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Report to the Ranking Minority Member, Committee on Small Business and Entrepreneurship, U.S. Senate

December 2002

SMALL BUSINESS ADMINISTRATION

Progress Made but Improvements Needed in Lender Ovesight

GAO-03-90

December 2002

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Highlights

Highlights of GAO-03-90, a report to the Ranking Minority Member, Committee on Small Business and Entrepreneurship, United States Senate

SMALL BUSINESS ADMINISTRATION

Progress Made but Improvements Needed in Lender Oversight

Why GAO Did This Study

The Small Business Administration (SBA) has increased its reliance on private lenders to provide small businesses with access to credit. The 7(a) program is SBA's largest business loan program, and SBA has established a preferred lender program (PLP) in which eligible lenders make 7(a) loans without prior SBA approval. SBA guaranteed $9.9 billion in 7(a) loans in 2001. Because lenders are exercising greater autonomy in making 7(a) loans, effective lender oversight is essential to SBA's success in achieving its mission. GAO evaluated SBA's 7(a) lender oversight and reviewed its organizational alignment for conducting PLP and Small Business Lending Company (SBLC) oversight.

What GAO Recommends

SBA should

- incorporate strategies into its review process to adequately measure the financial risk lenders pose to SBA and develop specific criteria for the "credit elsewhere" standard;
- provide policies and procedures for enforcement actions against preferred lenders and SBLCs; and
- separate the lender oversight function from the Office of Capital Access (OCA) and provide it with clear authority and guidance.

SBA disagreed with part or all of two recommendations and is considering issues raised in others.

www.gao.gov/cgi-bin/getrpt?GAO-03-90.

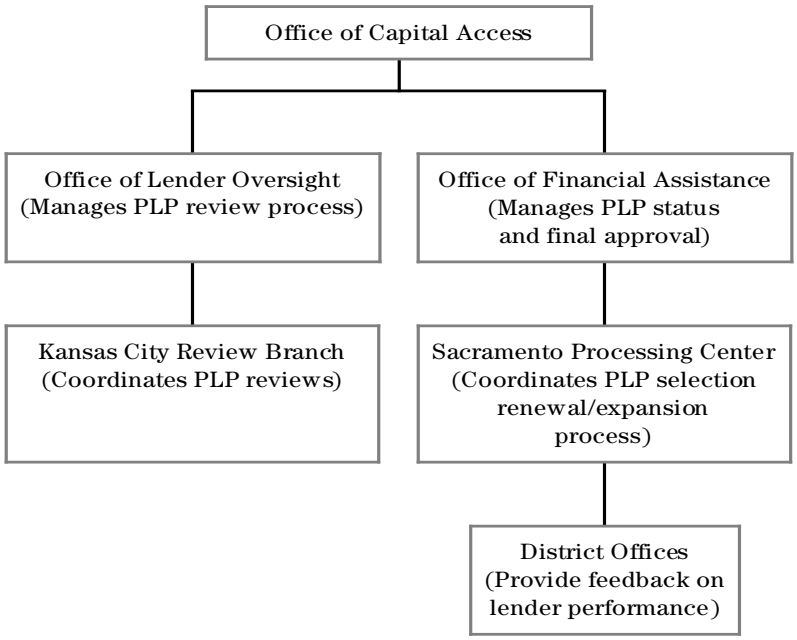
To view the full report, including the scope and methodology, click on the link above. For more information, contact Davi D'Agostino, Director, FMCI, on (202) 512-8678, or d'agostinod@gao.gov.

What GAO Found

SBA has made progress in developing its lender oversight program, but conducts only a cursory review of lenders' processes rather than a qualitative assessment of their decisions with regard to borrowers' creditworthiness and eligibility. The "credit elsewhere" standard—a test to determine whether the borrower can obtain credit without the SBA guarantee—is broad, making a meaningful assessment of lenders' decisions difficult. Although SBA has identified appropriate elements for an effective lender oversight program, it has been slow to incorporate all of the elements. For example, SBA does not adequately measure the financial risk PLP lenders pose to its portfolio and has not developed enforcement policies and procedures. SBA has also been slow to implement program improvements for its oversight of SBLCs, for which it has additional safety and soundness regulatory authority.

SBA's lender oversight function does not have the organizational independence or resources necessary to accomplish its goals. Two offices perform lender oversight from within OCA, whose other responsibilities include lending program promotion and management, thus presenting a possible conflict. Additionally, split responsibilities within OCA, and limited resources, have impeded SBA's ability to complete certain oversight responsibilities, such as the completion of review reports, which could result in increased risk to its portfolio.

Preferred Lender Oversight Responsibilities within OCA



Source: GAO analysis of SBA's structure.

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Abbreviations

FCA	Farm Credit Administration
LMS	Loan Monitoring System
NAGGL	National Association of Government Guaranteed Lenders
OCA	Office of Capital Access
OFA	Office of Financial Assistance
OFHEO	Office of Federal Housing Enterprise Oversight
OFO	Office of Field Operations
OLO	Office of Lender Program
PLP	Preferred Lenders Program
SBA	Small Business Administration
SBLC	Small Business Lending Company
SBPIA	Small Business Programs Improvement Act of 1996
SOP	Standard Operating Procedures

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United States General Accounting Office
Washington, DC 20548

December 9, 2002

The Honorable Christopher S. Bond
Ranking Minority Member
Committee on Small Business and Entrepreneurship
United States Senate

Dear Senator Bond:

The mission of the Small Business Administration (SBA) is to maintain and strengthen the nation's economy by aiding, counseling, assisting, and protecting the interests of small businesses and by helping individuals and small businesses recover from disasters. SBA has a total portfolio of about $44 billion, including $39 billion in direct and guaranteed small business loans and other guarantees and $5 billion in disaster loans.[1] Providing small businesses with access to credit is a major avenue through which SBA strives to fulfill its mission. The 7(a) loan program, which is authorized by Section 7(a) of the Small Business Act, is SBA's largest business loan program.[2] The 7(a) program is intended to serve small business borrowers who cannot otherwise obtain financing under reasonable terms and conditions from the private sector. This report contains the results of our review of SBA's oversight of lenders participating in its Preferred Lenders Program (PLP), in which lenders make loans guaranteed by SBA under Section 7(a) without prior SBA review or approval. In fiscal year 2001, 7(a) loan approvals totaled approximately $9.9 billion, of which preferred lenders made $5.3 billion. Prior to making SBA guaranteed loans, preferred lenders must make determinations regarding borrowers' creditworthiness and eligibility for SBA assistance. A key eligibility decision that lenders must make before approving a loan is whether a small business could obtain credit on similar terms without an SBA guaranty. SBA then reviews preferred lenders to assess their compliance with SBA rules and regulations. Lender oversight has become increasingly important to SBA as the agency has evolved from

[1]As of September 30, 2001.

[2]15 U.S.C. § 636 (2000).

making loans to depending on lending partners, primarily banks,[3] to make SBA guaranteed loans to small businesses.

You requested that we review SBA's oversight of its 7(a) lenders, particularly those participating in the PLP. As you requested, we (1) evaluated SBA's 7(a) lender oversight program to determine its likely success in achieving its goals and (2) reviewed SBA's organizational alignment for conducting preferred lender and Small Business Lending Company (SBLC) oversight.[4]

We analyzed SBA's oversight of its 7(a) lenders, particularly for preferred lenders, some of whom are SBLCs, licensed by SBA to make only 7(a) loans. In conducting our work, we defined oversight to include SBA's process for reviewing preferred lenders for compliance with SBA guidance and for evaluating them for initial and continued participation in the PLP. We focused our reviews in part to follow up on recommendations made in our June 1998 report, where we found that SBA was doing few reviews of its preferred lenders.[5] We reviewed recent developments in SBA's oversight of SBLCs, which account for approximately 19 percent of outstanding 7(a) loans, because we had previously identified improvements needed in SBLC oversight in a November 2000 report.[6] We analyzed PLP review guidance, review and lending data to the extent that is was available, and a sample of PLP and SBLC review reports. To evaluate their experiences in SBA's oversight program, we interviewed SBA headquarters and regional staff. We also interviewed PLP lenders and representatives of the National Association of Government Guaranteed Lenders.

[3]Other types of financial institutions, such as savings banks, are lending partners. In this report we refer to all financial institutions that make 7(a) loans as banks.

[4]SBLCs, which make only 7(a) loans, are privately owned and managed, nondepository lending institutions that are licensed and regulated by SBA but not generally regulated or examined by financial institution regulators.

[5]U.S. General Accounting Office, *Small Business Administration: Few Reviews of Guaranteed Lenders Have Been Conducted*, GAO/GGD-98-85 (Washington, D.C.: June 1998).

[6]U.S. General Accounting Office, *Small Business Administration: Actions Needed to Strengthen Small Business Lending Company Oversight*, GAO-01-192 (Washington, D.C.: November 2000).

Results in Brief

SBA has made progress in developing its lender oversight program, but it has not fully developed effective oversight programs that assess lenders' decisions on borrowers' creditworthiness and eligibility and the impact of lenders' decisions regarding risk posed to SBA's portfolio. SBA has identified appropriate elements for an effective lender oversight program; however, it has been slow to change programs and procedures to fully incorporate all of the elements. Risk management issues have become more critical for SBA as its current loan programs focus on partnering with banks that make loans guaranteed up to 85 percent by SBA. However, SBA has not yet consistently incorporated adequate measures of financial risk into the PLP review process or the SBLC examination program, two key loan and lender oversight tools. A key to SBA's successful management of its loan portfolio and achievement of its mission is its ability to ensure that lenders are complying with SBA rules and regulations when making 7(a) loans. However, the current PLP review process, which is used to ensure compliance, involves a cursory review of documentation maintained in lenders' loan files rather than a qualitative assessment of borrower creditworthiness or eligibility. Moreover, SBA has not developed clear enforcement policies, for preferred lenders or SBLCs, specifically describing its response in the event that its reviews uncover noncompliance. In addition, SBA is not consistent in how it funds the cost of its lender oversight, resulting in questionable funding arrangements that could limit SBA's flexibility in managing its program and its overall accountability. SBA has taken steps to make the PLP more streamlined and to manage the program consistently, particularly for large national lenders, but some lenders we interviewed complained that program participation can be confusing and administratively burdensome.

Although SBA has listed the oversight of its lending partners as a key priority of the agency, the function does not have the necessary organizational independence or resources to accomplish its goals. In our past work analyzing organizational alignment and workload issues, we have described the importance of tying organizational alignment to a clear and comprehensive mission statement and strategic plan, and providing adequate resources to accomplish the mission. SBA's lender oversight functions are carried out by two different offices within the Office of Capital Access (OCA), which also promotes and implements SBA's lending programs, thereby presenting a possible conflict because PLP promotion and operations are housed in the same office that assesses lenders' compliance with SBA safety and soundness and mission requirements. Split responsibilities within OCA and limited resources have impeded SBA's ability to complete certain oversight responsibilities, which could result in heightened risk to its portfolio or lack of comprehensive

awareness of portfolio risk. In congressional testimony describing an SBA workforce transformation plan, a senior SBA official announced that SBA will centralize all lender oversight functions within headquarters.

This report contains four recommendations. In general, we recommend that SBA (1) improve its review process, (2) clarify its enforcement authority, (3) make the PLP program more accessible, and (4) better emphasize lender oversight in its organizational alignment.

We obtained written comments on a draft of this report from SBA's Associate Deputy Administrator for Capital Access. SBA's comments are discussed near the end of this report, and its letter is reprinted in appendix III. SBA did not explicitly state that it agreed or disagreed with our recommendations. However, in specific comments on the four recommendations, SBA essentially disagreed with part or all of two recommendations and said that it was reviewing the issues we presented in the other two. SBA disagreed with our recommendation that it develop specific criteria to apply to the credit elsewhere standard but said it was considering approaches to better assess the financial risk lenders pose and to make qualitative assessments of its lenders' performance and lending decisions. SBA disagreed with our recommendation to separate lender oversight functions and responsibilities from OCA. Regarding our recommendations that SBA should, through regulation, develop clear policies and procedures for taking enforcement action and continue to explore ways to assist large national lenders to participate in the preferred lender program, SBA said that it was considering the best way to address the issues we raised.

Background

In pursuing its mission of aiding small businesses, SBA provides small businesses with access to credit, primarily by guaranteeing loans through its 7(a) and other loan programs, and provides entrepreneurial assistance through partnerships with private entities that offer small business counseling and technical assistance. SBA also administers various small business procurement programs, which are designed to assist small and small disadvantaged businesses in obtaining federal contracts and subcontracts. SBA also makes loans to businesses and individuals trying to recover from a disaster.

At the beginning of fiscal year 2003, SBA had 3,026 permanent employees and 1,221 temporary employees for disaster assistance work. In the last 10 years, SBA has changed its organization and how it delivers services. In response to budget reductions, SBA streamlined its field structure during

the 1990s, downsizing its 10 regional offices, moving the workload to either district offices or headquarters offices, and eliminating most of the regions' role as an intermediate management layer between headquarters and the field. About three-quarters of SBA's staff are assigned to the agency's field locations, which include 10 regional offices, 70 district offices as well as various other field locations. In addition to its federal workforce, SBA's infrastructure includes over one thousand resource partners located nationwide who provide technical and advisory assistance to small businesses. Figure 1 shows SBA district offices and processing and servicing centers.

Figure 1: SBA District Offices and Processing and Servicing Centers in the United States

Source: GAO analysis of SBA data.

SBA has changed the approach in its lending programs to delegating more authority to lenders for making loans that it guarantees rather than approving loans that lenders make. SBA's loan programs have also been the focus of a major organizational change with the creation of centers to process and service the majority of these loans—work that was once handled largely by district office staff. Processing and servicing of about three-quarters of SBA-guaranteed loans was handled in centers instead of district offices in 2000.

Under the 7(a) program, SBA provides guarantees of up to 85 percent on loans made by participating lenders. Within the 7(a) program, there are three classifications of lenders—regular, certified, and preferred lenders. SBA continues to provide final approval of loans made by its regular lenders through the district offices. Certified lenders have the authority to process, close, service, and may liquidate SBA guaranteed loans. SBA gives priority to applications and servicing actions submitted by certified lenders and will provide expedited loan processing or servicing. Preferred lenders are given full authority to make loans without prior SBA approval, making their own assessments of eligibility and creditworthiness. However, lender-approved preferred loans are submitted to SBA's Sacramento Processing Center, which, among other things, verifies that the lender has documented certain eligibility requirements, issues a loan number, and processes the loan guaranty. The Sacramento Processing Center, one of eight processing centers SBA maintains to process various types of loans, does all loan processing for PLP loans. Preferred lenders tend to be the largest 7(a) lenders, and they account for slightly over half of 7(a) lending. Less than 1 percent of 7(a) lenders account for greater than 50 percent of 7(a) loan dollar volume outstanding. According to SBA staff, most of these lenders are PLP lenders.

While SBA has delegated loan authorities to certified and preferred lenders, SBA still manages them by periodically authorizing or renewing certified or preferred lender status. SBA regulations state that certified and preferred lenders are to have their status renewed at least every 2 years by SBA. At the end of August 2002, SBA had over 400 preferred lenders. The district offices use the same review checklist used for reviews of preferred lenders to review non-PLP lenders.

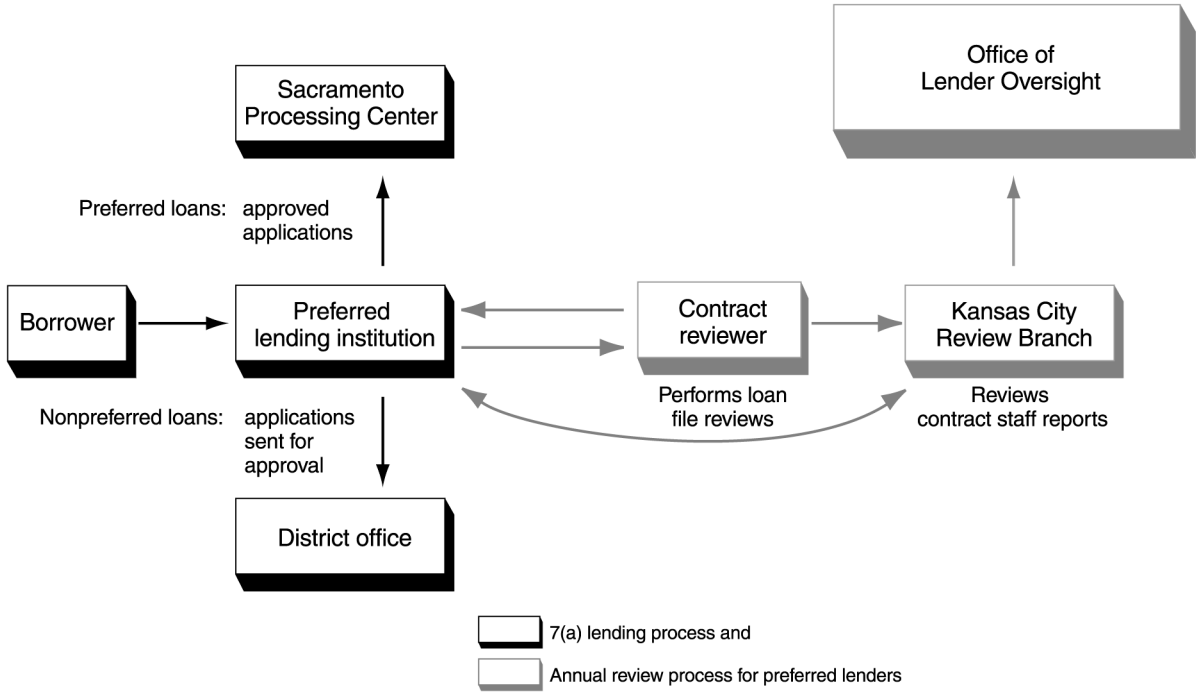
In addition to managing lender status, SBA exercises more direct lender oversight through its review process. The Small Business Programs

Improvement Act of 1996 (SBPIA) requires SBA to review program participation by preferred lenders annually or more frequently.[7] SBPIA did not change the oversight requirements for regular and certified lenders, which, according to SBA's standard operating procedures, are currently reviewed every 3 years. For preferred lenders, SBA has developed a review program that includes annual reviews of all PLP lenders who made preferred loans during the previous year. The objectives of the reviews are to determine (1) whether preferred lenders process, service, and liquidate loans according to SBA standards and (2) whether such lenders should continue to participate in the program. To make these determinations, SBA's lender review staff, which includes contract reviewers and SBA staff, analyze lenders' policies and review the documents in lenders' loan files for a sample of loans.

SBA originally managed the PLP lender oversight program through its Office of Financial Assistance (OFA), an office that is part of OCA. In fiscal year 1999, SBA created a new office, the Office of Lender Oversight (OLO), to ensure consistent and appropriate supervision of SBA's lending partners. OLO, which is also part of OCA, is responsible for managing all headquarters and field office activities regarding lender reviews, including safety and soundness examinations of SBLCs, issuing review and examination reports to the lenders and SBLCs, evaluating new programs, and recommending changes to existing programs to assess risk potential. OLO is also responsible for evaluating existing oversight regulations, policies and procedures; monitoring changes in accounting, banking, and financial industries that may affect their lenders; and recommending appropriate modification of SBA lender oversight policy. The PLP Review Branch located in Kansas City, Missouri was made part of OLO. It coordinates reviews with lenders and contract reviewers, participates in reviews, reviews contractor reports, prepares the review reports, and conducts exit meetings with the lenders. Figure 2 illustrates SBA's preferred lending and review processes.

[7]The assessment is to include, among other things, defaults, loans, and recoveries of loans made by the lender. P. L. No. 104-208, Div. D, Title 1, § 103 (h), 110 Stat. 3009-728 (1996) (codified at 15 U.S.C. § 634 note).

Figure 2: SBA Preferred Lending and Review Processes



Source: GAO analysis.

While OLO is responsible for many oversight functions, OFA has still retained some oversight responsibilities. OFA's current role in lender oversight is to provide final approval of lenders' PLP status. As noted previously, for a period of 2 years or less, lenders are granted PLP status in specific SBA districts. OFA collects information about the lender prepared by the Sacramento Processing Center, with input from one or more of SBA's 70 district offices, and decides whether to renew a lender's PLP status or to grant status in an additional district. OFA may also discontinue a lender's PLP status.

Other lenders participating in the 7(a) program are subject to a different oversight regime. Specifically, SBA divides SBLC program functions between OLO and OFA. OLO is responsible for SBLC on-site examination, and OFA handles day-to-day program management and policymaking. Ultimate responsibility for enforcement of corrective actions rests with OCA. As participants in the 7(a) program, SBLCs are subject to the same

review requirements as other 7(a) lenders, and they are also subject to safety and soundness oversight by SBA. For a period prior to 1982, SBA licensed 14 SBLCs to promote its efforts to increase the availability of financial assistance to small businesses.[8] Of the 14 SBLCs currently active in SBA's 7(a) loan program, 12 are certified as preferred lenders. SBLCs account for about 19 percent of outstanding 7(a) loans. SBA regulates SBLCs on the basis of its determination that the Small Business Act provided the Administrator with broad powers to promulgate and enforce rules and regulations for lenders participating in the 7(a) program. Since fiscal year 1999, SBA has had an agreement with the Farm Credit Administration (FCA)[9] to conduct safety and soundness examinations of the SBLCs.[10]

Lender Oversight Is Not Achieving All of Its Goals

SBA has identified goals for its lender oversight program that are consistent with appropriate standards for an oversight program; however, SBA has not yet established a program that is likely to achieve them. Since our last review, SBA has made progress in developing its lender oversight program, but there are still areas in need of improvement if SBA is to develop a successful program. SBA has highlighted risk management in its strategy to modernize the agency; however, PLP reviews are not designed to evaluate financial risk, and the agency has been slow to respond to recommendations made for improving its monitoring and management of financial risk—posing a potential risk to SBA's portfolio. PLP reviews are designed to determine lender compliance with SBA regulations and guidelines; however, they do not provide adequate assurance that lenders are sufficiently assessing eligibility and creditworthiness of borrowers. Although SBA has identified problems with preferred lenders' or SBLCs' lending practices, it has not developed clear policies describing its enforcement response to specific conditions. Thus, it is not clear what actions SBA would take to ensure that preferred lenders or SBLCs address any weaknesses in their lending programs. SBA has oversight

[8]SBA initially authorized 16 SBLC licenses, but only 14 of the licenses were used to establish institutions.

[9]FCA is an independent agency within the executive branch of the U.S. government; it is responsible for the regulation of the Farm Credit System institutions. One of FCA's primary functions is to examine System institutions for safety and soundness and their compliance with applicable law and regulation. FCA also contracts with other government agencies to provide examination services.

[10]Legal authority for auditing the operations of SBLCs lies with SBA's Office of Inspector General (OIG). OIG delegated this authority to OLO.

responsibilities regarding different types of lending institutions with different charters, and its arrangements for funding its reviews vary. These varying arrangements result in questions of propriety and a lack of consistency that could limit SBA's flexibility and accountability in conducting reviews, and in differences in the costs that lenders must bear for their oversight. Although the process for certifying lenders for PLP status—another means by which SBA oversees lenders—has become better defined and more objective, some lenders told us they continue to experience confusing and inconsistent procedures during this process due to varying recommendations from field offices.

SBA Recognizes Appropriate Elements of Oversight

Various SBA officials and publications have pointed to the importance of developing an oversight program that ensures that its lending partners minimize the risk of loss to SBA while making loans to eligible borrowers who require SBA assistance. For example, SBA's current Strategic Plan states that the goal of risk management has become more critical as loan-making and other functions have been outsourced and refers to the need "to protect taxpayers' interests and to ensure the long-term viability of our lending programs."[11] To evaluate the effectiveness of SBA's lender oversight program, we considered, with some modification as appropriate, elements that we have cited as appropriate for an oversight program to ensure that a financial institution carries out its public purpose or mission and operates in a safe and sound manner. [12] These elements include the authority to

- establish rules and regulations,
- examine and monitor all aspects of operations,
- set and define minimum capital requirements, and
- take enforcement action to ensure compliance.

These elements apply, to varying degrees, to SBA's oversight of preferred lenders and SBLCs. We discussed these elements with SBA officials who

[11] U.S. Small Business Administration, *SBA Strategic Plan, FY 2001—FY 2006*.

[12] U.S. General Accounting Office, *Government Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks*, GAO/GGD-91-90 (Washington, D.C.: May 1991).

also agree that, with modification, they are appropriate to SBA's responsibility to oversee its lending partners. One significant modification is that SBA is not the primary safety and soundness regulator for most PLP lenders, which are banks regulated by federal financial institution regulators, such as the Office of the Comptroller of the Currency. SBA's responsibility and authorities are therefore focused on the SBA loan portfolio of such lenders. SBLCs, however, do not have regulators other than SBA. Therefore, SBA is responsible for examining the financial condition of SBLCs as well as their compliance with PLP policies and procedures. SBA is responsible for defining minimum capital requirements for SBLCs. In summary, all four of the elements of oversight noted above apply to SBA's oversight of SBLCs, and the elements—with the exception of setting capital requirements—apply to SBA's oversight of the 7(a) portfolio of other preferred lenders.

We evaluated SBA's oversight of PLP lenders and SBLCs in light of the elements of oversight that we have identified in past work and that are listed above. As described below, SBA possesses authorities consistent with the above-described elements and has identified planned improvements designed to better incorporate the elements into its oversight program. However, SBA has not yet implemented many of the planned improvements, without which, the PLP and SBLC oversight program will continue to be inadequate and fall short of stated goals.

SBA Has Made Progress in Developing Its Lender Oversight Function

Since our June 1998 report, SBA has responded to a number of recommendations for improving lender oversight by developing guidance, establishing OLO and doing more reviews.[13] SBA developed "Standard Operating Procedures" (SOP) for oversight of SBA's lending partners and the "Loan Policy and Program Oversight Guide for Lender Reviews" in October 1999.

SBA established OLO in fiscal year 1999 to coordinate and centralize the lender review processes for PLP and SBLC oversight. OLO created a Reviewer Guide to provide direction to all personnel engaged in the PLP review process, and OLO officials said they conduct training for all SBA staff involved in conducting preferred lender reviews. OLO officials told us that in an effort to effectively oversee and monitor SBA lenders, they seek to use a strategy of evaluating risk generated by the lender to the SBA

[13] GAO/GGD-98-85.

portfolio, work with SBA program offices to manage PLP oversight operations, and plan to conduct regular and systematic portfolio analysis using a new loan monitoring system (LMS). SBA has been developing the LMS to enhance its ability to monitor and analyze borrower and lender risk and conduct off-site monitoring.[14] SBA's OIG has delegated the SBLC examination function to OLO. To minimize the number of visits SBLCs receive during a year, starting in April 2002, OLO combined PLP reviews with SBLC examinations performed by the FCA.

In an effort to improve the lender review process, SBA developed an automated, 105-item checklist that is designed to make its analysis more objective. Lender reviews, including PLP, are based on reviewers' findings using a lender questionnaire and a review checklist. SBA guidance explains that this automated format ensures an objective scoring process in that each question is given an answer of "yes," "no," or "n/a," and assigned a specific weight. The final score for PLP reviews is automatically calculated by the checklist and results in a compliance rating based on a four-tier system. SBA's ratings, from highest to lowest, include "substantially in compliance," "generally in compliance," "minimally in compliance," and "noncompliance."

The lender questionnaire addresses a lender's organizational structure and oversight, policy, and controls. The PLP checklist is divided into four sections analyzing different elements of the lender's operations for making 7(a) loans:

- processing, forms, eligibility, credit analysis;
- due diligence, authorization, closing;
- servicing, liquidation; and
- oversight, policy, and controls.

Answers of "n/a" do not count in the scoring process. Individual elements in the checklist refer to the presence of specific documents or analyses, such as financial statements and required SBA forms, that loan files must

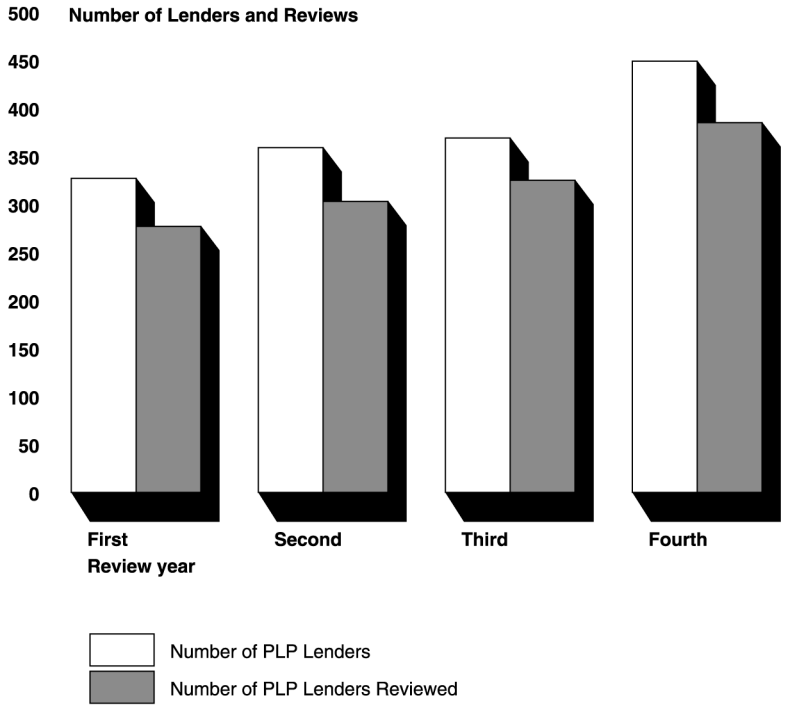
[14]In a September 4, 2002, briefing to the Committee on Small Business and Entrepreneurship, U.S. Senate, we reported that SBA has set October 2004 as the preliminary completion date for its LMS lender oversight initiative.

contain according to SBA guidance. Although guidance states that eligibility and credit questions are generally weighted more heavily than other questions, the reviewers' assessment of these components is cursory, as we discuss in more detail later. SBA officials said that prior to the implementation of the automated worksheet scoring process, PLP reviews were done in a narrative format and reviewer's assessments of lender performance were subjective. They noted that the new format makes the reviewer's assessment of lenders more consistent and objective. However, without a more substantive method of evaluating lender performance, this approach does not provide a meaningful assessment.

SBA has also increased the number of PLP reviews performed. In June 1998, we reported that SBA had not reviewed 96 percent of 7(a) lenders, including preferred lenders, in the districts we visited. SBA's review year runs from April 1 to the end of March of the next year.[15] In its first review year, beginning April 1, 1998, SBA performed 277 reviews out of 327 preferred lenders that approved a preferred loan in the previous fiscal year. In its fourth review year, which ended March 29, 2002, SBA performed 385 reviews out of 449 preferred lenders. SBA officials commented that they believe they reviewed 100 percent of PLP lenders. The difference in the number of lenders and the number of reviews performed is attributable, officials stated, to the consolidation of reviews of multiple lenders with the same parent company.

[15]SBA officials explained that the initial date of its contract with the vendor that conducts PLP reviews began on April 1, and they have since used this as the beginning of their review year.

Figure 3: Number of PLP Lenders and Reviews Performed for the First through Fourth Year



Source: SBA Office of Lender Oversight.

SBA's Lender Oversight Does Not Adequately Focus on Financial Risk

While elements of SBA's oversight program touch on the financial risk posed by preferred lenders, including SBLCs, weaknesses in the program limit SBA's ability to focus on, and respond to, current and future financial risk to their portfolio. Neither the PLP review process nor SBA's off-site monitoring efforts adequately focus on the financial risk posed by PLP and other lenders to SBA. SBA oversight of SBLCs is charged with monitoring how SBLCs administer their credit programs, identifying potential problems, and keeping SBA losses to an acceptable level. However, SBA's progress in reporting examination results in a timely manner and implementing other program improvements limits the effectiveness of SBA's SBLC oversight.

PLP Reviews Are Not Designed to Evaluate Financial Risk

SBA officials stated that PLP reviews are strict compliance reviews that are not designed to measure the PLP lenders' financial risk. Our review and that of SBA's OIG confirmed this. The PLP review serves as SBA's primary internal control mechanism to determine whether preferred

lenders are processing, servicing, and liquidating loans according to SBA standards and whether such lenders should participate in the delegated programs. While there are optional questions that touch on the financial risk of a given loan, review staff are not required to answer them; and SBA guidance explicitly states that the answers to the questions are for research purposes only and are not to be considered in making any determinations about the lender. We observed responses to these questions in only 3 of the 15 final PLP reports we reviewed.

By not including an assessment of the financial risk posed by individual lenders during PLP reviews, SBA is missing an opportunity to gather information that could assist it in predicting PLP lenders' future performance, thereby better preparing SBA to manage the risk to its portfolio. In its report on PLP lender oversight, the SBA OIG suggested that financial risk and lender-based risk should be considered as part of a comprehensive oversight program.[16]

While PLP lenders other than SBLCs all have a primary financial regulator that periodically examines their operations for safety and soundness, it is still important for SBA to assess the risk posed by these lenders' SBA portfolios. Because the SBA portfolio of these lenders is government guaranteed and because these portfolios would not likely be large enough to pose a significant risk to the bank's overall safety and soundness, the portfolio of SBA guaranteed loans may not receive attention from the institution's primary regulator under its risk-based examination approach. As a result, the risks of each lender's SBA portfolio to SBA may not be evaluated. SBA should also be concerned about the general condition of its lending partners so that SBA does not lose the lender as a partner in providing access to credit for small businesses. Therefore, it is essential that SBA assess and manage the risk posed by its lenders' SBA portfolios. SBA staff told us that although they do not interact with other federal financial regulators, review staff incorporates additional information such as bank call data, any publicly disclosed enforcement actions, press releases, and internal SBA information in assessing PLP lenders.

[16]The SBA Inspector General defines financial risk as the composite risk posed by loans and guarantees actually booked to SBA's portfolio and how they perform over time, and defines lender-based risk as the potential financial injury due to the lender's failure to perform its role properly. *Audit Report PLP Oversight Process*, Report Number 1-19, SBA OIG, September 27, 2001.

SBA's Off-Site Monitoring Efforts Are Not Consistently Used to Assess Risk

SBA's off-site monitoring efforts do not adequately assess the financial risk posed by PLP and other lenders. SBA currently uses loan performance benchmarking and portfolio analysis to serve as its primary tools for off-site monitoring. SBA officials stated that loan performance benchmarks are based on financial risk and serve as a measure to address a lender's potential risk to the SBA portfolio. However, we found that the benchmarks were not consistently used for this purpose. The loan performance benchmarks were developed by SBA's Risk Management Committee to serve as parameters for measuring satisfactory performance by lenders in the delivery of SBA loan programs and for field offices to prioritize lender reviews. [17] The five categories of loan performance benchmarks are based on a loan status report that lenders are required to complete monthly and submit to a private contractor. The information is then consolidated and sent back to SBA for inclusion in the lender evaluation worksheet used during the PLP certification process, (discussed later in more detail). Table 1 lists the loan performance benchmarks and definitions.

Table 1: SBA Loan Performance Benchmarks and Definitions

Benchmark	Definition
Currency rate	Percentage of loans that are 0 to 30 days past due in scheduled payments.
Delinquency rate	Percentage of loans over 60 days delinquent, including those in liquidation compared with total outstanding ("active") loan portfolio.
Default rate	Percentage of loans purchased, compared with total loans disbursed by a lender, consisting of the active portfolio plus paid-in-fulls and charge-offs.
Liquidation rate	Percentage of loans in liquidation status, compared with a lender's total active portfolio.
Loss rate	Amount or number of charge-off loans relative to total disbursed, excluding paid-in-full and charge-offs.

Source: SBA SOP.

We found that the use of loan performance benchmarks varied across district offices. Some district office officials used the benchmarks to periodically discuss performance with lenders, while others did not place much emphasis on the benchmarks except, to prioritize non-PLP lender reviews and acknowledge them during completion of the lender evaluation worksheet. SBA OIG recommended in its September 2001 report that an assessment of loan performance benchmarks should be included as part of

[17] The committee is composed of the Associate Administrator of each division within SBA.

the PLP review process because the benchmarks provide some assessment of risk. OLO responded that it is currently redesigning the PLP review process and will consider this recommendation during the redesign, which is discussed in more detail later in this report.

OLO does not perform routine analysis of SBA's portfolio to assess financial risk. Having primary lender oversight responsibility, OLO should be able to provide a sufficient level of financial risk monitoring. Prior to the establishment of OLO, the Risk Management Committee was responsible for tracking trends and other relevant lender oversight data in the SBA portfolio. SBA officials stated that once implemented, the LMS would serve as the primary database for producing consistent lender oversight reports and tracking trends. Staff currently produces ad-hoc reports to analyze aggregate lending data to look for trends and try to anticipate risk. For example, staff prepared a briefing for the Risk Management Committee in the Fall of 2001, which analyzed loan concentrations by industry and percentages of loans made by different types of lenders. OLO officials said that in the future, this type of analysis of industry and geographic concentrations to assess risk would become a routine part of off-site monitoring. While these are positive initiatives, such analysis has not been done on a routine basis.

OLO officials commented that due to limited resources their primary focus has been on individual lender oversight and analysis. However, OLO has recently added resources, including one staff member charged with responsibility for portfolio analysis and reporting. A template for monthly reporting has been developed and is being reviewed by various program offices. SBA officials noted that the loan monitoring system, which is now being developed, is intended to provide OLO with expanded data analysis capabilities. In the interim, data analysis is limited because OLO staff must use different databases that are not integrated. Therefore the analysis is labor intensive. During our work, we requested rating and benchmark data for a 5-year period, but OLO was only able to provide it for 2 years. SBA commented that this was because OLO assumed responsibility for analyzing benchmark data in the past 2 years. Prior to that time, benchmark data was analyzed in OFA. When OLO assumed this responsibility, it approached the analysis differently. To obtain comparable data in prior years, a database would need to be constructed from stored data from the loan accounting system.

SBA Is Redesigning Its PLP Reviews to Better Assess Financial Risk

OLO officials said that as the office continues to evolve, they are looking for ways to improve lender oversight to better assess and manage financial risks to SBA. In addition to enhancing off-site risk monitoring of lender performance, OLO officials announced at an April 2002 conference of lenders that they planned to redesign the PLP review process. With the assistance of an outside contractor, OLO has developed a PLP review program that would focus on compliance, performance, and operations of PLP lenders. The elements of the proposed new process, described at the conference and by OLO officials at other times, would include a review of portfolio performance, origination and processing, portfolio administration, servicing, compliance, and liquidation. SBA would produce a lender rating based on these elements (see table 2).

Table 2: Proposed PLP Review Rating Elements

Rating Elements	Definition
Portfolio performance	Growth rates of the lender's volume of SBA originations and outstanding SBA loans serviced, current delinquency and repurchase rates, liquidation rates, and other key risk-related factors.
Origination and processing	Material shortcomings as a result of origination and processing that could increase the likelihood of borrower default and/or delinquency.
Portfolio administration	Proper documentation of material information concerning the loans made. Established policies and procedures to protect the financial soundness of the lender's SBA portfolio including their proper implementation.
Servicing	Material shortcomings as a result of servicing that could increase the likelihood of borrower default and/or delinquency.
Compliance	The lenders demonstrated ability to comply with SBA requirements concerning elements of the loan process that could affect the SBA's financial risk and eligibility determinations on whether a loan qualifies for an SBA guarantee.
Liquidation	Factors that could affect the recovery on the loan, such as attainable price, limits on expenses incurred in the liquidation process, and proper legal authority to carry out the liquidation.

Source: SBA Office of Lender Oversight.

In contrast to the automated scoring of the 105-item checklist used in reviews currently; scores would be developed only for the six proposed categories and would be rolled up into a general rating based on the individual category ratings. OLO officials said that the guidance for implementing the proposed new review process is currently being developed, and it could be implemented in early 2003.

SBA Has Not Eliminated Weaknesses in SBLC Oversight that Pose a Potential Risk to the SBA Portfolio

SBA has not eliminated weaknesses in the oversight of SBLCs, cited by GAO and SBA's OIG, that continue to limit the effectiveness of SBLC oversight, thereby not taking action that could mitigate the risk to SBA's portfolio. FCA conducts broad-based examinations and evaluates each SBLC's capital adequacy, asset quality, management, earnings, and liquidity. The examinations are similar to safety and soundness examinations performed by bank and Government Sponsored Enterprise regulators. Currently, the FCA staff responsible for SBLC safety and soundness examinations also perform the same PLP reviews at SBLCs that SBA performs using contractors at preferred lenders with the same review checklist that is used for all 7(a) lenders. Upon the completion of its examinations, FCA provides a draft report on its findings to SBA for review and comment. Upon receipt of comments from SBA, FCA provides a final report to SBA, which, in turn, issues a final report to the SBLC.

We and SBA's OIG found that final SBLC examination reports were not issued in a timely manner. In a March 2002 report,[18] SBA's OIG reported that final reports from FCA's fiscal year 2001 SBLC examinations were not issued until February 2002, 10 months after the first draft report from FCA was received by OLO. Our work also confirmed these findings. We found that OLO does not maintain standards for the timeliness of its issuance of examination reports. However, it has recently developed draft customer service goals that call for SBLC examination reports to be finalized within 90 days of receipt of a draft report from FCA. As of August 2002, none of the examination reports from fiscal year 2002 had been issued. According to information provided by OLO in November 2002, seven examination reports had been finalized by FCA from fiscal year 2002 and were issued. The three remaining examinations were conducted at the end of the fiscal year and the reports are in varying stages of completion, according to SBA. According to the OIG, because of the delays in finalizing the reports and SBA's policy to delay any necessary enforcement actions until final reports are issued, two SBLCs were allowed to continue operating in an unsafe and unsound manner, despite early identification of material weaknesses during the fiscal year 2001 SBLC examinations. The effectiveness of any examination program is measured, to a large degree, on its ability to identify and promptly remedy unsafe and unsound conditions that may exist at the regulated entity. By delaying the reporting of such conditions

[18]SBA OIG, *Improvements Are Needed in the Small Business Lending Company Oversight Process*, Report No. 2-12, March 20, 2002.

and the initiation of remedial action, SBA has significantly limited the effectiveness of its oversight program for SBLCs.

SBA has been slow to implement recommendations from FCA for improving the SBLC examination program. In addition to examining the SBLCs, FCA was asked by SBA to provide its observations and recommendations for changes it believed were needed in the SBLC program. Each year FCA provides its views in a comprehensive summary report. In FCA's September 1999 report, it made 15 recommendations, 12 of which SBA agreed to implement.[19] For example, FCA recommended that SBA require the SBLCs to implement loan risk-rating systems, independent internal credit review processes, and to clarify its regulations governing capital requirements for the SBLCs. We reviewed the reports for fiscal years 2000 and 2001. In those reports, FCA made additional recommendations with which SBA has agreed. The 2001 report lists 11 recommendations, which included 8 recommendations from the 1999 report and 2 from the 2000 report. As we discuss later in this report, SBA officials explained that limited resources have contributed to the delay in implementation of many of these recommendations. Appendix I lists FCA's 11 recommendations from the 2001 report.

PLP Reviews Do Not Provide Adequate Assurance that Lenders Are Sufficiently Assessing Eligibility and Creditworthiness

The current PLP review involves a cursory review of documentation maintained in lenders' loan files rather than a qualitative assessment of lenders' decisions on eligibility or creditworthiness. A thorough PLP review process is key to an effective oversight program. PLP lenders are responsible for all decisions regarding eligibility and creditworthiness as well as confirming that all PLP loan closing decisions are correct and in compliance with all requirements of law and SBA regulations. It is also important for SBA to conduct a meaningful assessment of lenders' determinations because the "credit elsewhere" requirement[20] is broad and therefore subject to interpretation. SBA officials stated that while conducting PLP reviews, contract staff are only required to review loan files for completeness and required documentation. Review staff rely on the lender's attestations rather than independent assessments of loan file documentation.

[19]We listed the 15 recommendations in our November 2000 report.

[20]Section 7(a) of the Small Business Act states that "no financial assistance shall be extended if the applicant can obtain credit elsewhere." 15 U.S.C. Section 636(a).

Credit Elsewhere Requirements Are Difficult to Assess

Assessing whether a borrower is eligible for 7(a) assistance is difficult because the requirements are broad and variable, making a qualitative assessment of a lender's decision by a trained reviewer all the more important. The credit elsewhere provision is a standard that is particularly difficult to assess and one that must be determined prior to assessing credit factors. SBA regulations require the lender to attest to the borrower's demonstrated need for credit by determining that the desired credit is unavailable to the borrower on reasonable terms and conditions[21] from nonfederal sources without SBA assistance, taking into consideration the prevailing rates and terms in the community in or near where the applicant conducts business, for similar purposes and periods of time.[22] SBA guidance also requires preferred lenders to certify that credit is not otherwise available by signing a credit elsewhere statement to substantiate their compliance with SBA credit elsewhere rules and to retain the explanation in the borrower file.[23] SBA provides guidance on factors that may contribute to a borrower being unable to receive credit elsewhere. Generally these factors relate to weaknesses in the borrower's credit or that the loan would exceed policy limits of the preferred lender. Specifically, these factors include the following:

- The business requires a loan with a longer maturity than the lender's policy permits;
- The requested loan exceeds either the lender's legal limit or policy limit, regarding amounts loaned to one customer;
- The lender's liquidity depends upon selling the guaranteed portion of the loan on the secondary market;
- The collateral does not meet the lender's policy requirements because of its uniqueness or low value;
- The lender's policy normally does not allow loans to new ventures or businesses in the applicant's industry; and

[21]The SBA regulations do not further define "reasonable terms and conditions."

[22]13 C.F.R. Section 120.101

[23]SBA SOP 50-10(4)(E).

- Any other factors relating to the credit that, in the lender's opinion cannot be overcome except by receiving a guaranty.

Based on these criteria, the credit elsewhere test could always be satisfied by structuring an SBA guaranteed loan so that its terms and conditions differ from those available on the commercial market. As a result, these loans could be made available to businesses that could obtain credit elsewhere on reasonable market terms and conditions, although not the same terms and conditions offered with the SBA guarantee.

SBA officials stated that the credit elsewhere requirements are designed to be so broad as to not limit a lender's discretion and allow flexibility, depending upon geographic region, economic conditions, and type of business. For example, SBA officials said that when credit is more readily available, businesses that require SBA assistance might be held to a different standard, thereby making it more difficult to obtain the SBA guaranty than when credit is tighter. Nonetheless, the flexibility that lenders have along with the difficulty in assessing lenders' credit elsewhere decisions further support the need for developing specific criteria for a credit elsewhere standard. These changes would facilitate a more qualitative assessment of eligibility decisions made by preferred lenders.

PLP Reviews Do Not Qualitatively Assess a Lender's Credit Analysis

Because it is a cursory review of documents in the file, the PLP review does not qualitatively assess a lender's credit decision. Preferred lenders are required to perform a thorough and complete credit analysis of the borrower and establish repayment terms on the loan in the form of a credit memorandum. SBA guidance requires at a minimum, discussion in the credit memorandum of a borrower's capitalization or proof that the borrower will have adequate capital for operations and repayment, as well as capable management ability.[24] SBA officials said that lender review staff focus on the lender's process for making credit decisions rather than the lenders' decision. SBA officials said that it is unlikely that the review would result in a determination that the loan should not have been made. An SBA official stated that review staff would not perform an in-depth financial analysis to assess the lender's credit decision and that a lender's process would only be questioned in the case of missing documentation. For example, review staff would cite a lender if it did not document the borrower's repayment ability. This official said additional training would

[24]SBA SOP 50-10(4).

be required for lender review staff to make more qualitative assessments of loan documentation during the review process.

Some lenders criticized the lack of technical expertise of contract review staff. The lenders stated that review staff was unable to provide additional insight into material compliance issues during the review because of a lack of technical knowledge of the underwriting process and requirements. For example, one lender told us he was cited for not signing a credit elsewhere statement, but the reviewer did not evaluate a financial statement in the file substantiating the credit elsewhere assessment.

SBA Has Not Developed Clear Enforcement Policies for Preferred Lenders or SBLCs

SBA has authority to suspend or revoke a lender's PLP status for reasons that include unacceptable loan performance; failure to make enough loans under SBA's expedited procedures, and violations of statutes, regulations, or SBA policies.[25] However, SBA has not developed policies and procedures; that describe circumstances under which it will suspend or revoke PLP authority or how it will do so. SBA guidance does not include specific follow-up procedures for PLP lenders that receive poor review ratings but does discuss recommended patterns of follow-up. SBA officials said that, in practice, transmittal letters request action plans to address deficiencies for any ratings of minimally in compliance and not in compliance. In addition, lenders with ratings of not in compliance are to receive follow-up reviews 6 months after the regular review is conducted. SBA officials explained that because they want to encourage lenders to participate in PLP, they prefer to work out problems with lenders, and therefore rarely terminate PLP status. Another example of this approach applies to training offered by SBA to lenders with compliance problems. SBA district offices are required to offer training to the lenders, but the lenders are not required to take it. Where a lender persists in noncompliance, SBA will generally allow the status to expire, rather than terminating it. However, without clear enforcement policies, PLP lenders cannot be certain of the consequences of certain ratings; and, in addition, they may not take the oversight program seriously.

In November 2000, we recommended that the SBLC examination program could be strengthened by clarifying SBA's regulatory and enforcement authority regarding SBLCs. Although it has the authority to do so, SBA has yet to develop, through regulation, clear policies and procedures for taking

[25] 13 C.F.R. § 120.455 (2002).

supervisory actions. By not expanding the range of its enforcement actions—which it can do by promulgating regulations—SBA is limited in the actions it can take to remedy unsafe and unsound conditions in SBLCs. SBA regulations only provide for revocation or suspension of an SBLC license for a violation of law, regulation, or any agreement with SBA. Without less drastic measures, SBA has a limited capability to respond to unsatisfactory conditions in an SBLC. Unlike SBA, federal bank and thrift regulators use an array of statutorily defined supervisory actions, short of suspension or revocation of a financial institution's charter or federal deposit insurance, if an institution fails to comply with regulations or is unsafe or unsound.

SBA's Review Funding Mechanisms Are Questionable

SBA's current arrangement for funding its reviews and assessing fees on lenders is inconsistent and raises questions of propriety, fairness, and accountability. SBA has contracted with an outside firm to perform PLP reviews. SBA has decided not to use its appropriations to pay the contractor that performs PLP reviews. Instead, PLP lenders pay fees directly to the contractor. At present, the extent to which SBA has authority to engage in this process is unclear and is the subject of additional work we are performing beyond the scope of this report. However, the arrangement raises questions, beyond its legality, about appropriateness and fairness. SBA funds oversight of the remainder of its 7(a) lenders, without assessing a fee, from its appropriations. PLP reviews are not funded by appropriated funds, thus allowing an increasingly important agency function to circumvent direct oversight of the budget process. This raises additional questions about the appropriate funding mechanism for SBA's lender reviews. This funding arrangement with its contractor also limits SBA's flexibility in managing its lender reviews because fees are set and paid prior to the commencement of a PLP review based on the planned scope of the review.

SBA's Authority to Have Preferred Lenders Pay for Contractor Reviews Is Unclear

SBPIA required SBA to review preferred lenders annually or more frequently. Under the terms of a contract, which SBA negotiated with the firm that conducts PLP reviews on behalf of SBA, PLP lenders pay a PLP review fee directly to the contractor prior to the commencement of the review in order to cover the costs of the review. SBA guidance states that the annual fee structure is to be negotiated between SBA and the contractor and published each year.[26] The fee structure consists of a

[26]The most recent fee guidance was published for the third review year, effective June 2000.

schedule listing the fee that a lender will pay the contractor for its review, based on the number of loans in the sample to be reviewed by the contractor. Prior to a review, SBA determines the sample size, based on the lender's prior year's lending, and notifies the lender of the fee, instructing the lender to pay the fee to the contractor prior to the commencement of the review. The fees cover contractor salaries, travel, and administrative expenses.

SBA has elected not to fund the contract out of its appropriations. Instead, SBA has negotiated a contract under which the lenders pay a fee directly to the contractor. SBA officials explained that a major reason for the current arrangement with the contractor is that SBA is not authorized to keep the review fees, and it would have to turn the fees collected over to the U.S. Treasury.[27] SBA officials stated that they have requested Congress to authorize SBA to keep review fees to provide more flexibility in running its program. Without such authorization, SBA officials said they must have the lenders pay fees directly to the contractor so that those fees can be used to fund the PLP reviews. However, we note that SBA could have funded the contract out of its appropriations, since SBA and the U.S. government are the primary beneficiaries of the PLP reviews.

At present, the extent of SBA's authority to have such an arrangement is unclear. SBA said it has the authority to assess PLP lenders a fee but cannot retain any fees it collects. Section 5(b)(12) of the Small Business Act authorizes SBA to impose, retain, and use fees specifically authorized by law or which were in effect on September 30, 1994.[28] The extent to which this provision or another statute authorizes SBA to institute this arrangement is unclear and is an issue beyond the scope of this report. Appendix II contains a reprint of a letter we have sent to SBA requesting additional information on this arrangement.

[27]Under 31 U.S.C. § 3302(b), an official or agent of the federal government receiving money for the government generally must deposit the money in the U.S. Treasury, without deduction for any charge or claim.

[28]5 U.S.C. § 634(b)(12)(2000 & Supp. 2002) SBA's regulation 13 C.F.R. §120.454 states that "SBA may charge the PLP lender a fee to cover the costs of this review."

SBA Funds Oversight of Many 7(a) Lenders Without a Fee

In contrast to the PLP fee arrangement, SBA funds its reviews of its other lenders from appropriated funds. These reviews include the following:

- safety and soundness examinations and PLP reviews of SBLCs performed under agreement by FCA,[29]
- reviews of regular 7(a) lenders performed by SBA district office staff, and
- follow-up PLP reviews performed by SBA staff for PLP lenders that receive an unsatisfactory rating.

Figure 4 illustrates the various lender reviews, funding sources, and review arrangements.

Figure 4: SBA Lender Review Fee Format

	Who pays for review		Who performs review	
	SBA	Lender	SBA	Contractor
PLP reviews	○	●	●	●
SBLC examinations/PLP review	●	○	○	●
Non-PLP loans of PLP lenders	●	○	●	○
Non-PLP reviews	●	○	●	○
Follow-up PLP reviews	●	○	●	○

● Designates who pays for and performs review

Source: GAO analysis.

The current arrangement raises issues of fairness because some lenders pay for their SBA oversight while others do not.

[29]As a government entity, FCA can only receive funding from another government agency; therefore, SBLCs cannot pay FCA directly the way other preferred lenders pay contractors performing the reviews.

Agencies' Oversight Activities May Be Funded in Several Different Ways

Congress has created a range of structures in which agencies fund their oversight activities through the use of fee collections, assessments, or other sources of funding rather than on appropriations from the Treasury's general fund. The variations among these agencies can be attributed to how and when Congress makes the fees available to an agency and how much flexibility Congress gives an agency in using its collected fees without further legislative action. For some agencies, such as FCA and the Office of Federal Housing Enterprise Oversight (OFHEO), Congress limits the amount of assessments to be collected and made available through provisions in annual appropriations acts. In contrast, Congress provided permanent budget authority to the federal banking agencies—Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, and National Credit Union Administration—allowing these agencies to use all the funds collected without further legislative action. One factor in determining who pays for oversight costs is considering who is the primary beneficiary of the oversight.

As we noted earlier, the role of SBA regarding PLP lenders specifically and 7(a) lenders in general, is different from that of the regulators listed above, with the exception of SBLCs. SBA's lender oversight is intended to provide assurance that PLP lenders are properly following SBA policies and procedures. Therefore, PLP reviews are done primarily to benefit SBA and the U.S. government.[30] While allowing SBA to fund its oversight operations through fees or assessments on all of its lending partners would provide it with enhanced flexibility and the ability to charge its lenders more equitably, it would also limit congressional control of the oversight activity. Congress could give SBA greater budget flexibility but still maintain some degree of control over its funding level by placing a variety of limitations on SBA's offsetting collections, for example by designating fees for SBA's use, but limiting amounts to those appropriated annually; specifying the amount of fees to be collected; and specifying the purpose for which fees can be used.

To maximize SBA's accountability for the lender oversight function and ensure that it becomes the agency priority that SBA's own strategic plan suggests it should be, another option would be for Congress to explicitly designate in the appropriations act the amount that SBA is to devote for

[30]Lenders indirectly benefit from the reviews because compliance with program requirements is necessary to maintain PLP status.

that purpose. SBA would then be responsible for tracking the expenditure of those funds. Ultimately Congress must decide the appropriate funding mechanism for SBA and how it is to be applied among its various lenders.

SBA's Current Funding Arrangement Limits the Flexibility of the Program

The way in which SBA covers the costs of its lender oversight limits the flexibility of the program. As SBA redesigns the PLP review process to perform more meaningful reviews, continuing to use a contractor with a predetermined review charge could limit SBA's flexibility to pursue oversight issues that require more scrutiny than was initially planned. SBA would have to develop a way to compensate the contractor to more fully evaluate issues that raise concern upon initial review. Another factor that limits SBA's flexibility is SBA's practice of determining the loan sample to be reviewed based on the prior year's lending. This could lead to inappropriate sample sizes in instances where lenders significantly increase their lending level from one year to the next. SBA officials said that the agency's lack of authority to retain review fees could limit its flexibility in managing the redesigned PLP review program in the future as well. The current arrangement could force SBA to consider cost rather than oversight priorities in managing how costs are allocated and the way reviews are conducted.

SBA's Process for Administering PLP Status Presents Lenders with Challenges

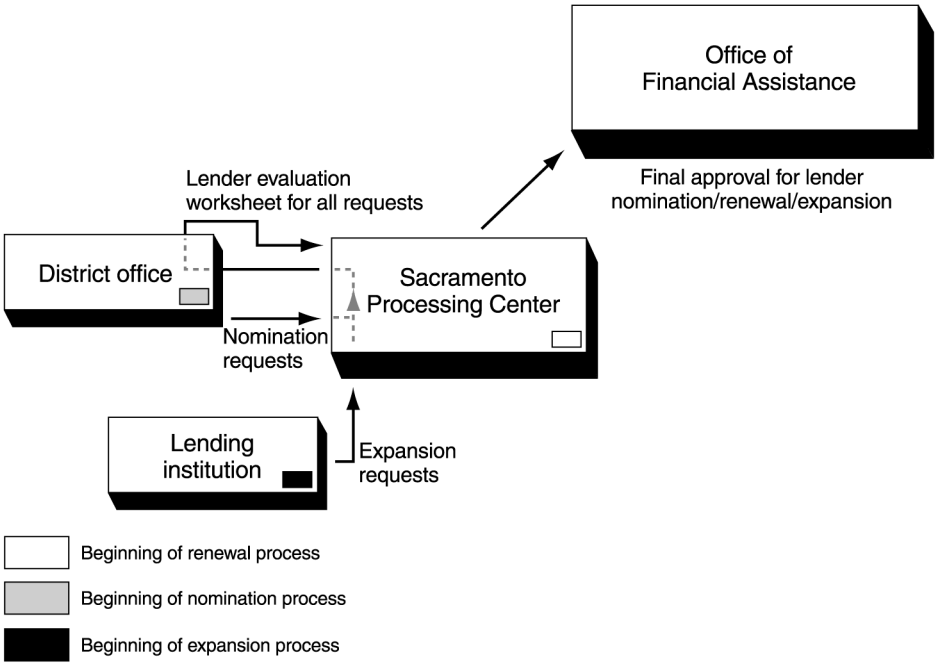
OFA has taken a number of steps to make the administration of lenders' PLP status more objective and transparent to lenders that qualify for the program. However, some lenders we interviewed indicated that they do not understand decisions made regarding their PLP status and that going through the process can be administratively challenging, particularly for larger lenders that operate in multiple SBA districts. Going forward, OFA is faced with the challenge of balancing the needs of its primary customers, small businesses, against the needs of its lenders—upon which SBA relies to make preferred loans.

SBA Grants PLP Status on a District-by-District Basis

SBA's preferred lender certification process begins when a district office serving the area in which a lender's office is located nominates the lender for preferred status or when a lender requests a field office to consider it for PLP status. The district will then request performance data regarding the lender from SBA's Sacramento Processing Center. The processing center then provides the district office with data required to fill in part of a worksheet developed for the nomination process. The district office then sends the completed worksheet, along with other required information, back to the processing center. The processing center analyzes the nomination and sends it with a recommendation to OFA for final decision.

Figure 5 illustrates SBA's process for lender nomination, renewal, and expansion of PLP status.

Figure 5: SBA's Process for Nomination, Renewal, and Expansion of PLP Status



Source: GAO analysis.

According to SBA's SOP, in making its decision, OFA considers whether the lender, (1) has the required ability to process, close, service, and liquidate loans; (2) has the ability to develop and analyze complete loan packages; and (3) has a satisfactory performance history with SBA. OFA also considers whether the lender shows a substantial commitment to SBA's "quality lending goals," has the ability to meet the goals, and demonstrates a "spirit of cooperation" with SBA.

OFA and district office staff said that although district offices do not provide final approval of PLP status for lenders in their districts, they generally play an important role and district input is given significant weight. Most of the district office staff we interviewed believed that they had considerable influence on OFA's decision regarding a lender's PLP status.

If OFA approves a lender's nomination, it will designate the area in which the lender can make PLP loans and will approve preferred status for a term not to exceed 2 years. If OFA does not approve the nomination, the Sacramento Processing Center will notify the lender and district office with an explanation of why the nomination was not approved. SBA's SOP states that the lender has no right of appeal to SBA. In its comments on this report, SBA noted that the lender can appeal SBA's decision to Federal District Court. According to SBA's procedures, if the lender wants to reapply for PLP status it must wait at least 1 year from the date of the refusal before reapplying to the district office.[31] SBA officials commented, however, that lenders may reapply once they have addressed the issues that caused the refusal. When a PLP lender's status expires, OFA may renew it as a PLP lender for an additional 2-year term, or less, if circumstances such as an unsatisfactory review rating dictate. SBA has recently begun to coordinate lenders' PLP reviews with their PLP renewals, allowing SBA to consider its current review of PLP lenders' loans, policies, and procedures as part of its decision.

A PLP lender may request an expansion of the territory in which it can process PLP loans by submitting a request to the Sacramento Processing Center. The processing center will obtain the recommendation of each district office in the area into which the PLP lender would like to expand its PLP operations. The processing center will forward the district recommendations to OFA for a final decision.

Some PLP Lenders Identified Concerns with the PLP Certification Process

Lenders we interviewed had varying experiences in gaining and maintaining their PLP status. While some lenders expressed general satisfaction with the process and their understanding of it, others cited problems. For example, several PLP lenders we interviewed said that they had their PLP status declined in a specific district, although they had already achieved PLP status in other districts. In some instances, lenders said that they did not understand why they had been turned down, in light of their proven performance. These lenders commented that some district offices were not open to working with lenders from outside their districts while others were. In our interviews with district offices, we sometimes heard differing descriptions from district office officials on the level of commitment required of a lender who wished to gain PLP status in their district. Some district officials said that a lender had to maintain a physical presence in the district, while others disagreed. However, all district office

[31]SBA SOP 50-10(4).

officials expressed the need for some regular discussion with a lender to understand the lender's commitment to the district.

Larger lenders, as well as the National Association of Government Guaranteed Lenders (NAGGL), noted the administrative burden of maintaining relationships with many of the 70 district offices to maintain PLP status. The lenders noted that to receive and maintain PLP status in a given district, it is generally necessary to meet at least annually with district office staff to discuss status and plans for future lending. For some large national lenders, this can amount to 40 or more visits per year. In response to this concern, NAGGL has recommended a national PLP status based on a uniform national standard to ease the administrative burdens on large national lenders that account for the largest volume of PLP lending.

District Office Staff Maintain that Local Involvement Is Key to PLP's Success

District office officials that we interviewed generally acknowledged that they want to understand a lender's plans for their district before agreeing to endorse a lender that wishes to gain PLP status in their district. District officials explained that PLP status is an important marketing tool for lenders and that, as advocates for the credit needs for small businesses in their districts, the district office officials see PLP status as a "carrot" to be used to encourage lenders to make a sufficient volume of loans to their district. They suggest that a "national" PLP lender might make a large volume of PLP loans nationwide, but none in their district. The officials reason that without a district-by-district PLP status, district offices would lose an important tool for encouraging lenders to respond to credit needs in their districts.

SBA Designed the Lender Evaluation Worksheet and Lender's Liaison Program to Improve the Process for PLP Lenders

To hold lenders to a uniform national standard while maintaining individual district office's preferences and reinforcing their relationships with PLP lenders, SBA developed a lender evaluation worksheet to facilitate the nomination, expansion, and renewal processes. According to SBA officials, the worksheet, introduced in September 2000, is a formula-driven spreadsheet to be used by district offices in making their recommendations regarding PLP status for lenders.[32] The worksheet was further refined, and a new version was introduced in April 2002. The worksheet replaces the former procedure that involved written recommendations from district officials; however, it continues to award

[32]The worksheet was also designed for recommendations regarding *SBAExpress* or *CommunityExpress* status for lenders, which are pilot programs under PLP.

points based on sometimes subjective criteria, such as the district office's assessment of the lender's SBA marketing and outreach efforts rather than the formulas in the spreadsheet. Where this is the case, district office staff is required to provide written justification for the points it awards.

SBA developed the Lender Liaison program, managed by its Office of Field Operations (OFO), to assist large national lenders in managing relationships with SBA. The program was formally introduced in December 1999; but according to OFA staff, the program took another 6 months to implement. The program involves the assignment of a single SBA official, generally a district director, to act as a liaison to a large national lender. In the event that a large lender should experience difficulty in managing its PLP status, it would have a single SBA official to call to assist in resolving any problems. OFO staff said that feedback they have received from lenders indicated that they like the program, finding it useful for resolving difficulties. Two of the lenders we interviewed participated in the program, and both expressed satisfaction with it. SBA has designated lender liaisons for 20 PLP lenders. Additionally, OFO has developed a proposal to make the program permanent and expand the program to 50 additional lenders. An OFO official explained that OLO identified 70 lenders who have PLP status in 6 or more districts and could benefit from the program.

SBA's Organizational Alignment Does Not Adequately Support SBA's Lender Oversight Functions

SBA's current structure does not adequately support lender oversight. In our past work analyzing organizational alignment and workload issues, we have described the importance of tying organizational alignment to a clear and comprehensive mission statement and strategic plan, and providing adequate resources to accomplish the mission. SBA has established OLO and developed standard operating procedures for lender oversight; but OLO still shares responsibility for some oversight functions with OFA and operates at staffing levels that OLO staff have said hampers their ability to accomplish necessary oversight tasks, sometimes resulting in significant delays that pose a potential risk to the agency. Without a clear division of responsibilities or accountability and the elimination of potential conflicts, the effectiveness of SBA's lender oversight is hindered.

We Have Outlined Necessary Elements for Successful Organizational Alignment

In our past work analyzing organizational alignment and workload issues at SBA and other agencies' efforts to improve management and performance, we have described the importance of tying organizational alignment to a clear and comprehensive mission statement and strategic plan. By organizational alignment, we mean the integration of

organizational components, activities, core processes, and resources to support efficient and effective achievement of outcomes. For example, we noted how agency operations can be hampered by unclear linkage between an agency's mission and structure, but greatly enhanced when they are tied together.[33] We have also noted the importance of human capital in achieving mission outcomes. We have identified human capital management challenges in key areas, which include the following:

- undertaking strategic human capital planning and organizational alignment and
- acquiring and developing staffs whose size, skills, and deployment meet agency needs.[34]

We have also noted in our past work the importance of separating safety and soundness regulation, as well as mission regulation, from the function of mission promotion.[35] While SBA's role regarding PLP lenders is slightly different from that of a safety and soundness regulator, the principle that an oversight function should be organizationally separate, maintaining an arm's length relationship from a program promotion function, still applies to SBA.

SBA's Current Organization for Lender Oversight Results in Decreased Accountability and Potential Conflicts

SBA officials have said and written that lender oversight is becoming an increasing priority for SBA; however, the function is not housed in an independent office with the exclusive role of providing lender oversight. OLO was created within OCA in fiscal year 1999 to ensure consistent and appropriate supervision of SBA's lending partners; however, OCA has other objectives, including the promotion of PLP to appropriate lenders. OFA, also part of OCA, is responsible for providing overall direction for the administration of SBA's lending programs, including working with lenders to deliver lending programs, including 7(a), and developing loan

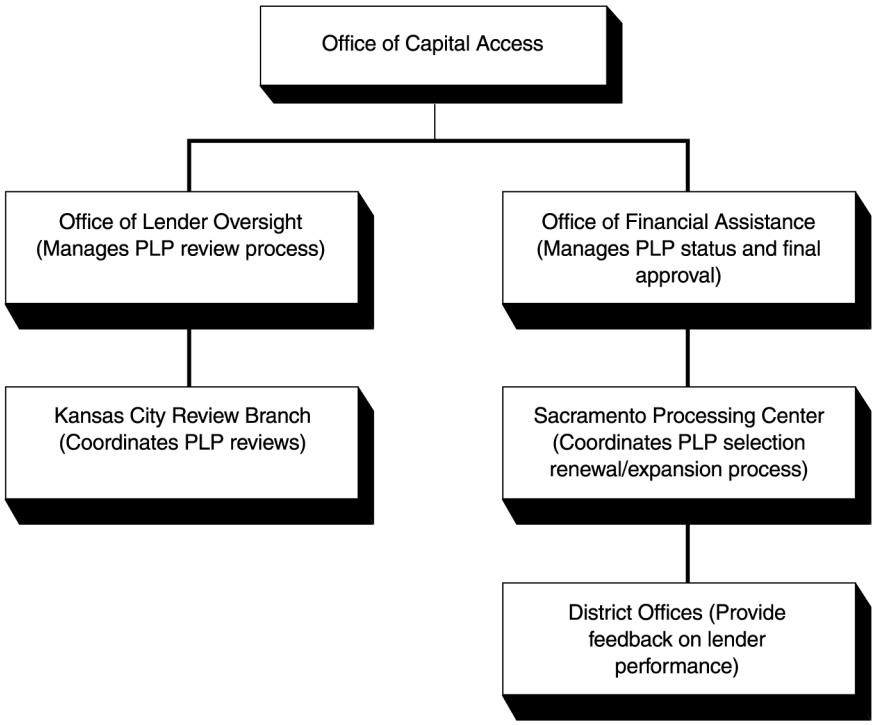
[33]U.S. General Accounting Office, *Small Business Administration: Current Structure Presents Challenges for Service Delivery*, GAO-02-17 (Washington, D.C.: October 2001).

[34]Also included are leadership continuity and succession planning, and creating results-oriented organizational cultures. U.S. General Accounting Office: *Managing For Results: Next Steps to Improve the Federal Government's Management and Performance*, GAO-02-439T (Washington, D.C.: February 15, 2002).

[35]U.S. General Accounting Office: *Federal Housing Finance Board: Actions Needed to Improve Regulatory Oversight*, GAO/GGD-98-203 (Washington, D.C.: September 1998).

policies and standard operating procedures. Figure 6 shows the organization of preferred lender oversight under OCA.

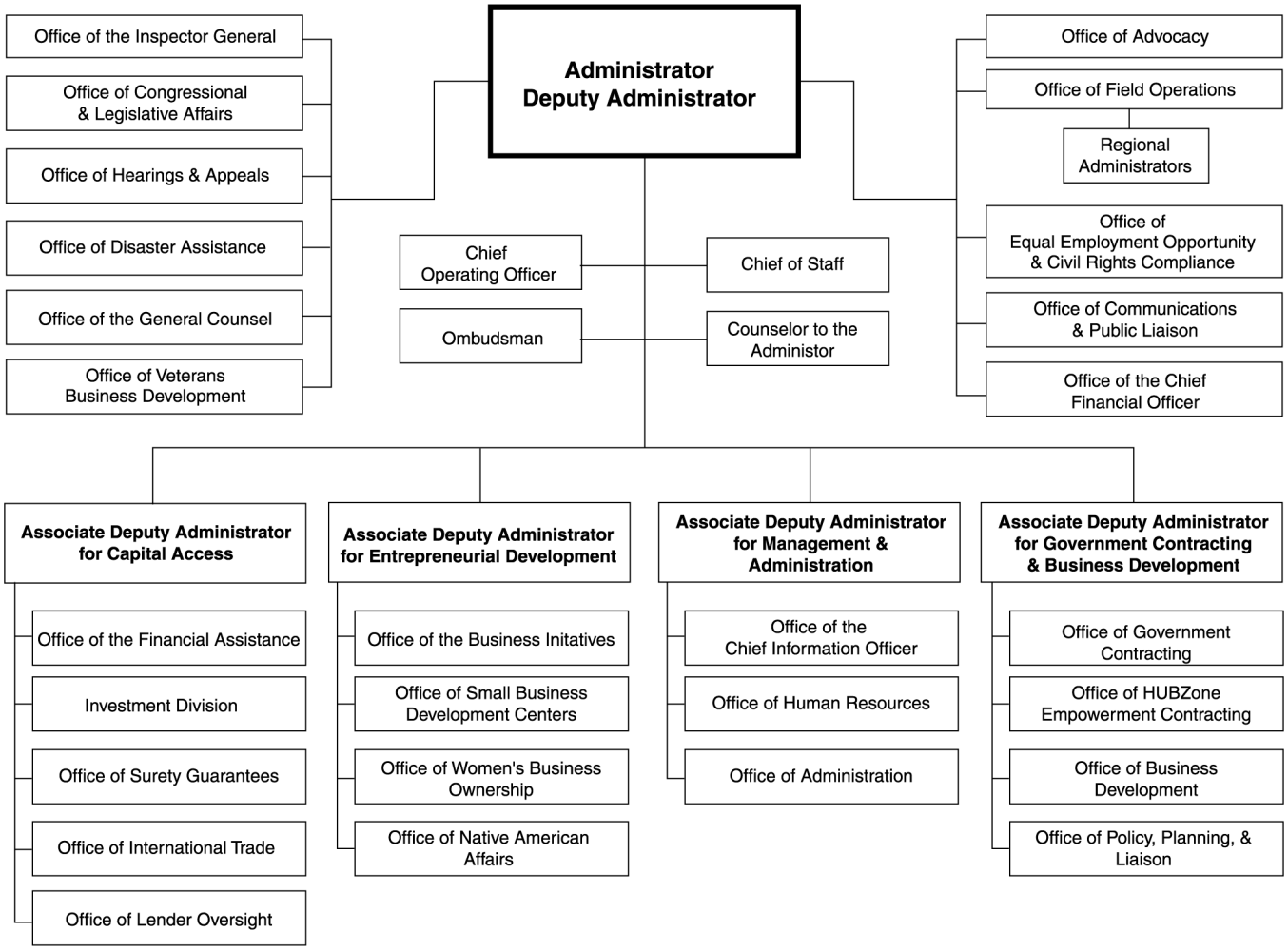
Figure 6: Preferred Lender Oversight Responsibilities within OCA



Source: GAO analysis of SBA's structure.

OFA's lender oversight role is to provide final approval of lenders' PLP status and to take necessary enforcement actions against SBLCs. Part of OFA's program promotion role is determining whether or not lenders should participate in the program. Thus the only explicit enforcement authority—the authority to revoke PLP status—resides with OFA rather than OLO. The presence of both OFA and OLO within OCA does not afford the oversight function an arm's length position from the promotion function. The organizational arrangement presents 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 (with the potential for discontinuing lenders' participation in PLP). In congressional testimony describing an SBA workforce transformation plan, a senior SBA official announced that SBA will centralize all lender oversight functions within headquarters.

Figure 7: SBA's Headquarters Organization Chart



Source: SBA.

Poorly Aligned Resources Hinder PLP and SBLC Oversight Effectiveness

Evidence of overlapping responsibilities and poorly aligned resources can be seen in delays SBA has experienced in completing certain tasks associated with lender oversight. These delays could hamper PLP and SBLC oversight effectiveness by delaying corrective action that might arise from review findings. Since some, but not all, responsibility for the lender oversight function migrated from OFA to OLO, both offices continue to mingle responsibilities for certain functions. The division of responsibility between OFA and OLO has created the need for more interoffice

coordination to complete certain tasks. For example, we found substantial delays in finalizing PLP review reports and, as noted earlier, in SBLC examination reports. In the sample we reviewed, we found that PLP review reports were issued an average of 156 days after the completion of the review. In two cases, it took more than 300 days to complete the reports. OLO officials explained that they did not have any published standards for report timeliness, but that they had developed draft "customer service" goals for fiscal year 2003 that called for review reports to be issued to the lender within 90 days of the completion of the review.

SBA's OIG concluded that the delays in completing SBLC reports were at least partially due to poor coordination between OLO and OFA, both of which were involved in reviewing the reports. OLO and OFA, respectively, are responsible for oversight and management of the SBLC program. As previously stated, OLO is responsible for SBLC on-site examination and off-site monitoring, while OFA handles day-to-day program management, policymaking, and enforcement of corrective actions. Coordination between the two offices; however, was not formally established and simply evolved over time. OIG said that this informal structure contributed, in part, to the delays in issuing the fiscal year 2001 examination reports. OLO staff said that limited staffing also contributed to delays. OLO began operations with three headquarters staff members in fiscal year 2000; and at the beginning of fiscal year 2002, they had six staff members. In the last quarter of fiscal year 2002, OLO staff increased to 10, and 2 additional positions have since been filled, for a total staff of 12. The Kansas City Review Branch operates with 10 staff. Overall, OCA currently operates with 415 staff.

To assist in establishing lines of authority between OLO and OFA and formalizing coordination between the two offices, the OIG recommended the development of a "supervisory committee."[36] To date, SBA has not implemented this recommendation. As we stated earlier, delays in reporting examination findings limit the accuracy of the findings when they are finally reported; and, in the meantime, the institution could have corrected or magnified the extent of weaknesses the examination

[36]U.S. Small Business Administration, Office of the Inspector General, Action Memorandum, March 20, 2002, Report No. 2-12. The IG report cites OMB Circular No. A-129, *Policies for Federal Credit Programs and Non-tax Receivables* as requiring agencies with federal credit programs to submit its reports of lender reviews to such a supervisory committee.

identified. SBA's OIG also noted that delays in issuing final examination reports to SBLCs also delays any remedial action SBA might take.

To enhance its SBLC oversight, SBA announced in 2000 that it intended to establish an off-site monitoring process for the SBLC program. According to OLO officials, this is still under development. OLO officials said delays in developing the LMS have contributed to their delays.

As noted earlier, OLO has not yet responded to our earlier recommendation to develop enforcement policies or to recommendations from FCA for improving its SBLC oversight. OLO officials have said that they are working on developing the enforcement policies and on implementing the FCA recommendations with which they agree, but again suggested that limited staff resources have contributed to the amount of time it has taken to complete actions in these areas.

Conclusions

As SBA's reliance on lending partners has increased, so has the importance of its lender oversight. In response to our past recommendations, SBA has done much to improve its lender oversight function. However, without continued improvement to better enable SBA to assess the financial risk posed by 7(a) loans and to ensure that its lending partners are making loans to small businesses that are eligible, SBA will not have a successful lender oversight program. The credit elsewhere standard is broad, making a meaningful assessment of lenders' decisions difficult. Moreover, SBA has not developed policies and procedures that clearly state SBA's actions regarding noncompliance by PLP lenders. While SBA has developed an examination program for SBLCs, its ability to appropriately respond to examination findings to remedy unsafe and unsound conditions continues to be limited by unclear enforcement authority and an inability to complete basic oversight tasks. By not completing these tasks, SBA could be allowing unsafe and unsound conditions to persist that could pose an unacceptable and unnecessary risk to its 7(a) loan portfolio.

Because it provides lenders with autonomy in making 7(a) loans, PLP is key to SBA's strategy of shifting more of its workload from itself to its lending partners to fulfill its mission of providing small business with access to credit. SBA has made improvements in its process for managing lenders' PLP status by making the process more objective and facilitating communication with larger lenders, who account for most PLP loan volume. Some large national PLP lenders continue to face challenges in dealing with multiple district offices' varying needs, but SBA will have to

balance the concerns of PLP lenders against the need to ensure that currently underserved small business customers in all districts are served.

SBA has taken a number of significant steps to develop its lender oversight function but has not made the commitment in the way of organizational independence or human capital investment. This is important in order to ensure SBA's success in developing an effective lender oversight function that achieves SBA's goals of protecting SBA from undue financial risk while ensuring that its assistance is provided to eligible small businesses.

Recommendations

To improve PLP and SBLC oversight, we recommend that the SBA Administrator:

- incorporate strategies into its review process to adequately measure the financial risk lenders pose to SBA, develop specific criteria to apply to the credit elsewhere standard, and perform qualitative assessments of lenders' performance and lending decisions.

- provide, through regulation, clear policies and procedures for taking enforcement actions against preferred lenders and SBLCs in the event of continued noncompliance with SBA's regulations. Specifically, the Administrator of SBA should adopt regulations that would clearly define SBA authority to take enforcement actions and specify conditions under which supervisory actions would be taken,

- continue to explore ways to assist large national lenders to participate in the PLP. These efforts could include further development and implementation of SBA's Lender Liaison program and continued attention to standardizing the PLP certification process and enhancing its transparency, as was done with the development of the Lender Evaluation Worksheet to assist lenders in their interactions with district offices, and

- separate lender oversight functions and responsibilities from OCA, including those currently done by OFA, such as responsibility for revoking preferred lender status and establish clear authority and guidance for OLO, or its successor office, that states, at a minimum, its program responsibilities and planned staffing for those responsibilities. This would provide an oversight office with greater autonomy within SBA to match the growing importance of lender oversight in achieving SBA's goal of ensuring that PLP lenders make loans to eligible borrowers while properly managing the financial risk to SBA.

Agency Comments

We requested SBA's comments on a draft of this report and the Associate Deputy Administrator for Capital Access provided written comments that are presented in appendix III. SBA did not explicitly state that it agreed or disagreed with our recommendations. In specific comments on the four recommendations, however, SBA essentially disagreed with part or all of two recommendations and said that it was "working to address" or considering issues we presented in the other two.

SBA said it was considering additional approaches to assess the financial risk that lenders pose and to allow for qualitative assessments of its lenders, but disagreed with our recommendation that it develop specific criteria to apply to the credit elsewhere standard. SBA cited its current safety and soundness examinations of SBLCs as an example of its efforts to assess financial risk. We agree, and our draft report noted the scope of the examinations of these special preferred lenders. In addition, SBA stated that its current reviews of preferred lenders do assess some degree of financial risk but that review reports may not indicate such an assessment unless a dollar amount of risk could be identified. Only 3 of the 15 PLP review reports that we reviewed provided any evidence of such an assessment and, as stated in our report, SBA's review guidance does not require such an assessment. In addition, SBA officials told us during the course of our work that PLP reviews are strict compliance reviews that are not designed to measure the PLP lenders' financial risk. With regard to developing specific criteria to apply to the credit elsewhere standard, SBA provided cites to law, regulation, and its SOP that discuss the credit elsewhere standard. We analyzed these sources in reaching our conclusion that the credit elsewhere standard is broad, making a meaningful assessment of lenders' decisions difficult. To make the assessment of lenders' decisions more meaningful, SBA should develop more specific criteria to apply to the credit elsewhere standard.

Regarding our recommendation that SBA provide, through regulation, clear policies and procedures for taking enforcement action, SBA said that it was working diligently to address the concerns we expressed on this issue. We note that our November 2000 report on the need for SBA to strengthen oversight of SBLCs included this same recommendation for the SBLC oversight program. Similarly, in response to our recommendation that it continue to explore ways to assist large national lenders to participate as preferred lenders, SBA said it was reviewing the issues identified in our draft and considering how best to address them.

SBA appears to have disagreed with our recommendation to separate lender oversight functions and responsibilities from OCA, but its

comments did not specifically respond to the recommendation. Instead, SBA emphasized that the senior executives heading OLO and OFA independently report to the head of OCA and restated that lender review functions were transferred from OFA to OLO in 2000. Nevertheless, SBA did not address issues such as the apparent conflict of interest in having oversight, certification, and promotion functions within the same office (OCA). In addition, the comments did not address delays in finalizing preferred lender review reports and SBLC examinations due to lack of coordination between the two offices. We continue to maintain that the current structural alignment and overlapping responsibilities of oversight functions, such as lender oversight and certification, within these two offices hinders effective oversight and presents the appearance of a conflict, given the promotional and programmatic responsibilities of OFA and OCA.

SBA stated in its comment letter that it identified a number of inaccuracies in our draft report. However, these were mostly technical corrections, which we incorporated as appropriate in this report. SBA's letter is reprinted in appendix III.

Objectives, Scope, and Methodology

To evaluate SBA's 7(a) lender oversight program, we analyzed SBA's oversight of its 7(a) lenders, particularly for preferred lenders, some of whom are SBLCs licensed by SBA to make only 7(a) loans. In conducting our work, we defined oversight to include SBA's process for reviewing preferred lenders for compliance with SBA guidance and for evaluating them for initial and continued participation in the PLP. We analyzed PLP review guidance, review and lending data to the extent that it was available, and a sample of PLP and SBLC review reports. We reviewed annual summary reports to SBA prepared by FCA that describe FCA's overall conclusions and recommendations from examining SBLCs. We interviewed SBA headquarters staff from OLO and OFA and regional staff, including a sample of 11 district offices and the Sacramento Processing Center. We also interviewed a sample of 10 PLP lenders to evaluate their experiences in SBA's oversight program. The sample included a geographically diverse group of large, medium, and small lenders, by loan volume. We also interviewed representatives of the National Association of Government Guaranteed Lenders.

To evaluate SBA's organizational alignment for conducting preferred lender and SBLC oversight, we reviewed SBA's fiscal year 2003 Budget Request and Performance Plan and draft Workforce Transformation Plan, as well as past GAO and SBA OIG work. We evaluated management

information that tracked OLO's report completion as well as staffing data. We interviewed OLO, OFA, and OIG officials. We also interviewed the FCA official responsible for overseeing its SBLC examination function, carried out under contract with SBA.

We conducted our work in Washington, D.C.; Kansas City, Missouri; Sacramento, California; Salt Lake City, Utah; and Baltimore, Maryland, between March and September 2002, in accordance with generally accepted government auditing standards.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this report. At that time, we will send copies of this report to the Chairman of the Senate Committee on Small Business and Entrepreneurship and the Chairman and Ranking Minority Member of the House Committee on Small Business, other interested congressional committees, and the Administrator of the Small Business Administration. We will make copies available to others on request. In addition, this report will also be available at no charge on our homepage at http://www.gao.gov.

Please contact me at (202) 512-8678, dagostinod@gao.gov or Kay Harris at (202) 512-8415, harrism@gao.gov if you or your staff have any questions. Major contributors to this report were Thomas Conahan and Toayoa Aldridge.

Davi M. D'Agostino
Director, Financial Markets
and Community Investment

Appendix I: Opportunities for Small Business Lending Company Program Enhancement Identified by the Farm Credit Administration

Beginning in fiscal year 1999, the Small Business Administration (SBA) contracted with the Farm Credit Administration (FCA) to examine the 14 Small Business Lending Companies (SBLC). At the end of each examination cycle, FCA provides a Comprehensive Summary Report (Report) to SBA that summarizes its examination activities and results for the year and also identifies opportunities for program enhancement. In its report for fiscal year 2001, FCA listed 11 items or recommendations in this section, all of which SBA agreed to implement. Eight of the recommendations initially appeared in FCA's 1999 Report, while two appeared in the 2000 Report. The fiscal year 2001 Report notes that while SBA may have initiated some actions to address issues from previous years, a complete resolution has not yet been effected.

The issues that appear in the fiscal year 2001 Report, are listed below by categories that appear in the FCA Reports. The year in which the issue was initially raised is indicated in parentheses.

Portfolio Management

- SBLCs should implement dynamic loan risk rating systems that correlate with the uniform classification system outlined in the SBLC Examination Handbook and report the results to the board management and SBA. Such a system is necessary to effectively identify, monitor, and manage loan risks on an aggregated program basis (1999).

- SBLCs should implement independent internal credit review (ICR) processes to validate the reliability of the risk rating system. An effective ICR process will also ensure that credit administration and other internal credit controls are implemented as required by the board and management. Some of the larger institutions had such an independent review process, but most had processes that were not comprehensive or were not independent (1999).

- SBLCs should be encouraged to develop additional underwriting standards for significant segments of their portfolios. In addition, the SBLCs should develop a mechanism that tracks noncompliance with underwriting standards. This would assist the board and management in their assessment of risk exposure and in establishing risk parameters (1999).

- SBA should provide clear definitions for measuring delinquent loan volume. Some institutions continue to report delinquency rates based on the "interest paid-through" date versus the more traditional

definition of "next payment due" date. Clarifying the definition of what constitutes a delinquent loan will promote consistency and a more accurate picture of risk in the SBLCs' portfolios (2000).

- Consider requiring the SBLCs to consolidate (as needed) borrower business and personal financial statements as part of loan underwriting to improve the analysis of loan risk exposure. Also, while the loan authorization requires the submission of financial statements on an on-going basis, SBA should provide the SBLCs some means to enforce this requirement (1999).

- SBLCs should continue to implement appropriate internal controls to ensure accurate, consistent and timely submission of loan information in 1502 reports.[1] Many SBLC officials continue to indicate a need for clearer and more concise SBA report requirements and definitions of the key reporting elements (1999).

- SBLCs should implement an appraisal review process (2001).

Financial Performance and Condition

- Require quarterly financial reporting that conforms to Generally Accepted Accounting Principles in the reports provided to SBA by the SBLCs. More frequent reporting combined with uniform standards would allow proactive monitoring of developing trends. Additional benefits could include fewer examination resources devoted to financial review and the ability to perform objective analysis and comparisons among the SBLCs (2000).

- Strengthen general oversight and monitoring of SBLC financial condition, especially oversight of compliance with minimum capital requirements. SBA regulations and other guidance do not require SBLCs to provide ongoing certifications of compliance with the minimum capital requirements (1999).

- Determine the reasonableness of the process for valuing SBLC servicing rights. Valuation of servicing rights is a key factor in assessing the financial position of institutions. Since the value of servicing rights

[1]These are monthly loan reports to SBA's contractor for compiling aggregate loan information. The report includes items such as interest rates, guaranteed portion of loan, and next installment due date.

contributed over one half of the capital in some SBLCs and were in excess of 100 percent of capital in two SBLCs, the assumptions underlying the processes for establishing their value should be validated. SBA may also wish to establish limits on the amounts of the servicing rights asset that may be counted toward capital calculations (1999).

- Consider modifying SBA capital regulations to address capital adequacy, capital structure, and define what components constitute regulatory capital. In addition, capital regulations should require increased levels of capitalization for more volatile assets, such as servicing rights (1999).

Appendix II: GAO Letter of Inquiry to the Small Business Administration

United States General Accounting Office
Washington, DC 20548

Via Fax

October 23, 2002

Ms. Louise Wilson
Chief, Financial Reviews Branch
Office of Financial Administration
Office of the Chief Financial Officer
Small Business Administration
Washington, D.C. 20416

Re: GAO Review of SBA's Lender Oversight

Dear Ms. Wilson:

As you know, GAO is conducting a review of SBA's oversight of lenders that participate in the Preferred Lender Program (PLP) (job code 250060). SBA's regulations provide for SBA review of a PLP lender's performance and the assessment of a fee to cover the costs of the review.[1] During our review, SBA officials told us that SBA does not conduct these reviews directly, but instead contracts with third parties to perform PLP reviews. SBA negotiates a fee structure with the contractor and, based on that structure, the PLP pays the contractor a fee to cover the cost of the review. Although our review has related primarily to the effectiveness of SBA's oversight policies and practices, we have identified several issues regarding fees assessed to PLP lenders and the structure of this aspect of the PLP program.

In connection with our analysis of SBA's authorities we have submitted questions to Diane Wright of your General Counsel's office and requested SBA's views on those issues. We initially e-mailed questions on October 10, in response to which SBA requested clarification and an indication of our timeframes and on Friday, October 18, we provided additional clarification of those questions. Yesterday, October 22, Ms. Wright advised our attorney that SBA officials may be available to meet next week with GAO representatives to discuss the questions, but that fixing a date and time depends on the yet uncertain schedules of SBA personnel. As discussed with Ms. Wright, we are available to meet to discuss these issues as soon as possible. Accordingly, we have requested SBA's views on the following matters.

[1] 13 C.F.R. § 120.454 (2002)

1. SBA regulations provide for the assessment of fees for performance reviews of PLPs (13 CFR 120.454) and audits of SBLCs (13 CFR 120.475). What is the statutory authority for each regulation? If SBA relied on section 5 (b)(12) of the Small Business Act, 15 U.S.C. 634(b)(12), please cite the law specifically authorizing the fees.

2. The SBA contracts with third parties to conduct PLP performance reviews. What are SBA's reasons for having contractors perform PLP reviews? What is SBA's authority for contracting with third parties to conduct PLP reviews?

3. A PLP is assessed for the review. Who assesses the fee - SBA or the contractor who performs the review? If the third party assesses the fee, what statutory provision authorizes SBA to delegate assessment of the fee to the third party contractor?

4. Who receives the review fee from the PLP – SBA or the contractor who performs the review? Does SBA have authority to collect the review fees directly and then pay the contractor for the review? If so, please identify the authority. If SBA has such authority but does not collect the fee, please explain why.

5. If the SBA were to collect the PLP review fee, would SBA have authority to retain or spend the fee, or would SBA be required to deposit the funds into miscellaneous receipts at the Treasury pursuant to 31 U.S.C. 3302(b)? If SBA has authority to retain the fees, please identify the pertinent statutory authority.

6. Does SBA have an appropriation account that is available for the purpose of paying for PLP performance reviews and oversight? Which account is available? Have any PLP performance reviews/oversight been funded from this or other accounts available to SBA?

We would like to receive your response by November 25, 2002. We would appreciate receiving copies of any documents related to or supporting the information requested. Please provide any other information you consider relevant to this matter. In view of the timetable for publication of our report, it appears that the specific information provided in response to the questions will not be addressed in the report. However, based on the resolution of our questions, our further inquiry into this matter may be appropriate. If you have any questions about this letter, please contact me (202/512-8678) or Katie Harris, Assistant Director (202/512-8415).

Sincerely yours,

Davi M. D'Agostino
Director, Financial Markets and
Community Investment

Page 2

Appendix III: Comments from the Small Business Administration

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

NOV 14 2002

OFFICE OF THE ADMINISTRATOR

Ms. Davi M. D'Agostino
Director, Financial Markets
and Community Investment
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. D'Agostino:

Thank you for the opportunity to review and comment on the draft report entitled "Continued Improvements Needed in Lender Oversight" (GAO-03-90).

In the past, the General Accounting Office (GAO) has provided constructive guidance to the Small Business Administration (SBA) with regard to the lender oversight function. We appreciate your continued support and acknowledgement that SBA has made progress in developing and implementing its lender oversight program. As you have noted in your report, actions by the Agency to address several of your recommendations are already underway.

Lender oversight is an important priority for SBA. As SBA continues to delegate more authority to its lenders, lender oversight provides a critical control in that process. We have added additional staff resources to the Office of Lender Oversight and have focused the agency's Loan Monitoring System (LMS) on the lender oversight and risk management components. Once operational, LMS will expand and enhance our data analysis capabilities and provide a critical means by which the Agency will perform oversight and risk management.

As we discussed in meetings with your staff, we appreciate GAO's recommendations with regard to expansion of the lender review process and development of enforcement mechanisms. SBA is considering these recommendations as well as other options. We have, however, noted a number of inaccuracies contained in the draft report. Enclosed with this letter is SBA's response to the findings and recommendations in the draft report, including technical corrections and comments. We are making significant progress in the development and implementation of our lender oversight program, are proud of what we have accomplished, and the steps we have taken and are taking are reducing the risk of loss to the taxpayers.

Enclosed are our specific responses to the recommendations included in the draft report and our technical corrections and comments. If you have any questions, please

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contact Richard Spence, Assistant Administrator for Congressional and Legislative Affairs, at 202-205-6700.

Sincerely,

for

Ronald E. Bew
Associate Deputy Administrator
for Capital Access

Enclosure

Response by

The Small Business Administration

Draft Audit Report
Continued Improvements Needed In Lender Oversight

I. SBA Response to GAO Recommendations

Recommendation 1 – Incorporate strategies into its review process to adequately measure the financial risk lenders pose to SBA, develop specific criteria to apply to the credit elsewhere standard, and perform qualitative assessments of lenders' performance and lending decisions.

Response – SBA is assessing the need to fully incorporate the financial risk concept into the examination process and to perform qualitative assessments of lenders' performance and lending decisions. A number of practices we have in place address these recommendations. First, the safety and soundness examinations of Small Business Lending Companies (SBLCs) conducted on SBA's behalf by the Farm Credit Administration (FCA) are, at their core, identifying the financial risk these lenders pose to SBA. A primary component of the examinations is an asset quality review that assesses financial risk. SBLCs generate and hold approximately 20% of SBA's loans. Second, in the PLP lender reviews some degree of financial risk is assessed. If collateral or security exceptions are identified, the potential financial risk is estimated and included in the report. The fact that there was no financial risk assessed and included in the report, does not indicate that an assessment was not made but, rather, that there was no dollar amount of financial risk specifically identified. SBA is considering another approach to lender reviews that may provide additional assessment of financial risk and allow for a qualitative assessment of lenders' performance and credit operations.

In response to the recommendation that SBA develop specific criteria to apply to the credit elsewhere standard, SBA points out that the Small Business Act ("Act"), SBA regulations and SBA Standard Operating Procedures already contain such criteria and guidance. Specifically, Sections 3(h) and 18(b)(2) of the Act, Sections 120.101 and Section 20.102 of SBA regulations, and SOP 50 10(4)(E) provide sufficient guidance.

Recommendation 2 – Provide, through regulation, clear policies and procedures for taking enforcement actions against preferred lenders and SBLCs in the event of continued non-compliance with SBA's regulations. Specifically, the Administrator of SBA should adopt regulations that would clearly define SBA authority to take enforcement actions and specify conditions under which supervisory actions would be taken.

Response – SBA is working diligently to address the concerns expressed on this issue.

Recommendation 3 – Continue to explore ways to assist large national lenders to participate in the PLP. These efforts could include further development and implementation of SBA's Lender Liaison program and continued attention to standardizing the PLP certification process and enhancing its transparency, as was done with the development of the Lender Evaluation Worksheet to assist lenders in their interactions with District Offices.

Response – We are reviewing the issues identified with regard to large national PLP lenders and are considering the best approach to address them. We believe that the District Offices play an important role in lender relations and management and are assessing a number of options to assist these lenders in a meaningful way.

Recommendation 4 – Separate lender oversight functions and responsibilities from the Office of Capital Access (OCA), including those currently done by the Office of Financial Assistance such as responsibility for revoking preferred lender status, and establish clear authority and guidance for the Office of Lender Oversight (OLO), or its successor office, that states, at a minimum, its program responsibilities, and planned staffing for those responsibilities. This would provide an oversight office with greater autonomy within SBA to match the growing importance of lender oversight in achieving SBA's goal of ensuring that PLP lenders make loans to eligible borrowers while properly managing the financial risk to SBA.

Response – SBA has already separated the lender oversight function from the Office of Financial Assistance (OFA). To that end, SBA created OLO as separate from OFA in 1999 and transferred the examination and lender review functions from OFA to OLO in 2000. As a result, lender reviewers no longer report to OFA and OLO does not report to OFA. The Associate Administrator for Lender Oversight is a member of the Senior Executive Service on the same level as the head of OFA. Both executives independently report to the Associate Deputy Administrator for Capital Access.

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