United States General Accounting Office

GAO

Report to the Chairman
Committee on Small Business
U. S. Senate

November 2000

SMALL BUSINESS ADMINISTRATION

Actions Needed to Strengthen Small Business Lending Company Oversight

GAO-01-192

Contents

Letter

	3
Results In Brief	4
Background	5
SBA Has Implemented a Safety and Soundness Examination Program	7
SBA Is Planning to Take Action on Most of FCA's Recommendations	11
Questions Surround Statutory Authority and Regulatory Tools to Effectively Supervise and Examine SBLCs	12
Conclusions	16
Recommendations for Executive Action	18
Agency Comments	18

Appendixes

Appendix I:	Scope and Methodology	20
Appendix II:	Farm Credit Administration Recommendations and Small Business Administration Responses	21
Appendix III:	Comments From the Small Business Administration	22
Appendix IV:	GAO Contacts and Staff Acknowledgments	24

G A O
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

November 17, 2000

The Honorable Christopher S. Bond
Chairman, Committee on Small Business
United States Senate

Dear Mr. Chairman:

This report contains the results of our review of the Small Business Administration's (SBA) oversight of Small Business Lending Companies (SBLCs). SBLCs are nondepository lending institutions that are licensed by SBA but are not generally regulated or examined by financial institution regulators. In June 1998,[1] we recommended that SBA develop and implement a mechanism to carry out its supervision and examination function for SBLCs. In response, SBA contracted with the Farm Credit Administration (FCA) to conduct safety and soundness examinations of the 14 SBLCs.

The 7(a) loan program[2] is SBA's largest lending program and its primary vehicle for providing small businesses with access to credit. The SBLCs play a significant role in the program. In fiscal year 1999 (the latest available data), the SBLCs made 4,445 loans valued at $2.4 billion, which was about 24 percent of the total dollar volume of all 7(a) loans approved in that fiscal year. For that year, the portfolios of the various SBLCs ranged from 22 outstanding loans amounting to about $7.7 million to 7,025 loans totaling about $2.2 billion.

In discussions with your staff, we agreed to provide an assessment of (1) the status of SBA's examination program with particular attention to the second-year examination plans for the SBLCs, (2) SBA's responses to FCA recommendations for improving SBA's SBLC oversight, and (3) whether SBA has adequate statutory authority and regulatory tools to effectively supervise and examine SBLCs. To address these objectives we reviewed FCA examination reports for fiscal years 1999 and 2000; FCA

[1] *Small Business Administration: Few Reviews of Guaranteed Lenders Have Been Conducted* (GAO/GGD-98-85, June 11, 1998).

[2] Section 7(a) of the Small Business Act (15 U.S.C.) 636(a) authorized this guarantee program.

recommendations to SBA and SBA responses; relevant statutes, legislative histories, and legal opinions related to SBA's oversight of SBLCs; and appropriate legislation pertaining to depository institution oversight. We also met with relevant officials from SBA, SBA's Office of Inspector General (OIG), and FCA. A more detailed description of our scope and methodology is contained in appendix I. We conducted our work at SBA's headquarters in Washington, D.C.; and FCA's headquarters in McLean, VA.

Results In Brief

Beginning in fiscal year 1999, SBA contracted with FCA to perform, for the first time, safety and soundness examinations of each of the 14 SBLCs. The examiners did not have the benefit of previous examinations to help define the scope of their first-year examinations. Therefore, they conducted broad-based examinations and evaluated each SBLC's capital adequacy, asset quality, management, earnings, and liquidity. The examinations were similar to safety and soundness examinations performed by financial institution regulators. FCA examiners concluded that the SBLCs were generally effective in promoting the SBA 7(a) program of financing small businesses, but the examiners found a number of deficiencies in the loan operations in a majority of the SBLCs. Deficiencies found included weaknesses in the important areas of loan underwriting and credit administration. FCA planned and conducted follow-up examinations (i.e., second-year examinations) in fiscal year 2000. FCA examiners used the results of the first-year examinations to help determine the scope of each follow-up examination. FCA examiners we interviewed told us that SBA did not limit their ability to exercise examiner discretion. In the second-year examinations, FCA officials said that the SBLCs had generally made good progress in addressing FCA examination findings and recommendations from the first-year examinations.

In addition to providing SBA with individual reports of examination on each SBLC, FCA, on September 30, 1999, issued a comprehensive summary report of its overall findings at the SBLCs and made 15 recommendations to SBA for improving and strengthening program effectiveness in its SBLC oversight. For example, FCA recommended that SBA require the SBLCs to implement loan risk-rating systems and independent internal credit review processes and to clarify its regulations governing capital requirements for the SBLCs. In August 2000, SBA officials met with FCA officials to discuss the recommendations and, for the most part, agreed with the recommendations. However, SBA disagreed with one recommendation that would require SBLCs to justify their valuations of future loan servicing fees that are treated as a contribution to capital. SBA officials told us that

discussions have begun among the appropriate SBA offices to implement the agreed-upon recommendations; but as of October 12, 2000, the recommendations had not been adopted.

SBA has implemented its examination program for the SBLCs through a delegation of examination authority from its Office of Inspector General (OIG). In the Inspector General Act of 1978, Congress transferred to OIG, SBA's Office of Audits and Investigations, which included SBA's Office of Examinations. The delegations resulted from SBA's position that because of the transfer, OIG has exclusive authority to conduct SBLC examinations. As of November 9, 2000, OIG had not taken a formal legal position on whether it has exclusive authority to conduct SBLC examinations. OIG stated that it delegated the examination authority to SBA because it did not have the resources to conduct the broad-scope, safety and soundness-related examinations. Because SBA had to rely on yearly delegations by OIG in order to conduct the examinations, it was hesitant to move forward in long-term planning of an examination approach and other activities that are related to the examination function. We believe that the SBA Administrator has the authority to examine SBLCs. In this report, we have a recommendation to the Administrator of SBA addressing examination authority.

The responsibility for licensing, supervising, and examining the SBLCs rests with SBA. Although SBA believes that it has authority to take corrective measures concerning SBLC risk exposures, operations, and other matters that would have the same effect as measures available to federal bank regulators, SBA regulations specify only that an SBLC's license can be suspended or revoked for a violation of law, SBA regulation, or any agreement the SBLC has with SBA. Questions arise whether SBA can impose and enforce less drastic measures than suspension or revocation of an SBLC's license and whether specific measures should be clearly set out in regulation. In this report, we have a recommendation to the Administrator of SBA addressing the lack of explicit regulations for undertaking intermediate enforcement actions.

Background

The Small Business Act of 1953 includes provisions establishing the Administrator's general powers to operate SBA programs. Section 7(a) of the act authorized SBA's 7(a) program and contains a provision that SBA is to authorize lending institutions and other entities in addition to banks to make loans authorized under section 7(a).

The 7(a) program is intended to serve small business borrowers who could not otherwise obtain credit under suitable terms and conditions from the private sector without an SBA guarantee. Under the program, SBA generally provides guarantees of up to 80 percent on loans made by participating lenders. SBA regulations require that 7(a) lenders be subject to supervision and examination by a state or federal regulatory authority acceptable to SBA.

Most SBA 7(a) lenders are depository institutions that are subject to safety and soundness supervision and examination by financial institution regulators. For a period prior to 1982, SBA licensed 16 Small Business Lending Companies to promote its efforts to increase the availability of financial assistance to small businesses. SBLCs are privately owned and managed, nondepository-lending institutions that are licensed by SBA but are not generally regulated by financial institution regulators. SBLCs that are subsidiaries of bank holding companies are subject to Federal Reserve Board oversight.

Fourteen SBLCs are currently active participants in SBA's 7(a) loan program, and all are certified by SBA as Preferred Lenders under its Preferred Lender Program. Preferred lenders have greater latitude in making 7(a) loans than other participating lenders. They are given full authority to rate the creditworthiness of small business loan applicants, and SBA's role is limited to a quick eligibility determination.

According to SBA's operating procedures, all lenders that participate in its loan program are subject to periodic, on-site compliance reviews of their policies and procedures to ensure that they are processing loans according to SBA's standards. SBA implemented a separate review program for Preferred Lenders in 1998. 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. SBLCs, like other 7(a) Preferred Lenders, are subject to these review requirements.

The 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. Its regulations provide that the SBLCs are subject to periodic audits by SBA's OIG. In fiscal years 1999, 2000, and 2001, SBA contracted with FCA, under delegations from OIG, to conduct safety and soundness examinations of the SBLCs. FCA is an independent agency within the

executive branch of the U.S. government; it is responsible for the regulation of 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.

Although most 7(a) lenders are also supervised and examined for safety and soundness by financial institution regulators, SBLCs are not. The primary objectives of bank examinations done by the federal bank regulators are (1) to provide an objective evaluation of an institution's safety and soundness, ensuring that it maintains capital commensurate with its risk; (2) to appraise the quality and overall effectiveness of management systems; and (3) to identify and follow up in those areas where corrective action is required to strengthen the institution's performance and compliance with laws and regulations. Safety and soundness examinations focus on management functions, such as internal controls that affect the ability of the financial institution to manage risks resulting from possible future changes in economic conditions. Therefore, these examinations are more risk-focused and forward-looking than lender compliance reviews.

Lenders fund 7(a) loans by holding the loans in their portfolios or by obtaining funds through two existing secondary markets.[3] Cash flows from pools of guaranteed portions of 7(a) loans are used to back 7(a) pool certificates. Cash flows from pools of unguaranteed portions of 7(a) loans are used to back 7(a) pool securities, which are sold in the unguaranteed 7(a) market. When 7(a) lenders sell 7(a) loans into the secondary markets, they retain servicing rights and receive fees for collecting payments from borrowers. The value of servicing rights is included on the lender's balance sheet as a source of capital.

SBA Has Implemented a Safety and Soundness Examination Program

In our 1998 review of SBA's oversight of 7(a) loan program lenders, we reported that SBA was not satisfying its supervision and examination requirement for the SBLCs and recommended that it develop and implement a mechanism that would provide for continuing supervision of the SBLCs. SBA subsequently initiated such a mechanism. According to SBA, the FCA examinations were the first safety and soundness

[3] See *Small Business Administration: Size of the SBA 7(a) Secondary Markets is Driven by Benefits Provided* (GAO/GGD-99-64, May 26, 1999) for more information.

examinations of the SBLCs. The first-year exams indicated that the SBLCs were generally effective in promoting the SBA loan program, but improvements were needed in internal controls and risk management. In the second-year exams, FCA concluded that the SBLCs had made good progress in responding to the first-year examination findings and recommendations. During fiscal year 1999, SBA also established an office specifically to ensure appropriate supervision of its lenders.

SBLC Examination Program

In our 1998 review of SBA's oversight of the 7(a) loan program, we reported that SBA was not satisfying its supervision and examination requirement for the SBLCs, we expressed concern that economic conditions could become less favorable and that in such circumstances 7(a) default rates could increase. We concluded that effective oversight of SBLCs could help SBA assess how prudently SBLCs were managed and how these institutions and their loan portfolios would perform under less favorable economic conditions. In our view, such oversight would require a forward-looking focus on risk management.

Although SBA maintains that the authority to examine SBLCs rests within SBA's OIG, OIG delegated the examination function to SBA. SBA and OIG contracted with FCA to conduct examinations, and in doing so the contract specified that the examinations were to be based upon principles of safe and sound SBLC operations. The initial examinations were conducted in fiscal year 1999. According to SBA, the FCA examinations were the first safety and soundness examinations of the SBLCs. In the OIG memorandum delegating the examination function to SBA, OIG stated that its limited resources did not permit it to conduct the examinations, but it would retain the authority to evaluate the quality and effectiveness of the examination program, as well as the authority to audit and investigate where appropriate. OIG subsequently delegated the examination authority for fiscal years 2000 and 2001.

FCA examined each of the SBLCs in fiscal years 1999 and 2000 under contracts for about $850,000 each year. SBA officials indicated that in the future many of the SBLCs that exhibited no serious weaknesses will be placed on an examination schedule of between 18 and 24 months, and the high-risk SBLCs will be examined annually. This schedule corresponds to the examination schedules for most depository institutions.

FCA officials told us that it has received complete cooperation from SBA. According to FCA officials, SBA has not attempted to limit or influence the examination process including reporting the exam results to the SBLCs.

First-Year Exams Identified SBLCs' Operational Weaknesses

After the initial round of examinations, FCA issued a comprehensive summary report of its examination findings to SBA. FCA also issued individual examination reports that SBA transmitted to the SBLCs. Overall, FCA concluded that its examinations, which focused primarily on asset quality, lending practices, portfolio management, regulatory capital compliance, and funding adequacy, found that the SBLCs were generally effective in promoting the SBA 7(a) loan program. However, it stated that the results of the examinations confirmed the need for additional internal controls and improved risk management in the SBLCs. FCA reported that the most prevalent deficiencies found involved credit administration, loan servicing, and collection practices. A significant number of these deficiencies were identified in a majority of the SBLCs. A random sample of loans indicated that a majority of the SBLCs had loans with potential weaknesses characterized by highly leveraged positions, unproven repayment capacity, and /or lack of management experience among borrowers. Loan servicing needed improvement at all the institutions examined. The most common weakness was failure to collect or analyze financial and other relevant information on a regular basis. As a result, most SBLCs were not timely in identifying potential problems in loans and addressing any concerns before they developed into loan delinquencies. FCA attributed the problems primarily to a failure to follow prudent lending practices and SBA's lending criteria.

FCA also concluded that the examinations demonstrated the need for SBA to exercise more effective oversight of the SBLC program. FCA stated that although credit risks in the SBLCs were manageable in the current business climate, unfavorable economic conditions could adversely affect their ability to manage the level of risk they maintain. In addition, FCA noted that many SBLCs rely heavily on securitization of the unguaranteed portion of their loans to create a substantial percentage of their revenue. Therefore, if one or two of the SBLCs encountered difficulties in a period of economic stress, it could adversely affect the securitization market for other 7(a) lenders.

Second-year Exams Emphasized Implementation of First-Year Recommendations

In the second-year examinations, completed in fiscal year 2000, FCA again examined each of the 14 SBLCs. An important element of these examinations was a follow-up on FCA's fiscal year 1999 examination recommendations. FCA examiners were to determine whether the SBLCs had taken action to correct deficiencies found in the first-year examinations. The second-year reports of examination were modified to include a section that contains a listing of all findings made in the first-year reports and a discussion and assessment of the actions taken by the SBLCs to address them. Another section contains recommendations made as a result of the second-year examination findings. According to both FCA and SBA officials, the SBLCs have made good progress in responding to the first-year examination findings and recommendations.

For the second-year examinations, SBA also implemented a procedure to direct the SBLCs to take specific corrective action on the basis of FCA's recommendations. This process allows SBA to explain, in writing, its position on examination findings; clarify any regulatory or procedural issues; and, where appropriate, require that corrective action be taken within a specified time frame.

At the time of our review, SBA's OIG was conducting an ongoing evaluation and quality review of the SBLC examination program. On the basis of its initial assessment of the procedures used by FCA in conducting the examinations and a review of selected examination workpapers, OIG concluded that FCA's examinations were adequate to assess the safety and soundness of the SBLCs.

Office of Lender Oversight

In August 1999, SBA approved the establishment of the Office of Lender Oversight to serve as a focal point for its lender oversight efforts and, according to SBA, to ensure that the progress made in the last few years was institutionalized within the agency. The office will consolidate several oversight activities that had previously been performed by several offices within SBA. The responsibilities of the office include

- evaluating existing oversight regulations, policies, and procedures and promulgating new ones where appropriate;
- monitoring changes in the accounting, banking, and financial industries and recommending appropriate modification of SBA oversight policy;
- coordinating all headquarters and field office activities with respect to lender reviews; and

- evaluating new SBA programs and changes to existing ones to assess their risk potential and required oversight.

At the time of our review, the office had not become fully operational. SBA officials told us that when staffing is completed, one of the office's primary tasks will be to review SBA's lender oversight regulations and processes, particularly those related to the SBLCs.

SBA Is Planning to Take Action on Most of FCA's Recommendations

In addition to examining the SBLCs, FCA was asked to provide its conclusions and recommendations for changes it believed were needed in the SBLC program and SBA's SBLC examination policies and procedures. FCA's initial recommendations to SBA were included in its September 30, 1999, comprehensive summary report, which contained 15 recommendations. See appendix II for a summary of the recommendations and SBA's responses to them.

SBA generally concurred with 12 of the 15 recommendations in the report, agreeing that changes were needed in its policies and procedures on SBLCs. FCA recommendations with which SBA generally concurred included (1) requiring SBLCs to establish minimum underwriting standards consistent with SBA lending criteria and (2) continuing to require SBLCs to implement appropriate internal controls to ensure accurate and consistent loan information reports. It partially agreed on two recommendations and disagreed on one recommendation.

SBA disagreed on FCA's recommendation to require SBLCs to justify their valuations of future loan servicing fees that are treated as a contribution to capital. FCA stated that the valuation of the servicing fees was an important contributor to the SBLCs' capital and had not been adequately tested. In response, SBA stated that it was not aware of a ready market for servicing rights, and it had not yet made a determination of the reasonableness of the valuations. This disagreement between SBA and FCA could have important implications for evaluating capital adequacy.

SBA officials told us that, as of October 12, 2000, it was still working on the policy and/or procedural changes that would be needed to implement the 12 recommendations with which SBA generally agreed.

Questions Surround Statutory Authority and Regulatory Tools to Effectively Supervise and Examine SBLCs

SBA has determined that its OIG has the exclusive authority to conduct examinations of the SBLCs. On the basis of this determination, OIG has delegated its examination authority on an annual basis since fiscal year 1999 to SBA's Office of Capital Access. Reliance on the contingency of receiving a delegation has led to uncertainty surrounding the examination of SBLCs. As a result, SBA's planning for long-term examination coverage of the SBLCs and other oversight activities that are related to the examinations has been adversely affected. In our view, the delegations are unnecessary because SBA already has SBLC examination authority.

In connection with SBA's supervisory authority over SBLCs, SBA's regulations provide that SBA may suspend or revoke an SBLC license for a violation of law, regulation, or any agreement with SBA. Because the regulations specify only suspension or revocation of an SBLC's license, the question arises whether SBA has the authority to impose and enforce less drastic measures if called for by the circumstances of a particular SBLC. Federal bank and thrift regulators have an array of supervisory actions they can use should an institution fail to comply with regulations or if it is managed in an unsafe or unsound manner. In contrast, SBA regulations specify only a narrow range of supervisory actions it can take to address SBLC violations or unsafe and unsound conditions.

Statutory Examination Authority

The issue of SBLC examinations is not addressed specifically in the Small Business Act of 1953. In fact, SBA's authority to qualify SBLCs, as well as supervise and periodically examine these entities, is derived from the broad powers Congress provided SBA. Specifically the act provided the Administrator general regulatory powers and allowed SBA to authorize banks and "other financial institutions" to make 7(a) loans.[4]

Consistent with these broad powers, in the mid-1970s, SBA began chartering SBLCs, which it determined to be within the statutory class of "other financial institutions,"[5] and subjected them to its supervision and

[4] See 15 U.S.C.§ 634(b)(6) (allowing the Administrator to make any rules necessary to carry out the authority contained in the act), §636(a) (empowering the Administrator to make qualified small business loans in cooperation with banks and other financial institutions); see also Comp. Gen. Op. B-114835, March 30 1976.

[5] In 1988, Congress amended section 636(a) and changed the term "other lending institutions" to "other financial institutions."

examination. In 1975, SBA promulgated regulations specifically providing for SBA to examine SBLCs. SBA placed that examination function in the Office of Examinations, which, according to SBA, was part of its Office of Audits and Investigations. According to SBA, this office conducted periodic audits, including financial audits, of SBLCs pursuant to SBA regulations.

In 1978, Congress enacted the Inspector General Act of 1978 (IG Act), which contained a provision transferring SBA's Office of Audits and Investigations to OIG.[6] As stated above, this office included SBA's Office of Examinations, which at the time of the enactment of the IG Act performed SBLC audits. Subsequent to the passage of the IG Act, SBA amended its regulations to subject SBLCs to periodic audits by OIG. In our June 1998 report on SBA's 7(a) lender oversight, we noted that OIG had conducted audits at three SBLCs in a 5-year period from 1993 to 1998. We further concluded that SBA needed to develop and implement a mechanism to carry out its supervision and examination function. Beginning in late 1998, when SBA decided that a more comprehensive review of the SBLCs was needed, OIG delegated authority to examine SBLCs to SBA and has done so each year since.[7] In each of the delegations, OIG retained its oversight and quality control functions with respect to the SBLC examinations and related processes. We believe that the examinations being performed by SBA through FCA are an appropriate part of the regulatory framework for SBA's effective oversight of SBLCs.

[6] 5 U.S.C. Appx. §9(a)(1)(T).

[7] SBA, and OIG in turn, contracted with FCA to conduct the examinations.

Although SBA and OIG, in effect, are allowing SBA's Office of Capital Access to conduct examinations (through FCA), SBA's Office of General Counsel had concluded that the IG Act gives OIG exclusive authority to conduct SBLC examinations. As of November 9, 2000, OIG had not taken a formal legal position on whether it has exclusive authority to conduct SBLC examinations.[8] SBA maintains that because the SBLC examination function was part of the Office of Audits and Investigations prior to the enactment of the IG Act and was transferred properly to OIG, any other SBA office is precluded from performing this function.[9] We disagree with SBA's conclusion that OIG has exclusive authority to perform examinations and audits of SBLCs.

As set forth above, the Administrator, pursuant to the broad powers set forth in the Small Business Act, may license, supervise and examine SBLCs. In our view, the IG Act does not divest SBA of these powers. Further, although we agree that OIG has the authority to conduct risk-based examinations of SBLCs, we do not believe that OIG's authority is exclusive. The IG Act was designed to establish independent internal audit entities to more effectively combat fraud, waste, and abuse in the programs and operations of covered agencies.[10] To this end, Offices of Inspector General were established to conduct and supervise independent audits and investigations relating to the programs and operations of the covered agencies. Neither the IG Act nor its legislative history suggests that in carrying out their missions, inspectors general were provided exclusive authority to perform all of the functions, particularly nonaudit functions, assigned to their predecessors. Further, if constrained by such prior assignments of nonaudit functions, inspectors general would be unable to function as independent sources of internal audit and investigation as contemplated by the IG Act, and such a result would be unreasonable.

Given SBA's authority to supervise and examine SBLCs, the role of SBA's Inspector General under the IG Act and the nature of the function at issue, we believe that the SBA Administrator has the authority to directly assign

[8] According to SBA's Inspector General, OIG was in the process of developing a formal legal position on this issue.

[9] SBA Legal Memorandum to the General Counsel dated March 6, 1998. This memorandum concludes that to transfer the examination function out of OIG to another SBA office, SBA would need a statutory amendment to the Small Business Act.

[10] See S. Rep. No. 951071, 95th Cong., 1st Sess. 6-8, reprinted in 1978 U.S. Code Cong. & Admin. News 2676, 2681-2683.

the SBLC examination function to the Office of Lender Oversight. This office was created to ensure that the progress made in lender oversight in the last few years was institutionalized within the agency. SBA officials told us that the year-to-year nature of the delegation arrangement has inhibited planning for long-term examination coverage of the SBLCs, as well as other oversight activities that would flow from the examinations. They also noted that the uncertainty of the situation contributed to the delay in the establishment of the Office of Lender Oversight. SBA's plans are to have the office be responsible for conducting or contracting for examinations of the SBLCs.

The direct assignment of the SBLC examination function by the Administrator would allow SBA to properly exercise its authority over SBLCs, while still allowing OIG to effectively carry out its independent oversight responsibilities under the IG Act. By making this assignment, SBA would remove the uncertainty it currently faces in the implementation of its SBLC examination program.

Supervisory Authority

SBA regulations provide that SBA may revoke or suspend an SBLC license for a violation of law, regulation, or any agreement with SBA. Because the SBA regulations specify only revocation or suspension of an SBLC's license, the question arises whether SBA has the authority to impose and enforce less drastic measures if called for by the circumstances of a particular SBLC. Unlike SBA, federal bank and thrift regulators have available an array of statutorily defined supervisory actions, short of suspending or revoking a financial institution's charter or federal deposit insurance, that they can use if an institution fails to comply with regulations or is in an unsafe or unsound condition. For example, banking regulators are specially given the authority to issue cease and desist orders if a banking institution has engaged in an unsafe or unsound practice. Bank regulators can also impose civil money penalties against both depository institutions and institution-affiliated parties. The Small Business Act does not specifically provide such powers to SBA. A 1999 Booz-Allen and Hamilton study[11] concluded that because the current enforcement structure permitted only suspension or revocation, SBA offices rarely took enforcement actions.

[11] *Business Process Re-engineering Study,* July 1999, by Booz-Allen and Hamilton.

SBA officials indicated that SBA's available supervisory actions are similar to or achieve the same results as the supervisory actions available to the federal bank regulators, except for the authority to impose money penalties. According to the officials, the general authority under the SBA Act gives SBA the authority to use suspension and revocation measures. SBA officials also told us that an SBLC's status as a Preferred Lender is subject to a supplemental agreement with SBA. The officials said that the threat of nonrenewal of Preferred Lender status is a strong incentive for SBLCs to respond to supervisory action. The officials said that SBA recently followed through on a threat to remove Preferred Lender status from an SBLC for not complying with SBA regulations. We recognize that Preferred Lender status is valuable to the SBLCs. However, we believe that SBA's removal of Preferred Lender status from an SBLC should be the result of a clear and reasonable process that is specified in regulation.

Federal bank and thrift regulators have available an array of statutorily defined supervisory actions short of suspension or revocation and regulations specifying the conditions under which those actions would be taken. SBA, however, does not have regulations clearly specifying enforcement actions short of revocation or suspension and the conditions that would trigger such actions. For example, SBA regulations do not specify enforcement actions that would be taken when an SBLC experiences capital deterioration or is engaging in an unsafe or unsound practice. On the basis of our work on financial institution regulation, we believe that it is important that SBA have regulations in place that specify clear policies and procedures regarding what enforcement actions SBA would take and the conditions that would trigger such actions. Such transparency helps financial institutions understand what is expected of a well managed institution, makes them aware of the repercussions of not taking corrective action, and helps ensure that they are supervised in a consistent manner.

Conclusions

SBA has made changes to the oversight of SBLCs that are consistent with our 1998 recommendation to develop and implement a mechanism to satisfy its supervision and examination function for SBLCs. These actions should allow SBA to become better informed about the financial condition and overall management practices of the SBLCs.

Although FCA concluded that the SBLCs were generally effective in promoting the SBA 7(a) program mission of financing small businesses, FCA examiners, in their first set of reviews in fiscal year 1999, found

numerous deficiencies in the SBLCs 7(a) loan operations. The SBLCs have responded positively to FCA's examination recommendations, but FCA believes, and we agree, that the results of the examinations demonstrate the need for continuous oversight of the SBLC program.

FCA believes that there are a number of areas in which SBA could strengthen the SBLC program and SBA's monitoring and supervision of these institutions. SBA officials told us that the agency is planning to take appropriate action on most of FCA's recommendations. However, FCA expressed concern, as we did in our previous report, about the financial risk to SBA's loan portfolio associated with less favorable economic conditions. Such conditions could place upward pressure on 7(a) default rates. SBA needs to have access to information that accurately identifies risk in both individual loans and the total portfolio. The initial SBLC examination results have provided some information to aid in such risk identification, but a continued effort is needed.

In fiscal year 1999, the SBLCs were subjected to risk-focused examinations for the first time. Although SBA maintains that OIG has the exclusive audit authority for the SBLCs, OIG has delegated its examination authority to SBA on a year-to-year basis. The year-to-year arrangement inhibited SBA from moving forward in long-term planning of an examination approach and other oversight activities that are related to the examination function. In our view, the delegations are unnecessary because SBA already has SBLC examination authority.

Another issue that needs to be addressed is whether SBA has appropriate supervisory authority to take and enforce action against an SBLC for activity that may not warrant a suspension or removal as provided under existing regulations. SBA believes it has adequate authority to take corrective measures concerning SBLC risk exposures and that these measures would have the same effect as the supervisory authorities available to federal bank regulators. SBA regulations specify only that an SBLC's license can be suspended or revoked for a violation of law, SBA regulation, or an agreement between SBA and the SBLC. Questions arise whether SBA can impose and enforce less drastic measures than suspension or revocation of an SBLC license. We believe that specific measures should be clearly indicated in regulation to help promote more effective supervision of the SBLCs.

Recommendations for Executive Action

We recommend that the Administrator of SBA directly assign the SBLC examination function to the Office of Lender Oversight.

We also recommend that the Administrator of SBA ensure that SBA provides, through regulation, clear policies and procedures for taking supervisory actions. Specifically, if SBA determines that it does have the necessary statutory authority, we recommend that the Administrator of SBA develop and adopt SBLC regulations that would clearly define SBA authority to take supervisory actions and specify conditions under which supervisory actions would be taken. If SBA determines that it does not have necessary statutory authority, we recommend that the Administrator of SBA make a legislative proposal to ensure that the agency has the supervisory authorities necessary to direct and enforce corrective action of conditions that may not merit a suspension or removal of lending status.

Agency Comments

We received comments on a draft of this report from Mr. Charles Tansey, Associate Deputy Administrator for Capital Access, Small Business Administration. These comments are reprinted in appendix III. SBA also provided technical comments, which we have incorporated where appropriate.

In his written comments, Mr. Tansey agreed with our findings and conclusions. He stated that subject to a legal review, SBA would assign the examination function to the Office of Lender Oversight. He said that SBA's General Counsel has been asked to formally reexamine the previous 1998 position and issue an opinion on the assignment of the examination function as soon as practicable. If the General Counsel agrees that the assignment can be done without legislative change, SBA will immediately implement the recommendation. SBA agreed with our second recommendation for executive action to develop intermediate supervisory actions in regulation. SBA stated that both recommendations are supportive of steps the agency has taken or plans to take.

As agreed with your office, unless you announce the contents of this report earlier, we plan no further distribution until 30 days from the date of this letter. At that time, we will send copies of this report to Senator John Kerry, Ranking Minority Member, Senate Committee on Small Business; Representative James M. Talent, Chairman, and Representative Nydia M. Velazquez, Ranking Minority Member, House Committee on Small Business;

the Honorable Aida Alvarez, Administrator, SBA; and other interested parties. Copies will also be made available to others upon request.

Please contact William Shear or me at (202) 512-8678 if you or your staff have any questions. Key contributors to this report are listed in appendix IV.

Sincerely yours,

Thomas J. McCool
Managing Director
Financial Markets and Community
Investment

Scope and Methodology

To assess the status of the Small Business Lending Company (SBLC) safety and soundness examination program, we interviewed officials from the Small Business Administration's (SBA) Office of Capital Access and SBA's Office of Inspector General (OIG) and the Farm Credit Administration (FCA). We reviewed SBA's policies and procedures for examining SBLCs, FCA examination plans for evaluating each SBLC, and the examination reports for fiscal years 1999 and 2000. We also looked at the extent to which the fiscal year 1999 exam results were included in the fiscal year 2000 examination plans in order to determine whether SBLCs had taken action to correct deficiencies found in the first examinations. We also interviewed SBA officials and reviewed documents on specific changes made to address improving SBA's oversight program and other policy and procedural changes planned.

To determine SBA's response to FCA recommendations to its fiscal year 1999 examinations, we discussed the recommendations with FCA and obtained SBA and OIG views on the deficiencies identified. We also reviewed OIG evaluations of action taken to implement the recommendations and documented the status of SBA responses to each of the recommendations.

To determine SBA's statutory authority to effectively supervise and examine SBLCs, we reviewed the relevant statutes, legislative histories, and legal opinions related to SBA's oversight of SBLCs. We met with SBA officials to discuss their perspective on the scope of SBA's authority to take corrective measures when an SBLC engages in inappropriate or unauthorized practices. We also reviewed appropriate legislation pertaining to depository institution oversight.

We conducted our work at SBA's headquarters in Washington, D.C.; and FCA's headquarters in McLean, VA, between April 2000 and September 2000 in accordance with generally accepted government auditing standards.

Farm Credit Administration Recommendations and Small Business Administration Responses

Recommendations	SBA Responses
1. Small Business Lending Companies (SBLCs) should implement a dynamic risk-rating system and report results to SBA.	SBA concurs. Where these systems do not now exist, SBA is asking SBLCs to put them in place.
2. SBLCs should implement independent internal credit review processes.	SBA concurs but believes that each SBLC needs to develop one appropriate for its own use. SBA is working with FCA to identify models for SBLCs. SBA is also seeking input from SBLCs on processes they think would be useful to them.
3. Require the SBLCs to establish minimum underwriting standards consistent with SBA lending criteria.	SBA agrees in general with the recommendation. It will not, however, dictate standards. SBA expects all 7(a) lenders, including SBLCs, to comply with its general loan policies and procedures.
4. SBLCs should consolidate personal and business financial statements.	SBA agrees in principle, but its policy is not to require the consolidation of personal and business financial statements. This does not preclude, on a case-by-case basis, a lender from considering extraordinary personal liabilities or expenses or personal assets or income that may affect repayment ability.
5. Clarify requirements on the minimum amount of a loan that must be retained.	SBA believes that existing policies and regulations address this. SBA will remind SBLCs of its policies when appropriate through instructions to the SBLCs following examinations.
6. Continue to implement appropriate internal controls to ensure accurate and consistent loan status reports.	SBA agrees. Since the SBLC exam process began, SBA has continued to work on resolving this issue. If this issue is identified in an individual report, SBA will follow up in a second round of exams. SBA developed criteria to evaluate reporting and incorporated them into the exams.
7. Clarify capital regulations.	SBA agrees and plans to update its regulations in this area.
8. Strengthen general oversight and monitoring, especially compliance with capital requirements.	SBA agrees and will address this issue in planned revision to regulations.
9. Continue to ensure that SBLC financial reports are submitted in timely manner.	SBA agrees.
10. Assess risk exposure associated with securitization of SBLCs' portfolios.	SBA is satisfied with current regulations on securitization, but it will look carefully at exam findings for each SBLC when requests for approval to securitize are being considered.
11. Determine reasonableness for valuation of servicing rights for SBLCs.	SBA does not believe there is a ready market for servicing rights, but it is discussing this with the operating groups.
12. Promote consistent 7(a) procedures between SBA headquarters and districts.	SBA agrees and maintains a continuing dialogue between headquarters and districts on proper interpretation of policy.
13. Consider developing comparative peer reports.	SBA agrees with the concept that some information may be meaningful to share among SBLCs.
14 Clarify rules on reimbursement of SBLCs for payment of delinquent taxes and insurance.	SBA plans to issue more instructions after reviewing the issues.
15. Allow some form of prepayment fees for 7(a) loans.	Language to allow prepayment fees is included in legislation currently pending to reauthorize the 7(a) program.

Source: Small Business Administration.

Comments From the Small Business Administration

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

NOV 9 2000

Mr. Thomas McCool
Director, Financial Markets
and Community Investment
United States General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

Thank you for the opportunity to provide comments on the General Accounting Office's draft report entitled "Small Business Administration: Actions Needed to Strengthen Small Business Lending Company Oversight." We appreciate the time and effort that your staff has spent on this study, and we appreciate the support that your agency has provided on an issue of high priority to the Small Business Administration (SBA).

Over the past few years, we have worked rigorously to put in place an effective oversight program for the Agency's lending partners, and we are proud of our accomplishments in that regard. Since your June 1998 report on SBA's lender oversight activities, SBA has fully institutionalized an annual compliance review program for the participants of our Preferred Lender Program (PLP). We have also completed, for the first time in the Agency's history, two full cycles of safety and soundness examinations for our Small Business Lending Companies (SBLCs). In addition, we have put in place for our field offices a review program for the Agency's non-PLP, non-SBLC lenders. Further, as the draft report indicates, we have established an Office of Lender Oversight to institutionalize the progress we have made and to help ensure that lender oversight continues to receive the attention and resources it deserves.

Subject to legal concurrence, we agree with the recommendation to directly assign the SBLC examination function to the Office of Lender Oversight. We also agree with the second recommendation for executive action contained in the report. Both recommendations are supportive of the steps we have taken and those we plan to take.

Last summer, SBA appointed a new General Counsel for the Agency, and he was briefed on your Agency's study of the SBLC examination effort shortly after his appointment. Following that briefing, he and our Deputy General Counsel reviewed a 1998 staff attorney's opinion, and indicated that, subject to additional research and analysis, there may be a change in the legal conclusion reached. The 1998 memorandum concluded that a statutory change was necessary in order to assign responsibility for the conduct of SBLC examinations to the Office of Capital Access (OCA). Relying on that 1998 opinion and with the support of the Office of Inspector General (OIG), the Agency

Federal Recycling Program Printed on Recycled Paper

Mr. Thomas McCool Page 2

proposed in both FY 1999 and FY 2000 legislative language to transfer that examination authority from OIG to OCA. Because GAO's review of this issue was underway, and because we hoped that our legislative proposal would be given favorable consideration by the Congress, we asked our General Counsel to defer his formal review of this issue until the GAO review was completed. Last week, when we received your draft report, we asked our General Counsel to proceed to formally examine this issue, and to issue his opinion as soon as is practicable. After consultation with OIG, we will immediately implement your first recommendation if the General Counsel's opinion agrees with your views that the authority to accomplish the transfer of examination authority exists without legislative change.

You and your staff in the Financial Markets and Community Investment Division at the GAO have provided the highest quality of advice on and support for our efforts to strengthen the management of the Agency's programs. This is particularly true in the lender oversight area, and our progress has been furthered by your assistance.

Thank you again for the opportunity to review and comment on the draft report. If you have any questions regarding these comments, please feel free to contact me at 202-205-6657.

Sincerely,

Charles Tansey
Associate Deputy Administrator
for Capital Access

GAO Contacts and Staff Acknowledgments

GAO Contacts

Thomas J. McCool, (202) 512-8678

William B. Shear, (202) 512-4325

Acknowledgments

In addition to those named above, Rosemary Healy, Monty Kincaid, Jack Strauss, and Paul Thompson made key contributions to this report.

Ordering Information

The first copy of each GAO report is free. Additional copies of reports are $2 each. A check or money order should be made out to the Superintendent of Documents. VISA and MasterCard credit cards are accepted, also.

Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:
U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013

***Orders by visiting*:**
Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders by phone:
(202) 512-6000
fax: (202) 512-6061
TDD (202) 512-2537

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

Orders by Internet:
For information on how to access GAO reports on the Internet, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web home page at:

http://www.gao.gov

To Report Fraud, Waste, or Abuse in Federal Programs

Contact one:

- **Web site: http://www.gao.gov/fraudnet/fraudnet.htm**
- **e-mail: fraudnet@gao.gov**
- **1-800-424-5454 (automated answering system)**

PRINTED ON RECYCLED PAPER

United States
General Accounting Office
Washington, D.C. 20548-0001

Official Business
Penalty for Private Use $300

Address Correction Requested

Bulk Rate
Postage & Fees Paid
GAO
Permit No. GI00