United States Senate
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510–6350

May 12, 2008

The Honorable Steven C. Preston
Administrator
U.S. Small Business Administration
409 Third Street, S.W.
Washington, D.C. 20416

Re: Office of Inspector General (OIG) Report on Oversight of Small Business Administration (SBA) Supervised Lenders (OIG Report No. 08-12)

Dear Administrator Preston:

After reading the OIG report released last week entitled, "Oversight of SBA Supervised Lenders," we wanted to once again express our frustration with the SBA's lender oversight efforts. As you are aware, this is the second time in seven months that the OIG has been critical of the SBA's failure to take proper enforcement measures against high-risk lenders. In November, you testified at a Senate Committee on Small Business and Entrepreneurship (Committee) hearing in connection with a prior OIG report that helped uncover more than 70 fraudulent SBA loans, totaling about $76 million. At the time, you assured us that the new lender oversight process being implemented by the SBA would vastly improve enforcement efforts.

Unfortunately, that has apparently not happened. The new OIG report describes how the SBA purchased over $239 million in guarantees on loans made by four lenders that failed to meet the performance benchmarks established by the SBA. As of September 2007, the SBA had incurred a cumulative net loss from the four lenders of $329 million. In two instances, the SBA actually expanded the authority for lenders with portfolios at risk. Such occurrences are simply unacceptable, especially at a time of growing uncertainty in our nation's credit markets.

As we have indicated in the past, we believe that one of the root causes of the SBA's poor lender oversight record can be attributed to the inherent conflicts that exist in the organizational structure adopted by the SBA. Like two previous OIG reports, the latest OIG report criticizes the SBA for housing the Office of Credit Risk Management (OCRM)—the SBA office charged with lender oversight—within the Office of Capital Access (OCA), which is the SBA office responsible for promoting the agency's loan programs. Specifically, the placement of OCRM within OCA creates a conflict of interest between OCA's goal of encouraging lender participation and the need to take proper enforcement actions. As a result of this inherent conflict, significant problems like those highlighted in the new OIG report continue to undermine the integrity and credibility of the SBA's new lender oversight program.

In addition to the SBA failing to make appropriate structural changes, the Administration has also recently added to the conflict of interest problem by proposing a controversial rule to codify the SBA's lender oversight procedures. (*See*, 72 FR 61752.) We have a number of concerns regarding that proposed rule. First, it does very little to clarify the enforcement powers granted to OCRM. Instead, under several provisions of the proposed rule, OCRM would actually surrender some of its powers by delegating them to OCA. (*See*, §120.451, 72 FR 61770.) As the recent string of OIG reports has indicated, OCA is not capable of performing adequate lender oversight because its primary responsibility is to promote loan production. Therefore, greater powers—not less—need to be given to OCRM under the proposed rule. In fact, OCRM should not fall within OCA's purview at all, and instead should be in its own, separate SBA division.

We are concerned by the broad use of permissive—rather than mandatory—language (*i.e.*, "may" versus "shall" clauses) throughout the proposed rule. While we understand that the SBA needs some latitude in determining appropriate enforcement actions, the need for broad discretion must be balanced against the overarching goal of creating clear, uniform, and fair oversight guidelines. By describing when the SBA *must* take certain actions (*e.g.*, suspending or revoking "preferred lender" status), mandatory provisions will help eliminate some of the inconsistencies and uncertainty that have hindered the SBA's previous lender oversight efforts. Our position is shared by the OIG, which in its most recent report criticized the proposed rule for not properly identifying the circumstances that would trigger specific enforcement actions. (*See*, OIG Report No. 08-12, p.11.)

To address our concerns, please provide answers to the questions set forth below, so we can better understand the SBA's rationale in drafting the proposed lender oversight rule.

1. Although the introductory paragraph states that the rule "would establish the role and responsibilities of [OCRM]," it appears that OCRM has been given just one express power under the rule. (*See*, §120.1005, 72 FR 61778.) Explain with specificity the enforcement power(s) granted to OCRM under the proposed rule.

2. It appears that very little responsibility would be vested in the newly-created Lender Oversight Committee (LOC), which directly contradicts the recommendations from each of the OIG's past three lender oversight reports. Describe the express powers that would be given to LOC under the proposed rule.

3. Explain why the proposed rule would eliminate a lender's right to appeal to the SBA's Office of Hearing and Appeals, and instead would require a lender to appeal directly to a Federal district court.

4. Describe the SBA's rationale for granting OCA the power to decide when to require additional capital reserves from an SBA lender; it appears this should be properly determined by OCRM or LOC—not OCA.

5. Identify which SBA office will be charged with the responsibilities set forth in proposed §120.1000 *et seq*. For instance, proposed §120.1050 states that "SBA may conduct on-site reviews of the SBA loan operations of SBA Lenders." However, the rule fails to identify which SBA office will have that power. We assume the power will be vested in OCRM, but please confirm.

6. Explain why the SBA proposes to accelerate the deadline for submission of Certified Development Companies' annual reports from 180 to 90 days. (*See*, §120.830(a), 72 FR 61778.)

7. Explain why "Other Regulated Small Business Loan Corporations" may be granted an exemption to certain provisions of the oversight rule, while similarly-situated "Non-Federally Regulated Lenders" cannot apply for such an exemption.

8. Explain how the risk assessment tools that underlie the proposed rule are appropriate and effective for the SBA's direct microloan program.

9. Explain how the proposed oversight rule could prevent another Business Loan Corporation type fraud and reduce the high rate of unnecessary purchases of guarantees on defaulted loans.

Please provide the SBA's responses to the questions set forth above on or before May 31, 2008.

As has been communicated to the SBA, the Committee would like to engage in a dialogue with agency officials as the proposed rule is finalized. We believe this dialogue will help produce a lender oversight system that achieves an appropriate balance between risk mitigation and loan production, creating a fair, objective, and consistent program for SBA's partners and the 100,000 small business borrowers who benefit from the agency's lending programs each year.

In closing, we reiterate our concerns regarding the efficacy of the SBA's "Risk Rating System," which has yet to be objectively tested over the course of a full economic cycle. To that end, we are formally requesting a Government Accountability Office study to analyze the rating system's predictive capabilities. While this study is being conducted, we urge the SBA to support the Senate's budget amendment, which will provide the SBA with additional funding to offset the newly imposed lender oversight fees. Once that funding is provided, we urge the SBA to suspend the lender oversight fees and request appropriate funding in future budgets until a complete evaluation of the new risk rating system has been undertaken.

Should you have any questions or concerns, please do not hesitate to contact us or have your staff contact Nick Coutsos on Chairman Kerry's staff at (202) 224-5175 or Linda Le on Ranking Member Snowe's staff at (202) 224-7884, with any questions. Thank you in advance for your prompt attention to this matter, and we look forward to your responses.

Sincerely,

JOHN F. KERRY
Chairman

OLYMPIA J. SNOWE
Ranking Member