objectives of the 7(a) program. The widening gap between the program's mandate and available resources provides a framework for our analysis.

In reviewing SBA's liquidation procedures, the inspection team used documents from OFA, the Office of Information Resource Management (OIRM), and the Office of the Chief Financial Officer (CFO). We also examined relevant documents from other organizations, such as the Federal Deposit Insurance Corporation (FDIC), OMB, the National Association of Government Guaranteed Lenders (NAGGL), and the National Association of Development Companies (NADCO). The team conducted interviews with SBA officials at 11 district offices and with representatives from 17 lending institutions, including 13 PLP lenders, three CLP lenders, and one general program lender. Fourteen of the lenders were banks and three were Small Business Lending Companies (SBLC). We also conducted an extensive review of the current legislation, regulations, and Standard Operating Procedures (SOPs) governing the liquidation process.

To select the district offices for field visits, the team reviewed SBA-generated data on loan liquidation volume, charge-off volume, and the ratio of bank- serviced to SBA-serviced liquidations for 1995. Using this information, along with geographic locations, the team developed a matrix of offices to visit. We concentrated on selecting districts with diverse data elements to ensure a broad representation of perspectives. We also focused our attention on districts with significant experience in liquidating loans, i.e., those that handled at least one hundred liquidation cases in 1995. After drafting an original list of districts, the team consulted with senior OFA officials, who recommended the addition of one district. With the additional district, the OFA officials agreed that the list was appropriate for obtaining a range of Agency views on the advantages and disadvantages of turning more liquidation responsibility over to lenders. (See Appendix A for information on the districts visited for this report.)

To ensure inclusion of a broad representation of lenders in the sample, the team considered the asset size, loan volume over a five year period, liquidation volume over a five year period, and participation status (PLP, CLP, or general lender) in the SBA loan program. The team consulted with district officials to identify appropriate lenders to include in the sample. Again, the objective was to interview lender representatives from diverse institutions to obtain their perspectives on the potential costs and benefits of giving the lenders greater responsibility for liquidating SBA loans. (See Appendix B for loan and liquidation data that describes the characteristics of the lenders visited.)

All work on this inspection was conducted between June 1996 and September 1996 in accordance with the **Quality Standards for Inspections** issued in March 1993 by the President's Council on Integrity and Efficiency.

CONCLUSIONS

1. Existing Controls in the Liquidation Process Should Adequately Protect the Interests of the Government, If Consistently and Effectively Applied.

There are a number of regulations, SOPs, and controls currently in place which either encourage lenders to obtain maximum recoveries or allow SBA to take action against lenders for negligent liquidation actions. Controls include a required lender liquidation plan; a reduced guarantee percentage on 7(a) loans; the ability to deny or repair SBA's guarantee liability; requirements for participation in the general, CLP, and PLP programs; and laws outlined in the Uniform Commercial Code (UCC) governing the sale of some collateral. The lenders stated that these factors provide effective incentives and disincentives and safeguard SBA's interest when objectively and uniformly applied. In addition, lender liquidation responsibility is being expanded through recent legislation and the SBA's revised regulations. Particularly with respect to the PLP and CLP participants, Congress has determined that lenders should have more authority in the liquidation process.

The following controls guide lenders in the liquidation process:

a. SBA Requires a Detailed Liquidation Plan.

Any lender given liquidation responsibility by SBA is required to complete a liquidation plan. For lenders without the PLP or CLP designation, the liquidation plan must be approved by SBA before any action is taken. The Small Business Improvement Act of 1996 gives PLP lenders complete authority to liquidate loans without obtaining the prior approval of SBA. CLP lenders are given automatic approval if a plan has not been approved or denied within a specified length of time.

SBA's standardized liquidation plan provides the Agency with information on why a loan should be transferred to liquidation status, the cause of the business breakdown, a proposed recovery plan, and an estimate of the value of recovery and expenses, including attorney fees.

b. Non-guaranteed Portion of the Loan Gives the Lender a Stake in the Outcome.

In FY 1996, SBA reduced the guarantee percentage to 75 percent on all general business loans over $100,000 and to 80 percent on loans of $100,000 or less,[4] making lenders liable for a larger portion of their loans. A number of lenders and SBA officials stressed that liability for the unguaranteed portion of a loan is a strong motivation for achieving maximum

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[4]The only exception to the 80 percent guarantee limit is for the Export Working Capital Loans (EWCP). The Small Business Improvement Act of 1996 raised the guaranty amount for EWCP loans to 90 percent.

recoveries.

c. SBA Can Deny Liability or Reduce Guaranty.

Federal regulations state that SBA is released from liability on its guarantee when the lender has failed to liquidate a loan in a prudent manner.[5] Denial of liability is pursued only when all other efforts to correct problems have failed. The SOPs state that SBA should explore all other options for resolving the problem including a reduction of the guaranty ("repair") or a voluntary cancellation of the guaranty by the participant. While denial of liability is used infrequently, it can provide an incentive for program participants to responsibly manage and liquidate their SBA loans.

d. Participation in the Preferred and Certified Lender Programs is Selective.

SBA operates two special programs within its 7(a) loan guarantee program: the CLP and the PLP. For CLP participants, loan applications and servicing actions are given priority by SBA loan officers. In exchange for quicker service, the lenders are required to close, service, and, in some cases, liquidate SBA guaranteed loans. Participants in the PLP program are authorized to ". . . process, close, service, and liquidate SBA guaranteed loans with reduced requirements for documentation to and prior approval by SBA."[6]

A number of lenders indicated that preferred lender status provides a strong incentive to efficiently liquidate SBA loans. For example, one PLP participant stated that it was proud to be a PLP lender and wanted to keep the special designation. A district official confirmed that because many lenders seek PLP status, it is an effective incentive in making sure lenders efficiently liquidate their SBA loans. The official felt that SBA should do more to monitor the performance of lenders given the authority to liquidate loans and use the PLP or CLP designation as a tool to keep lenders focused on the interests of SBA.

e. The Uniform Commercial Code (UCC) Provides Rules for Selling Some Collateral.

A lender can be sued by a borrower if the latter can show that the lender acted in a commercially unreasonable manner regarding the disposition of non-real estate collateral. Article 9-504 of the UCC states "[A] sale or other disposition may be . . . at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be *commercially reasonable* [emphasis added]." Rulings involving Article 9-507 reiterate that a debtor has the right to recover any losses caused by an unreasonable sale, provided a debtor who has defaulted can show that repossessed

[5] Federal Regulations (13 CFR § 120.524).

[6] Ibid, § 120.450.

collateral was sold for less than fair market value.[7] A lender can be held financially responsible for the difference between the fair market value of the collateral and the proceeds received from the sale. One lender interviewed cited the UCC as a motivation for maximizing recoveries.

In the Small Business Improvement Act of 1996, Congress took steps to strengthen the role of PLP and CLP participants in the liquidation process. The Act stated that PLP lenders are delegated ". . . *complete authority* to service and liquidate such loans *without obtaining prior approval* of the Administration for routine servicing and liquidation activities . . . [emphasis added]."[8] Lenders are limited only if there is an actual or apparent conflict of interest. A provision was also added to permit CLP participants to liquidate loans ". . . pursuant to a liquidation plan approved by the Administrator."[9] The Act specifies that if a liquidation plan is not approved or denied within 10 business days from the date the request is made (or within 5 days for any routine liquidation activity), the plan is automatically approved. OFA plans to incorporate these changes into the SOPs and to provide district officials with policy guidance for applying these new provisions.

SBA's own regulations make the role of lenders in liquidating loans less clear. They state that one of the requirements for all participating lenders is the ability to process, close, service and liquidate loans. While the wording implies that all lenders are deemed capable of liquidating their SBA loans, other language is more ambiguous: ". . . *generally*, after SBA honors its guarantee, the lender must continue to hold the Loan Instruments and service and liquidate the loan [emphasis added]."[10] The regulations also state that if SBA chooses to service or liquidate a loan, the lender must turn the loan over to SBA.

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[7] Uniform Commercial Code, § 9-507, note 53 - Contrail Leasing Partners, Ltd. v. Consolidated Airways, Inc., 742 F.2d 1095 (7th Cir. 1984); and note 56 - Bank of China v. Chan, 937 F.2d 780 (2nd Cir. 1991).

[8] PL 104-208, Title 1 of Division D, the Small Business Improvement Act of 1996, § 103 (a) (II).

[9] Ibid, § 103 (C) (ii)

[10] Federal Regulations (13 CFR § 120.512).

2. SBA Currently Does Not Take Full Advantage of Lender Liquidation Capabilities .

It is the Agency's policy to encourage lenders to liquidate their SBA defaulted loans.[11] As previously mentioned, regulations, SOPs, and other safeguards already provide guidance and protect taxpayers from any lender who does not liquidate collateral efficiently. To protect the public interest, SBA has the authority to take over servicing when a situation, such as a conflict of interest or a complicated liquidation, warrants such action. Furthermore, SBA has the authority to deny liability or to repair the guaranty if the lender has failed to comply materially with any of regulations, Loan Agreement, or Authorization; failed to make, close, service, or liquidate a loan in a prudent manner; or misrepresented or failed to disclose to SBA a material fact regarding the loan.[12]

The inspection team found no compelling reasons for keeping PLP and CLP lenders from taking on full responsibility, as mandated by legislation, for liquidating their SBA loan portfolio. With few exceptions, lenders who make commercial loans as part of their business should be equipped to liquidate those loans. Inherent in every loan is a risk of default and liquidation and, as some lenders pointed out, all credible lenders have procedures for loan liquidations. Further, bank lenders are regulated by Federal and State agencies that require written liquidation procedures, and there is increasing pressure from lender associations and the Congress to give more authority to program participants to liquidate their own loans. Given the existing authority in SBA regulations, the substantial increase in 7(a) loan volume in recent years, and the reduction in SBA staff available to liquidate loans, district officials appear to have strong incentives for providing PLP and CLP lenders with every opportunity to liquidate their SBA guaranteed loans. The OIG inspection team believes that PLP and CLP lenders should not be burdened with proving their ability to liquidate loans on a case-by-case basis because that ability is a requirement for becoming a CLP or PLP participant in the first place.

Lenders interviewed during the inspection stressed their frustration with SBA practices that require approval from the district for each step in the liquidation process--including actions taken after the liquidation plan was approved. This was particularly true of PLP participants who, according to the Agency's regulations, ". . . must liquidate any SBA guaranteed defaulted loan in its portfolio."[13] The lenders asserted that filing a liquidation plan is useful, but protracted delays in obtaining SBA approval often prove costly because of the increased opportunity for collateral to be lost or damaged. In addition, they noted inconsistencies at the district level in determining how much liquidation responsibility should be given to lenders, including PLP and CLP lenders. A typical example of what appears to be an excessive transactional role by SBA was provided by a PLP participant who has been required by the district office to obtain permission for each liquidation action, even after the plan has been approved. While the lenders

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[11]Ibid.

[12]Ibid, §120.524.

[13]Ibid, § 120.453.

we spoke with overwhelmingly supported expanding their role in the liquidation process, they stressed that this authority should only be given to lenders with a proven track record in loan underwriting and recovery.

Two distinct points of view appear to exist in SBA's district offices with regard to how much responsibility lenders should be given to liquidate loans. Some districts give lenders a great deal of latitude in liquidating their own loans; others stress close control over liquidation activities, requiring lenders to seek SBA approval for each step in the process. This inconsistency among district offices confuses and frustrates lenders seeking guidance on what is expected of them when they liquidate a loan. Further, lenders that deal with more than one district are subject to differing liquidation rules. PLP and CLP lenders argue that having to wait for permission at each step causes unnecessary delays that can be detrimental to recovery; they assert that moving quickly in a liquidation affords the greatest possibility for a high recovery. For example, one lender stated that waiting for approval to liquidate can result in lost inventory. Moving in fast and taking possession of inventory or other collateral protects it from "walking out the back door" and produces higher recoveries for both the lender and SBA.

The inspection team found strong differences of opinion between various district officials and lenders regarding the willingness and ability of lenders to take on more liquidation responsibility and to maximize recoveries. For example, some district officials believe that smaller lenders and those with low loan and liquidation volume do not have the staff or the expertise to efficiently liquidate SBA loans. SBA rules and regulations are complex, and these officials believe that unless a lender is constantly exposed to the process, it will not be effective in liquidating loans. Alternatively, smaller lenders interviewed contended that their size is an advantage because it allows them to maintain close contact with small business borrowers and monitor their business activity closely. Moreover, they asserted that they are aware of how losses, no matter how small, affect profitability. Some lenders did agree that with a low volume of liquidations, more direction from SBA may be required, but many felt that lenders should be precluded from participating in SBA lending programs if they do not demonstrate the necessary expertise.

Another area of disagreement concerns lender motivation to maximize recoveries. Some Agency officials believe that lenders do not have sufficient incentive once the guarantee has been paid, so it is important that SBA closely supervise lender-serviced liquidations. Conversely, lenders stressed that they are concerned with making a profit, which requires recovering as much as possible of the nonguaranteed portion of a loan. They argued that working out a loan and achieving a high recovery are more important than SBA's emphasis on closing cases, a practice which may detrimentally affect recoveries.[14]

Other reasons district officials stated for exercising tight control of much of the liquidation process include the following:

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[14]SBA has adopted a new policy that encourages districts to close cases within twelve months--and within eighteen months if litigated.

- There is a substantial amount of turnover in private lender staff. District officials pointed out that it is really individuals--not their lending institutions--who develops skills in liquidating loans. Bank mergers, employee promotions, and job transfers make it difficult for SBA to accurately gauge an institution's capability to liquidate loans at any given time.

- Some lenders are reluctant to take on more responsibility for liquidating loans. Because of the cost and time involved in liquidating, they prefer to have the Agency liquidate their SBA loans.

- Lenders are constantly looking for advice from the Agency--fearing that any mistake they make will result in the loss of a loan guarantee. As a result, too often the SBA liquidator then ends up handling the liquidation process.

Lenders countered these arguments by pointing out advantages that they have over the Agency in liquidating SBA loans:

- Many lenders have established branch systems that allow many of them to develop an in-depth knowledge of the community and their customers. This serves as an early warning system for potential problems with a particular loan. Lenders with a network of branches believe they are in a better position to work out and, if necessary, liquidate SBA loans than are Agency officials located in a district office.

- Lenders' smaller caseloads allow them to move more quickly on liquidations. Currently, many SBA liquidators' caseloads are very large--some are handling over 100 cases apiece. According to both SBA and lender officials, this workload results in slow response times in the approval of lender liquidation actions.

- Lenders have the ability to hire outside contractors, if needed, to speed up the liquidation process and provide flexibility in obtaining legal services. SBA has to use U.S. Attorneys on loan liquidations. According to an SBA attorney, among others, their caseloads are usually heavy and SBA liquidation cases are not a high priority. This can slow the liquidation process and result in lower recoveries.

- Lenders in the PLP and CLP programs have made commitments to the SBA. By liquidating collateral in a timely and efficient manner, they can demonstrate their ability to maintain their sought-after status as Certified or Preferred lenders.

While substantially increasing lender responsibility for liquidations appears both practical and necessary, turning over full authority may not be a prudent policy in all cases. Currently, SBA has no systems in place to review a lender's aggregate performance, assess its success as liquidators, or establish sanctions for poor performance.

SBA is gathering data on lender liquidations, but the information currently available on individual lenders is incomplete. For example, there is no reliable data available from either SBA or the lenders that tracks the performance of individual lenders in the liquidation process. An April 19, 1996, Liquidation Improvement Project Team report confirmed that ". . . data problems [at SBA] exist. The agency has no idea whether costs (e.g., bank's, environmental [impact studies], appraisals, auctioneers, etc.) are fair or not." Lender data provided to the inspection team was also inconsistent in terms of detail and quality.

Because of these deficiencies in performance data, district officials are hampered in their ability to assess lenders' handling of their liquidation responsibilities. Until a system is in place to measure their effectiveness, it may be imprudent to turn full liquidation authority over to general program lenders. Both PLP and CLP lenders have been reviewed by the Agency through both the application process and periodic monitoring.[15] Therefore, if they are not capable of liquidating SBA loans, we believe they should not remain in either program. General program lenders have not gone through a comparable review process, and their ability to liquidate has not been examined. While SBA should continue to carefully monitor their liquidation activities, it would be advisable for the Agency to explore ways to increase the general lenders' role in the liquidation process.

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[15]PL 104-208 requires SBA to establish a standard review program for preferred lenders. This review will consist of annual assessments of lender loans, defaults, and recoveries of loans. This review is also to be used for new entrants to the program. Current SOPs require a biennial review of preferred lenders.

RECOMMENDATIONS

We recommend that the Associate Administrator for Financial Assistance:

1. **Develop policies to refocus SBA's efforts away from transactional liquidation activities and toward improved monitoring of PLP and CLP liquidation performance.**

2. **Use the new decision-making authority given to PLPs and CLPs to conduct a test of a "hands-off" liquidation policy.**

3. **Create a reliable method to measure individual lender liquidation performance.**

SBA no longer has the resources to continue to approve each liquidation action for all SBA- and lender-serviced liquidations--even if it were a desirable function for SBA to perform. Agency officials and lenders both stressed that SBA liquidator workloads are currently too large to be handled effectively. For example, four out of the six Agency liquidators with whom we spoke had one hundred or more cases. Reduced clerical staffing has increased the amount of paperwork liquidators must complete, and the problem is likely to grow in the future as the liquidation volume expands and staffing levels remain constant or decrease. Delays resulting from heavy Agency workloads frustrate lenders and may reduce recoveries. Also, U.S. Attorneys often cannot find time to handle SBA liquidation cases. While no data was available on how long it takes for U.S. Attorneys to litigate such cases, an SBA attorney provided several examples of cases sent to U.S. Attorneys for prosecution that were ignored because of standing backlogs and prosecutorial priorities.

With respect to PLP and CLP lenders, we believe that SBA should move aggressively away from its traditional transactional liquidation activities and instead focus its limited resources on more effective monitoring of lender liquidation activity, intervening only when serious problems are indicated. This approach would require the Agency to develop and implement objective criteria for measuring lender performance, e.g., purchase rates, recovery rates, timeliness, and the costs of liquidation, including any legal expenses. While this plan would also require more uniform implementation of policies by the districts than currently exists, the main benefit would be a more efficient use of both SBA and lender resources. It would also facilitate a decrease in the workload of SBA liquidation staff to more reasonable levels and allow the staff to apply their knowledge and experience in a way that would better protect taxpayer dollars. The PLP and CLP lenders should feel less encumbered in performing their liquidation responsibilities, but they would also be held more accountable through SBA's aggressive monitoring.

SBA liquidator efforts could be redirected to performing functions that promote efficiency in lender liquidations. For example, instead of being assigned cases individually, liquidation staff could be given a portfolio of lenders in their district to monitor and be required to visit each lender periodically to examine a sample of liquidation cases for compliance. They could also be responsible for reviewing a final status report on each liquidation case to ensure that baseline

liquidation recovery levels are maintained.

The OIG inspection team found that there is no system currently in place to track the ability of individual lenders to liquidate SBA loans. Inconsistencies in how program policies are carried out at the district level hinder efforts to determine the overall effect of lenders taking on greater liquidation responsibilities. The absence of information on liquidation performance may also impede SBA in measuring the impact of internal efforts to promote efficiency. The current Congressional mandate to turn over full authority to PLP lenders and expand the authority of CLPs provides an excellent opportunity for SBA to begin measuring the ability of SBA's most trusted lenders to liquidate their bad loans. According to a number of lenders, the intervention by district offices that insist on approving each step of the liquidation process has created unnecessary delays in many of the liquidation efforts of PLPs. At this point, no one can estimate with any certainty the impact on recoveries if preferred lenders were given full, and CLPs expanded, authority to liquidate loans. Developing procedures to implement the new legislation provides SBA an opportunity to establish consistent directives at the district level to encourage lenders to achieve maximum recoveries in the minimum about of time.

If SBA moves away from transactional activities, i.e., reduces its intervention in the lenders' liquidation operations and converts more of its liquidation activity to a monitoring function, the Agency will need to collect data that tracks each lender's performance in liquidating loans. While the Small Business Improvement Act of 1996 requires SBA to collect a variety of data on its guaranteed loans, no mention is made of monitoring the costs of lender liquidations.[16] Yet, we found this to be one of the primary concerns expressed by SBA officials. The Agency requires liquidation plans to include estimates of costs and instructs SBA officials to review and determine the reasonableness of these expenses. SOPs also direct a lender to obtain SBA's approval before proceeding with major changes in a plan, including expenses. Because cost information is only examined on a case-by-case basis, the information cannot be used for evaluative purposes. Aggregate collection and tracking of detailed cost information would allow SBA to determine average liquidation costs and to identify those lenders with abnormally high costs.

OFA plans to require each lender liquidating an SBA loan to submit a "wrap-up" report that will summarize the results of the liquidation. The report will include an accounting of all recoveries and expenses, copies of site visit reports, a copy of the initial lender liquidation plan, an explanation of how collateral was liquidated, and detailed information supporting legal fees. This information will provide SBA the opportunity to develop a profile on individual lender liquidation performance and track lenders' aggregate liquidation activities. Capturing this information will facilitate meeting the data collection requirements of the Small Business Act amendments, as well as those of the Government Performance and Results Act. It could also

[16]Section 102 of the Small Business Improvement Act of 1996 requires SBA to establish a database capable of providing timely and accurate information in order to identify loan underwriting, collections, recovery, and liquidation problems.

provide important performance measures for use in determining which lenders need closer monitoring. The OIG is prepared to assist the Agency in additional efforts to gather meaningful data by designing a pilot test to determine the recovery rates and expenses over a set time period of a sample of PLPs given full responsibility for their liquidations.

Final Comments

The OIG inspection team was impressed with the knowledge and dedication of both the SBA officials and lender representatives we contacted and was also struck by how well many SBA liquidators are managing such large caseloads. Each liquidation case is different and involves a set of complex factors including legal considerations, monetary constraints, and policy goals. Consequently, the team believes that SBA liquidators can continue to provide critical services in a role that focuses on monitoring PLP and CLP liquidations, rather than continuing direct operational responsibilities for such activities.

While we have not attempted a detailed analysis of SBA liquidation workloads, it appears that most, if not all, of the existing staff could be engaged in the monitoring and troubleshooting tasks required of effective policy implementation by the Agency. There appears to be room for building greater efficiency into the liquidation process, particularly in expanding the role of SBA's lending partners. The experience of SBA's field liquidators and the willingness of lenders to assume more responsibility for liquidation provide a foundation for collecting data, effectively monitoring lenders, and consistently executing SBA liquidation policy.

APPENDIX A

SBA District Characteristics

This table describes liquidation activity in the six districts visited by the inspection team.

District	Liquidation Volume [a]	Charge-Off Volume [b]	Ratio of Servicing (SBA %/Bank %) [c]
Augusta, ME	68	185	50/50
Boston, MA	202	49	96/4
Chicago, IL	196	59	37/63
Dallas, TX	226	57	59/41
Los Angeles, CA	614	26	70/30
San Francisco, CA	494	49	53/47

This table describes liquidation activity in districts consulted for background and supporting information.

District	Liquidation Volume [a]	Charge-Off Volume [b]	Ratio of Servicing (SBA %/Bank %) [c]
Birmingham, AL	76	41	100/0
Denver, CO	88	21	86/14
Clarksburg, WV	27	16	12/88
Montpelier, VT	96	57	19/81
San Diego, CA	125	32	34/66

[a] Liquidation volume represents the number of loans in liquidations as of 4/1/96. Source: Office of Financial Assistance, U.S. Small Business Administration.

[b] Charge-off volume represents the number of loans charged off in FY 1995. Source: Data provided by the Office of Resource Information Management, U.S. Small Business Administration.

[c] Calculated from FY 1995 data provided by the Office of Resource Information Management, U.S. Small Business Administration.

APPENDIX B

LENDER CHARACTERISTICS

The inspection team asked the 14 lenders we visited to characterize their experiences with bank-serviced SBA loan liquidations. The intent was to obtain information that described our sample.

Number of SBA loans originated by each lender
in the last 5 years (includes 7(a) and Low Doc)

YEAR	1991	1992	1993	1994	1995
AVERAGE	47.73	56.25	55.67	72.42	85.17

Number of SBA loans liquidated by each lender
in the last 5 years (includes 7(a) and Low Doc)

YEAR	1991	1992	1993	1994	1995
AVERAGE	2.55	3.09	5.73	4.36	6.18

Average time it takes to complete a
bank-serviced SBA loan liquidation

AVERAGE (in months)	9.25

Number of lender staff assigned to
small business liquidations

AVERAGE SIZE OF STAFF PER LENDER	3.75

Lender cost as a percent of
total liquidation cost

	1991	1992	1993	1994	1995
Attorneys	69.40	61.2	44.50	34.83	40.43
Environmental Report	6.40	7.40	6.17	10.50	1.29
Appraisers	5.80	6.80	23.00	4.67	7.14
Auctioneers	0.00	1.60	4.83	7.17	5.00
Taxes	2.40	5.80	0.17	3.83	1.00
Utilities	0.00	0.00	2.67	0.83	7.00
Other	16.00	17.20	18.67	21.50	23.14