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GAO

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

January 2003

SMALL BUSINESS ADMINISTRATION

Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain

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GAO-03-87

January 2003

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Highlights

Highlights of GAO-03-87, a report to the Ranking Minority Member, Committee on Small Business and Entrepreneurship, U.S. Senate

SMALL BUSINESS ADMINISTRATION

Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain

Why GAO Did This Study

SBA's loan asset sales are being closely watched because similar sales are projected for other government agencies as a means of reducing loan assets and servicing costs. To assess the progress and effects of SBA's loan sales, GAO undertook this study to (1) describe the process for selling loans, (2) identify how lenders and borrowers have reacted to loan sales, (3) determine whether SBA is properly accounting for its loan sales and their subsequent impact on credit subsidy estimates, and (4) assess whether loan sales generated operational benefits for the agency. GAO did not determine whether SBA maximized proceeds from the loan sales.

What GAO Recommends

We recommend that, before doing more loan asset sales, SBA correct the accounting and budgeting errors and misstatements. Also, the Inspector General, with SBA's independent auditors, should assess the impact of identified errors in the financial statements and determine whether audit opinions for fiscal years 2000 and 2001 financial statements need to be revised. We also recommend that SBA improve its tracking of borrower inquiries and complaints and analyze the benefits and other effects on agency operations of the sales. SBA generally agreed with our findings and recommendations but did not respond to the recommendation to analyze the operational effects of loan sales.

www.gao.gov/cgi-bin/getrpt?GAO-03-87.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Davi M. D'Agostino or Linda M. Calbom, (202) 512-8678.

What GAO Found

From August 1999 through January 2002, SBA held five loan asset sales, disposing of a total of $4.4 billion in disaster assistance home and business loans (85 percent) and regular business loans (15 percent). SBA created a sales process that has attracted investors and responded to their concerns. Lenders who participate in the 7(a) business loan guaranty program were also satisfied with the sales as an option for disposing of their defaulted loans. SBA relies on borrower inquiries and complaints to determine whether purchasers of the loans are using prudent loan servicing practices, as required in the loan sale agreements. However, information on borrowers' reactions to loan sales is incomplete, because SBA does not have a comprehensive process to capture the inquiries and complaints it receives.

SBA incorrectly calculated the accounting losses on the loan sales and lacked reliable financial data to determine the overall financial impact of the sales. Further, because SBA did not analyze the effect of loan sales on its remaining portfolio, its reestimates of loan program costs for the budget and financial statements may contain significant errors. In addition, SBA could not explain significant declines in its loss allowance account for disaster loans. Until SBA corrects these errors and determines the cause of the precipitous decline in the loss allowance account, SBA's financial statements will likely be misstated, and the audit opinion on past financial statements may be incorrect. Further, the reliability of current and future subsidy cost estimates will remain unknown. These errors and the lack of key analyses also mean that congressional decisionmakers are not receiving accurate financial data to make informed decisions about SBA's budget and the level of appropriations the agency should receive.

Our analysis of the operational benefits from loan sales suggests that some benefits that SBA reported either have not yet materialized or were overstated. SBA conducted a limited analysis of the impact of loan sales on its loan servicing centers, showing that loan servicing volume had been reduced. However, loan sales had a much greater impact on disaster loan servicing than on business loan servicing. Therefore, how the sales will help SBA realign its workforce in the small business programs remains unclear.

It would be imprudent to continue SBA loan asset sales in the absence of reliable and complete information on the accounting and budgetary effects. A successful loan sales program is not solely about maximizing proceeds and attracting investors: it is also a means of improving an agency's ability to achieve its mission and to best serve the American people. Moreover, as OMB continues to encourage loan asset sales, it is important that agencies embarking on new loan asset sales programs have the capability to properly carry out and account for these activities.

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Abbreviations

CFO	Chief Financial Officer
OMB	Office of Management and Budget
SBA	Small Business Administration
SFFAS	Statement of Federal Financial Accounting Standards

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

January 3, 2003

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

Dear Senator Bond:

In 1999, the Small Business Administration (SBA) began a loan asset sales program, at the direction of Office of Management and Budget (OMB), to reduce the amount of debt the agency owned and serviced. SBA's loan asset sales program is of particular interest because OMB has tentatively planned loan asset sales at other federal credit agencies. OMB is interested in increasing loan asset sales in order to improve the management of loan assets and to transfer loan servicing responsibilities to the private sector.

SBA guarantees business loans through its lending partners in the 7(a) program and makes direct loans for disaster assistance to individuals and businesses. Before SBA began its loan asset sales program in 1999, the agency had never sold large volumes of loans in bulk. More than $9 billion in disaster assistance and other direct loans and defaulted business loan guarantees were eligible for sale. As of January 2002, SBA had conducted five sales, divesting itself of about 110,000 loans with an outstanding balance of $4.4 billion.[1] Approximately 85 percent of the loans SBA sold were direct disaster assistance loans, most of which have below-market borrower interest rates. When SBA originally made these loans, it received appropriations to cover expected default costs as well as financing costs related to offering below-market interest rates to borrowers. The subsidy allowance account was established to cover these anticipated losses, which generally range from $17 to $33 for every $100 that SBA lends. This allowance indicates that the economic value of the loans is less than the loan balance at inception. The difference between the outstanding loan balance and the subsidy allowance is the net book value. When investors determine the price they are willing to pay for SBA's loans, they also consider default risks and the low interest rate on most SBA disaster loans. As a result, investors bid less than the outstanding balance owed on these loans.

[1]In August 2002, SBA held its sixth sale of about 30,000 loans with an outstanding balance of $657 million. Additional sales are planned.

In determining whether or not to sell these loans, SBA estimated the current value to the government, also known as the hold value,[2] in accordance with OMB Circular A-11. In essence, the hold value is the expected net cash flows from the loans, discounted at today's Treasury rates. This differs from the net book value recorded on SBA's books, which is the expected net cash flows from the loans discounted using Treasury rates in effect when the loans were disbursed. Therefore, the hold value takes into account changes in interest rates since the loans were disbursed, whereas the net book value does not. As a result, changes in interest rates since the loans were disbursed will not affect the determination of the benefit of a loan sale to the government based on the hold value.[3] In contrast, the accounting gain or loss on a loan sale—the net book value compared with the sales proceeds—will be influenced by changes in interest rates since the loans were disbursed.

SBA received about $2.7 billion in total proceeds and paid about $200 million in selling costs on its first five sales. These net proceeds exceeded the hold values of the loans to SBA by about $606 million. However, as discussed above, properly accounting for the sales and their subsequent impact on loan program costs is more complex and could render a different outcome regarding the accounting gain or loss. Our assessment of SBA's accounting treatment for these sales is discussed later in this report.

Because selling loans in bulk is a new and ongoing activity for SBA, and OMB plans to expand loan sales in federal credit programs, you asked us to conduct a broad review of the loan asset sales program. Specifically, you asked us to (1) describe SBA's process for selling loans, (2) identify how lenders and borrowers have reacted to loan sales, (3) determine whether SBA is properly accounting for its loan sales and their subsequent impact on credit subsidy estimates, and (4) assess whether the loan sales are generating operational benefits for the agency.

[2]The hold value of the loans selected for sale represents the estimated value to the government of continuing to hold the loans until they are repaid, either at or before maturity. The hold value is calculated on a present value basis, with future payments discounted at current interest rates. This is a detailed loan-by-loan analysis that specifically considers the cash flows and characteristics of the loans included in the sales.

[3]The hold value is designed to be a decisional tool used to determine whether or not it is currently advantageous for SBA to sell loans. The hold value is calculated using current Treasury interest rates in order to reflect current market conditions in the decisionmaking process.

To respond to these reporting objectives, we reviewed strategic plans, procedures, and other related documents that SBA used to plan and manage the loan asset sales program; reviewed the results of the sales in terms of types of loans sold, and proceeds; interviewed SBA officials, contractors, investors, and lenders involved in the loan sale process; reviewed and analyzed inquiries and complaints from borrowers; and analyzed SBA data related to the impact of the loan sales on loan servicing workloads and other benefits. We also analyzed relevant budget and accounting data used to record the results of loan sales for both budgetary and financial statement purposes, including reestimates of subsidy costs, the values of loans sold, and proceeds and costs of sales. We compared these data with the applicable guidance.

To assess SBA's estimates of hold values for loans sold, we reviewed an external validation of the hold model used for sales one through three that was prepared by an SBA contractor, who concluded that the calculations were accurate and reasonable. Since SBA changed to a more sophisticated hold model after sale three, we also reviewed the methodology and assumptions used in SBA's revised model to estimate hold values for loans sold in sales four and five, and found the approach to be reasonable.[4] However, we did not audit the data used to calculate the hold values for each sale and therefore did not conclude on the reasonableness of the hold values for any of the sales. We discussed SBA's budgeting and accounting procedures for loan sales with the agency, with its independent auditor, and with OMB officials. We reviewed SBA's audited financial statements for fiscal years 1999 through 2001 and related audit workpapers for fiscal years 2000 and 2001.

All of our analyses were based on data from the first five sales, which occurred between August 1999 and January 2002. The sixth sale, held on August 6, 2002, was not completed in time for us to include it in our analyses, because transferring servicing of the loans to the purchasers and completing accounting adjustments take several weeks after the sale date. We did not determine whether SBA maximized loan sale proceeds. We performed our review from January 2002 through October 2002 in Washington, D.C.; Birmingham, Alabama; Little Rock, Arkansas; Los

[4]SBA's revised hold model was first used to estimate hold values for sale four. Hold values from this more sophisticated model were calculated at the loan level rather than being based on a loan pool approach or averages, and the revised model's calculations were based on the actual data from all loans selected for sale rather than on a sample of data from the loans selected for sale.

Angeles and Santa Ana, California; Denver, Colorado; and Philadelphia, Pennsylvania, in accordance with generally accepted government auditing standards. Appendix I provides a detailed discussion of our scope and methodology.

Results in Brief

A primary objective of SBA's loan sales is to maximize proceeds by designing a sales process that attracts and satisfies investors. In order to ensure that investors have all the information they need to make informed bids, SBA has invested resources in developing a carefully structured loan sale process. SBA field offices and servicing centers review loan files to determine which loans can be sold, although lenders must approve the sales of small business loans. A contractor assembles the loan information for investors, and financial advisers create loan pools and advertise the sales. Before a sale goes forward, OMB must approve it. OMB generally approves the sale if the estimate of the value to the government of holding the loans (based on current interest rates) is less than the estimated market value calculated by financial advisers. Beginning with the second sale, SBA has offered primarily performing, secured disaster assistance loans that share many of the characteristics of home mortgages and have attracted mostly large commercial and investment banks. SBA has consulted with investors since the loan sales began in order to structure the sales in accordance with market demands, and it has developed a "lessons learned" process to improve future sales. Most of the investors with whom we spoke or whose survey responses we reviewed responded favorably to the information that SBA provides about the loans for sale and the organization of the loan pools. These investors also reported that they plan to continue participating in SBA's sales.

Lenders with whom we spoke that had participated in the 7(a) business loan guaranty program were satisfied with the loan sales. Most of the lenders with whom we spoke were pleased with the proceeds from the sales and viewed participating in the sales program as a useful way to help manage their portfolios. Some of the lenders also noted that SBA had improved certain aspects of the program since the first sale. However, it was more difficult for us to determine the reaction of borrowers whose business or disaster assistance loans were sold, as SBA does not have a comprehensive process for documenting and tracking borrower inquiries and complaints to ensure that borrower protections are working. Borrower protections included in the loan sale agreements are limited, requiring only that purchasers affirm they were qualified to service the loans and agree to use prudent loan servicing practices. These protections are intended to

ensure that borrowers are not taken advantage of or pressured to change a loan's terms or conditions. SBA's primary mechanism for enforcing these protections is to follow up on borrower inquiries and complaints, but we found that the agency did not have a system in place to capture all the inquiries and complaints received by headquarters or field offices. As a result, we could not determine how many borrowers had actually contacted SBA with complaints about the loan sales.

During our review of SBA's budgeting and accounting for loan sales,[5] we found errors that could significantly affect the reported results in the budget and financial statements for fiscal years 2000 and 2001. For example, SBA incorrectly calculated accounting losses on loan sales, which were then reported in the footnotes to its financial statements. Further, OMB budget guidance directs agencies to make reestimates of program costs for all changes in cash flow assumptions in order to adjust the subsidy estimate for differences between the original estimated cash flows and the actual cash flows.[6] However, SBA did not conduct key analyses of either the loans sold or its remaining portfolio, in order to determine the impact of the loan sales on its reestimates of program costs for its remaining loans. Because of the lack of reliable financial data, we were unable to determine the actual gain or loss on SBA's loan sales for the budget and financial statements. We also found that SBA had significant unexplained declines in its disaster loan program subsidy allowance account, to the point of showing that this subsidized program was expected to generate a profit. Between fiscal years 1998 and 2001, the balance in this account declined from $1.2 billion to a negative $77 million—that is, by over 100 percent—while the outstanding loan balance owed by borrowers declined by only 42 percent. SBA could not provide support for the balance or explain the reason for this anomaly. Despite these errors and uncertainties, SBA's auditor gave unqualified audit opinions on SBA's fiscal years 2000 and 2001 financial statements.[7] We discussed these issues with SBA's auditors, who indicated that they are currently assessing the cause of

[5]The accounting standards for loan programs were established to mirror budget guidance. This mirroring allows for consistency between loan program cost estimates and the results for the financial statements and budget.

[6]Cash flow assumptions include known and forecasted information about the characteristics and performance of a loan or group of loans that are used to estimate future loan performance and program costs.

[7]An unqualified audit opinion indicates that the balances in the financial statements are free of significant errors known as material misstatements.

the unusual balance in the subsidy allowance account and, if necessary, plan to reevaluate their audit opinions on the fiscal years 2000 and 2001 financial statements. Until SBA performs further analyses to determine the full impact of these errors and uncertainties, the financial effect of its loan sales and the reliability of the current and future subsidy rates will remain unknown, and congressional decisionmakers will not receive the accurate financial data they need to make informed decisions about SBA's budget and the level of appropriations the agency should receive.

Though SBA has reported that its loan sales will help the agency realign its workforce and improve the management of its loan portfolio, these benefits either have not yet materialized or may be overstated. SBA has said that loan asset sales are beneficial to the agency because it does not have the capacity to service all of its loans. In addition, the agency noted, selling loans should allow it to reallocate the personnel who are servicing loans to functions that are more critical to SBA's mission, such as lender oversight and outreach to small businesses. We found that loan sales have most reduced the servicing workloads for disaster assistance loans; they have had less of an impact, however, on servicing workloads for 7(a) business loans, as lenders did not always consent to sell these loans. Further, because the reductions in loan servicing have involved disaster assistance loans, it was unclear to what extent loan sales would help the agency realign its workforce in the district offices that primarily serve small businesses. We found some support for the other benefits SBA identified, but other factors may also have contributed to some of these outcomes. For example, SBA has reported that because of loan asset sales, more borrowers have paid off their loans. However, the increase in the number of loans paid off per year began prior to loan asset sales, suggesting that some of these borrowers might have paid off their loans regardless of whether a loan sale had occurred.

Although loan asset sales may be beneficial to the government, we were unable to determine the accounting and budgeting effects of SBA's loan asset sales because of problems identified in this report. This report includes recommendations to SBA and its Inspector General. To provide accurate and reliable information on the impact of the program and to address the accounting and budgetary problems, we recommend that (1) SBA improve the process for tracking borrower inquiries and complaints; (2) SBA correct the accounting and budgeting errors and misstatements before conducting additional loan sales; (3) the Inspector General work with SBA's financial auditors to assess the impact of the errors in the

financial statements; and (4) SBA more thoroughly analyze the benefits and other effects of the sales on agency operations.

We obtained written comments on a draft of this report from SBA's Chief Financial Officer, from the Inspector General, and from Cotton and Company, SBA's independent financial statement auditor. In commenting on a draft of this report, SBA generally agreed with the overall findings and recommendations, especially the need to better assess the financial impact of SBA's loan sales program. SBA noted that it is taking steps to address the process for documenting and tracking borrower inquiries and complaints. SBA also stated that it is actively engaging a contractor to help resolve the accounting and budgetary issues, and that it has worked extensively with its independent auditor to identify causes and options for resolving the issues we identified. SBA did not specifically respond to our recommendation for a more thorough analysis of the impact of loan sales on agency operations. SBA requested that we delay issuance of the report until March 2003. By then it hoped to have determined the causes of the accounting and budgetary problems, and to be able to propose an appropriate methodology for resolving them. Though we appreciate the desire to provide a plan of action for addressing these problems in our final report, it is not our policy to delay issuance of our reports until problems we have identified are resolved.

The Inspector General also agreed with our recommendations and is working with Cotton and Company and SBA management to determine the magnitude of the errors in SBA's fiscal years 2000 and 2001 financial statements. The Inspector General also stated that Cotton and Company informed the IG office that the audit opinion on the fiscal years 2000 and 2001 financial statements should no longer be relied upon, as they may be materially incorrect because of the errors identified in this report. The comments also stated that Cotton and Company plans to withdraw its unqualified audit opinion on those financial statements, and to issue disclaimers of opinion.

Although Cotton and Company agreed with the findings of our report, it stated that the report would be more fair and balanced if we further elaborated on the inherent risks and complexities associated with accounting estimates and loan sales. Cotton and Company also stated that it believes there is a lack of comprehensive implementation guidance for agencies on making credit subsidy and loan sale cost estimates. We agree that accounting for and auditing credit subsidy estimates and loan sales are inherently complex, and we describe these complexities in the background

section of the report. Further, the errors we identified in the financial statements and the related footnotes were primarily concerned with flaws in the application of existing guidance rather than with insufficient guidance. In addition, the anomalies in the disaster loan subsidy allowance account were clearly apparent, and SBA was unable to provide a viable explanation for these anomalies.

Background

The President's fiscal year 1998 budget proposed that SBA begin selling disaster and business loans that the agency was servicing and transition from the direct servicing of loans to overseeing private-sector servicers. Before its loan asset sales program began, SBA was servicing approximately 300,000 loans, with a principal balance of over $9 billion. About 286,000 of these loans, with a principal balance of $7 billion, were for disaster assistance.

SBA's loan asset sales program is part of a governmentwide initiative to make loan asset sales a potential tool for improving the management of federal credit programs. In the conference report accompanying the Treasury, Postal, and General Government Appropriations Act, 1996,[8] congressional conferees directed OMB, in coordination with the federal agencies involved in credit programs, to evaluate the potential for selling loan assets to the private sector. Furthermore, the Debt Collection Improvement Act of 1996 encourages federal agencies that provide loans to sell delinquent debt when appropriate.[9] In June 2002, OMB issued guidance requiring agencies to analyze their loan portfolios and loan management costs in order to determine whether privatizing functions such as loan servicing by selling loan assets or outsourcing would produce greater efficiencies. Other federal credit agencies have significantly larger loan portfolios than SBA that could be available for loan sales, including the Departments of Agriculture and Education, which held $78 billion and $96 billion, respectively, as of fiscal year 2001.

SBA's loan sales include defaulted, formerly guaranteed 7(a) and 504 (development company) business loans and direct disaster assistance loans. SBA provides small businesses with access to credit, primarily by

[8]H.R. Rep. No. 104-291 at 40–41 (October 25, 1995), to accompany Pub. L. No. 104-52 (Nov. 19, 1995).

[9]Pub. L. No. 104-134, Title III, ch. 10, § 31001, 110 Stat.1321-358 (1996).

guaranteeing loans through its 7(a) and 504 programs.[10] For the 7(a) program, SBA guarantees up to 85 percent of the loan amount made by private lenders to small businesses that are unable to obtain financing under reasonable terms and conditions through normal business channels. Under the 504 program, SBA provides its guaranty through certified development companies—private nonprofit corporations—that sell debentures that are fully guaranteed by SBA to private investors and lend the proceeds to qualified small businesses for acquiring real estate, machinery, and equipment, and for building or improving facilities. When a 7(a) or development company loan defaults, SBA pays the claim and either relies on the lender to recover as much as it can by liquidating collateral or takes over the loan servicing and liquidation.[11] Because SBA has paid the guaranty and thus owns the loan, these defaulted business loans—whether liquidated by the lender or by SBA—may be included in SBA's loan asset sales.

SBA also makes loans directly to businesses and individuals trying to rebuild in the aftermath of a disaster, and it primarily services these loans directly.[12] Most of the disaster assistance loans have low interest rates, sometimes less than 4 percent, and long repayment terms of up to 30 years. Interest rates on disaster loans vary, depending on the borrower's ability to obtain credit in the private sector. For example, if a borrower cannot obtain credit elsewhere, the interest rate is typically below the market rate, but a borrower who can obtain credit elsewhere is likely to receive a higher rate. Since SBA owns the disaster loans, all disaster loans are eligible to be sold.

The Federal Credit Reform Act of 1990 was enacted to require agencies to more accurately measure the government's cost of federal loan programs and to permit better cost comparisons, both among credit programs and

[10]The 7(a) program is established under section 7(a) of the Small Business Act, 15 U.S.C. § 636 (2000 § Supp. 2002). The 504 program is established under Title V of the Small Business Investment Act of 1958. See 15 U.S.C. § 696 et seq. (2000 § Supp. 20002).

[11]Liquidation is the act of enforcing collection on a debt that has defaulted by selling underlying securities that the borrower has pledged as collateral. If collateral proceeds are insufficient to cover the outstanding balance, lenders may pursue personal guarantees or obligations provided by business owners or others in support of the loan.

[12]SBA implemented a pilot, as mandated by the Small Business Programs Improvement Act of 1996, to outsource 30 percent of the servicing of its disaster home loan portfolio.

between credit and noncredit programs.[13] The act gave OMB responsibility for coordinating credit program cost estimates required by the act. OMB is also responsible for approving all loan sales. Authoritative guidance on preparing cost estimates for the budget and conducting loan sales is contained in OMB Circular A-11, *Preparation, Submission, and Execution of the Budget.* The Federal Accounting Standards Advisory Board developed the accounting standard for credit programs, including loan sales.[14] This guidance is generally found in Statement of Federal Financial Accounting Standards No. 2 (Statement 2), *Accounting for Direct Loans and Loan Guarantees*, which became effective in fiscal year 1994. This standard, which generally mirrors the Federal Credit Reform Act and budget guidance, established accounting guidance for estimating the subsidy cost of loan programs as well as recording loans and loan sales for financial reporting purposes.[15] The subsidy cost is the present value of disbursements[16]—over the life of the loan—by the government (loan disbursements and other payments) minus estimated payments to the government (repayments of principal, payments of interest, other recoveries, and other payments).

For financial statement purposes, loans are reported at both the outstanding balance and at the present value of their estimated net cash inflows, known as the net book value, which is reported on the balance sheet. The difference between these two amounts is the subsidy allowance, which is reported along with the outstanding loan balance in the footnotes of the financial statements. The allowance represents the cost of the loan program that is not expected to be recovered from borrowers, including default costs and financing costs from subsidizing below-market rate loans. Statement 2 states that when loans are written off, the unpaid principal of the loans is removed from the loans receivable balance and the same amount is charged to the subsidy allowance. Prior to the write-off, the

[13]Federal Credit Reform Act of 1990, Pub. L. No. 101-508 § 13201 (1990), 2 U.S.C. § 661 et seq. (2000 and Supp. 2002).

[14]The board was created by OMB, Treasury, and GAO to develop accounting standards for the federal government.

[15]In accordance with the Federal Credit Reform Act of 1990, the subsidy cost of loans does not include administrative costs of the program.

[16]Present value is the worth of the future stream of returns or costs in terms of money paid immediately. In calculating present value, prevailing interest rates provide the basis for converting future amounts into their "money now" equivalents.

uncollectible amounts should have been fully provided for in the subsidy allowance through the subsidy cost estimate or reestimates.

Further, as part of implementing credit reform, agencies are required to estimate the subsidy cost for budgetary purposes. Generally, these estimates are updated or reestimated annually after the end of the fiscal year to reflect any changes in actual loan performance since the estimates were prepared, as well as any expected changes in assumptions related to future loan performance. Changes in subsidy cost that are recognized through reestimates are funded through permanent indefinite budget authority.

Before a loan sale, as part of its approval process, OMB reviews the hold value of the loans being sold as compared with their estimated market value.[17] A contractor that assists SBA with the loan sales estimates a market value, which indicates the anticipated proceeds on the loan sale based on current market trends and conditions, and the loans being sold. Comparing the market value with the hold value determines whether it is more beneficial for the government to hold or to sell the loans. However, this determination does not take into account the impact of any changes in administrative costs that results from the loan sales. The glossary at the end of this report provides a list of commonly used terms related to credit program budgeting and accounting.

SBA's Sales Process Is Designed to Satisfy Investor Demands

SBA officials told us that the loan asset sale process is designed to maximize SBA's sales proceeds by attracting as many investors as possible to the bidding process. The process can take 9 months or longer as contractors, SBA field offices, and lending partners work together to prepare loans for sale. For a sale to take place, SBA must have OMB's approval, which partly depends on an analysis of whether the expected value of the loans to investors is greater than the estimated value to the government. The price obtained for loans sold and investor interest in the first five sales depended in part on the characteristics of the loan pools.

[17]Hold value is the estimated value of loans to the government in the event that the loans were held to maturity or resolution, stated on a present-value basis, discounted with interest rates from the most recent President's budget at the time the estimate is prepared. This is a more detailed loan value analysis than the credit subsidy estimate, because it specifically considers the cash flows and characteristics of the loans included in the sales and is calculated on a loan-by-loan basis.

Large commercial and investment banks have purchased the performing disaster assistance loans that make up the majority of SBA's sale portfolio, and primarily small investors have bought the nonperforming business loans.[18] Beginning with the first loan sale, SBA instituted a "lessons learned" process to analyze and improve its efficiency and investor satisfaction from sale to sale. Most investors interviewed by us or by SBA contractors stated that SBA has responded to requests for more information and is now providing the information needed to calculate bids. Most investors also said that they plan to continue bidding on future sales.

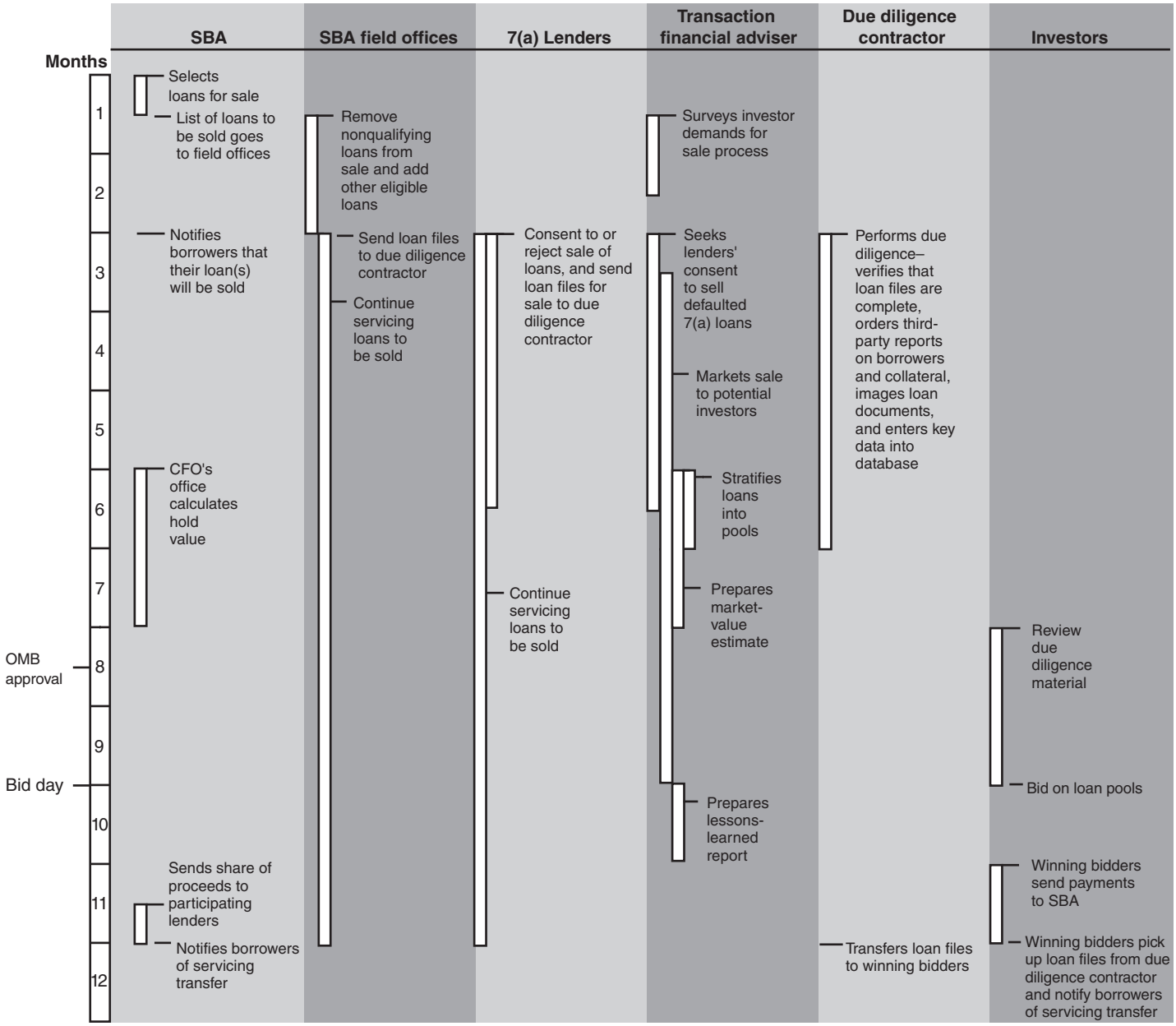
Loan Sales Require Detailed Planning and an Investment of Resources

SBA's asset sales team, which manages the loan asset sale program at SBA headquarters, coordinates the efforts of contractors, SBA field offices, and lending partners to execute a loan sale (fig. 1). Two financial advisers and a due diligence contractor are involved in each sale.[19] The program financial adviser is hired on a multiyear contract to supervise the work of other contractors and consult on strategic planning issues, such as sale design and loan selection. A transaction financial adviser is also hired for each sale, to provide marketing and to manage logistics. All participants in the sales process must work closely together over the approximately 9 months needed to carry out a loan sale and the 2 months required to close it out.

[18]Small investors are organizations, not individuals. SBA used this term in documents and conversations with us to describe the more moderately sized institutions bidding on loan sales.

[19]The goal of due diligence is to provide accurate information about the loans for sale to potential investors so that they may make informed bids.

Figure 1: Time Line of a Loan Sale



Source: GAO analysis of SBA data.

SBA and the program financial adviser select the loans for each sale, and SBA's servicing centers and district offices review them, removing any that

should not be sold, such as loans that are paid in full, are charged off as a loss in SBA's accounts, or are in litigation. Before every sale, SBA's loan asset sales team sends a detailed procedural notice to field offices to guide them through every step. The guidance covers loans that should be removed from the sale, loans that may be added,[20] and procedures for shipping the loan files when the list is finalized. SBA's 7(a) lending partners review SBA's requests to sell defaulted 7(a) loans and provide consent at their discretion. SBA's field offices and 7(a) lenders send the final selection of loan files to the due diligence contractor.

SBA's due diligence is the most costly and probably the most important element of the loan sale process. For sales three through five,[21] due diligence averaged 87 percent of total sales costs, which have reached up to $32.7 million per sale, not including salaries and expenses for SBA personnel. SBA officials told us, however, that money invested in due diligence results in higher bids from investors. In part, due diligence is costly because SBA's loan information systems do not capture some data that investors need to make a purchase decision, such as collateral information. The due diligence contractor must collect this information from the loan files and create electronic images of documents. Investors also want reports such as current credit scores, property appraisals, and broker price opinions, which the due diligence contractor orders before a sale. The due diligence contractor extracts the key data elements from the reports and loan files and enters them into a database that investors can access.

The transaction financial adviser sorts the loans into relatively homogeneous pools according to characteristics such as the type of loan, the type of collateral, and the loan's status (performing or nonperforming). Loan pools vary in size to appeal to different types of investors. Large commercial and investment banks have been the primary bidders on blocks of loans (multiple pools with common characteristics), which have an aggregate unpaid principal balance of at least $115.8 million. Smaller pools of loans are also created so that other types of investors can compete in the

[20]For example, if a borrower has multiple SBA loans and one is selected for sale, the field offices are instructed to add the borrower's additional loans to the list of loans for sale.

[21]SBA's loan sale process has evolved, and information provided by SBA indicated that sales three through five better reflect SBA's current sale process and selection of loans for sale than do sales one and two.

bidding. Between 14 and 25 investors bid in sales one through five, with a total average of 4.2 bidders for both large blocks and smaller pools of loans.

Before SBA goes forward with a sale, SBA's Office of the Chief Financial Officer estimates the value to SBA of holding these loans to maturity or of some other resolution, such as a prepayment or default. A "hold" model was specifically designed to estimate the value to the government of the loans selected for sale on a present value basis, discounted with current interest rates. At the same time, the transaction financial adviser prepares a market value estimate of what SBA would likely receive if it sold the loans to the private sector. SBA compares these estimates to determine whether selling the loans would provide a higher expected return than would holding and servicing them. These estimates are provided to OMB for its approval to go forward with a sale. For each of the five sales we reviewed, the market value estimates were greater than SBA's estimates of the hold value, or value to government, and thus OMB approved each sale.

SBA officials and contractors explained that market value estimates have exceeded hold values because investors are more efficient in collecting on nonperforming loans than is the government, and investors take different factors into account in valuing performing loans. As a result, investors often place a higher value on these loans. According to SBA's program financial adviser, private-sector lenders service defaulted loans more productively than the government because they have greater flexibility in pursuing workouts, including the ability to treat borrowers differently based on factors such as creditworthiness. SBA officials told us that private investors value performing loans largely on the basis of what is recoverable under the loan contract, including collateral. SBA, however, lends to borrowers based on their ability to repay, and focuses on getting them to make payments. Furthermore, compared with government agencies, private-sector lenders have a greater number of portfolio management strategies at their disposal, such as securitization.[22] Securitization generally yields a higher price than does selling a whole portfolio of loans, because the seller can split up the portfolio to meet the demands of a wide range of investors with varying levels of risk tolerance.

[22]Securitization of loans is the process of aggregating similar loan assets and dividing them into groups of investment instruments for sales that investors will evaluate separately, according to levels of risk.

Sales Results and Investor Interest Depended in Part on the Loan Pools' Characteristics

For each sale, SBA received proceeds from loans sold that exceeded the estimated value to the government of the loans, as calculated by SBA's hold model. SBA's proceeds as a percentage of the unpaid balances of the loans sold have varied with each sale because, among other factors, the characteristics of the loans sold differed with each sale. As shown in table 1, SBA's return on the sales, expressed as gross proceeds as a percentage of total unpaid principal balance, ranged from 44.1 percent to 73.6 percent in the first five sales. Although SBA ultimately aimed to maximize proceeds, the agency selected loans for sale according to its own constraints and perceived market interests. In the first sale, SBA sold business loans that SBA had made and serviced directly. According to SBA, most of these loans were performing and secured by collateral. As shown in figure 2, disaster assistance loans made up approximately 92 percent of all loans sold in the other sales. Most disaster assistance loans have low interest rates—around 4 percent or lower. Because these loans have below-market interest rates, they offer lower scheduled borrower payments than do similar loans with higher interest rates.[23] Therefore, investors price their bids to compensate for the SBA loans' lower scheduled payments. In sale two, SBA sold disaster assistance loans for the first time, and according to SBA officials, investors also priced their bids to account for the risk they saw in purchasing an unfamiliar loan product. Furthermore, in sale two, SBA focused on selling a large number of loans serviced by its offices in Guam, Puerto Rico, and the Virgin Islands, where servicing was more difficult and costly. In sale four, SBA primarily sold performing, secured disaster assistance loans, in an effort to enable investors to securitize these loans purchased from SBA.

[23]Similar loans refer to loans with comparable maturities, prepayment risks, and default risks.

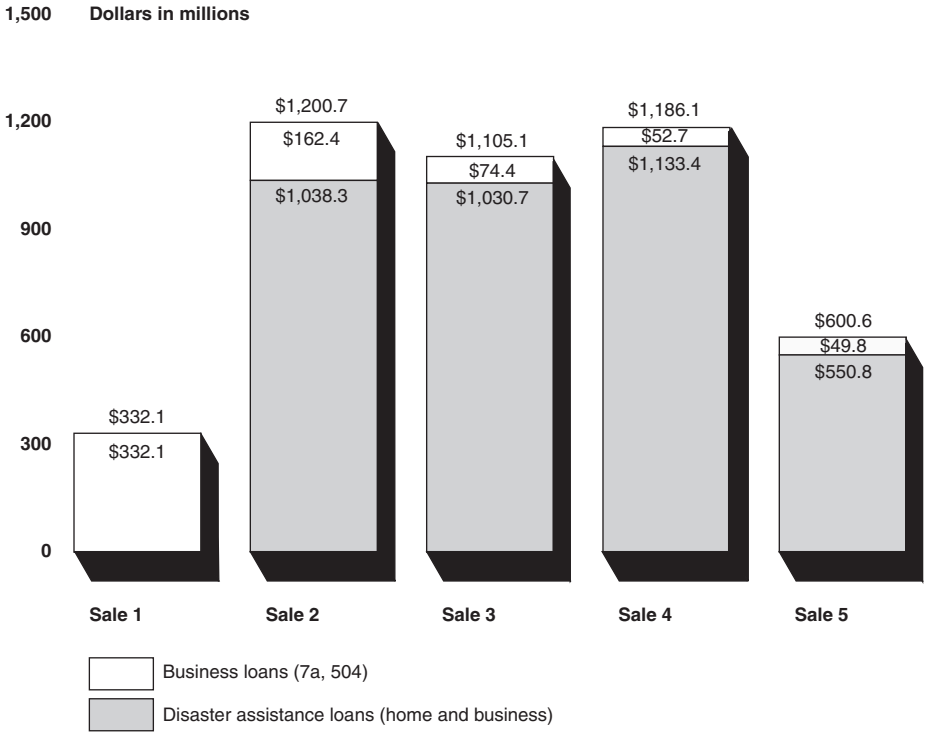
Table 1: Key Information on SBA's Loan Sales One through Five

Dollars in millions	Sale 1	Sale 2	Sale 3	Sale 4	Sale 5
Unpaid principal balance	$332.1	$1,200.7	$1,105.1	$1,186.1	$600.6
Gross proceeds	$195.1	$530.0	$662.5	$873.3	$402.8
Gross proceeds/Unpaid principal balance	59%	44%	60%	74%	67%
Estimated percentage of disaster loans secured	n. a.	88%	95%	99%	76%
Estimated percentage of disaster loans performing	n. a.	78%	82%	89%	88%
Estimated percentage of business loans secured	88%	84%	94%	84%	81%
Estimated percentage of business loans performing	61%	37%	32%	36%	10%

n. a. = not applicable

Source: SBA.

Figure 2: Total Balance of Loans Sold



Source: SBA.

SBA officials and investors told us that large investors, including investment banks, have bought the performing disaster home loans, and according to SBA, at least one investor is securitizing and trading them like other mortgage-backed securities. Most of the 7(a) loans sold since sale two have been nonperforming, and many were sold in smaller pools that small investors can bid on, according to SBA officials. Two small investors with whom we spoke have purchased these loans to try to return them to performing status and resell them at a profit.

SBA Used Investor Feedback to Shape and Improve the Sales Process

From the outset of the loan asset sales program, SBA used feedback from investors to shape and improve the sales process, with the aim of attracting as many investors as possible and obtaining quality bids on loan pools. As part of presale marketing, the transaction financial adviser consults with potential investors to determine which loan offerings, loan data, and sale procedures will yield the greatest interest. Investors are also surveyed after

the sales to obtain feedback to consider in planning future sales. SBA officials told us that these surveys are an integral part of the lessons-learned process that SBA established for the close of each sale, to help the agency target and address problems. According to SBA officials, analyzing SBA's processes and applying lessons learned have made SBA more efficient in activities such as removing loans that do not meet sale criteria. According to SBA officials, this process has reduced the number of loans that investors have sold back to SBA for not meeting the conditions of the agency's representations and warranties.[24] SBA officials also spoke with investors to identify common concerns that may have been leading them to discount their bids. According to SBA, after the early sales, many investors reported that they wanted SBA to provide additional data, such as borrower credit scores and lien information. SBA responded by adding information to its database, including credit scores and lien information, to reduce investor uncertainty about the quality of loans for sale.

The six investors with whom we spoke and most of the 42 survey responses for sales four and five positively assessed SBA's loan sale process. Most investors stated that the loan pools are well organized and that SBA provides the data they need to make informed bids. Furthermore, our review of the information provided to investors found minimal problems with the completeness of the data. The investors with whom we spoke indicated that they will continue to bid on sales. Other investors interviewed by the transaction financial adviser—including those who have not bid in past sales—reported that they are interested in participating in future sales. SBA officials believe that the refinement process and provision of better data to investors has yielded higher bids.

[24]Representations and warranties are a set of legally binding statements by the seller that are intended to assure buyers that the assets being sold meet certain qualitative expectations. Representations and warranties are accompanied by obligations to "cure" conditions that are breaches of the original representations, as well as by remedies available to the investor if the condition cannot be cured. Such remedies may require a repurchase or substitution of an obligation.

Lenders Expressed Satisfaction with SBA's Loan Sales, but SBA's Data on Borrowers' Reactions Was Incomplete

Lenders and borrowers also play a role in the loan sale process. Although many 7(a) lenders that participated in SBA's loan sales reported satisfaction with the way in which the sales were conducted, borrowers' reactions were difficult to measure. An important factor in the reactions of both groups is that lenders' involvement is voluntary but borrowers' is not. Lenders must consent before SBA can sell business loans they made, while borrowers have no choice. Most of the 7(a) lenders with whom we spoke said they are satisfied with the loan sale process and the proceeds they are receiving on loans they consented to sell. However, lenders' participation in sales is limited and driven by a practical decision: whether greater net returns will result from selling the loan or from liquidating it. The reaction of borrowers was difficult to assess because of weaknesses in SBA's system for collecting and following up on inquiries and complaints—its primary method of ensuring that borrowers whose loans are sold are protected.

Most 7(a) Lenders with Whom We Spoke Are Satisfied with the Loan Sales

Lenders who participate in SBA's 7(a) loan guaranty program have an interest in the outcome of the sales, because they still have a stake in the 7(a) loans for sale. When a 7(a) loan defaults, SBA honors its loan guaranty, paying the lender 75 to 85 percent of the unpaid principal balance. Thereafter, the lender and SBA share any loan payments according to the percentage set out in the guaranty. Therefore, SBA must obtain consent from the lender before selling a defaulted 7(a) loan. We spoke with 12 7(a) lenders who have all participated in more than one SBA loan sale, and 10 said that they had used the loan sales as an additional portfolio management tool for nonperforming loans. According to 8 of the lenders whom we interviewed, proceeds from the sales they participated in were satisfactory; 2 lenders stated that SBA is obtaining market value for nonperforming 7(a) loans. One lender stated that SBA sales have tapped a market for nonperforming loans that his company would not otherwise be able to access.

According to SBA, following the early sales lenders raised two concerns, which the agency has since addressed. First, in the first four sales, lenders did not know how to estimate the proceeds they would receive by selling loans. And second, when some lenders received their shares of sales proceeds, SBA did not clearly identify the price paid for each loan. These practices resulted in accounting problems for the lenders. Beginning with the fourth sale, SBA sent lenders one check and a list of the earnings from each loan sold. Beginning with the fifth sale, SBA also began providing information on returns from past sales to help lenders decide whether to

consent to sell loans. Four lenders we spoke with specifically noted that SBA had made improvements to its loan sale process in areas such as distributing sale proceeds and seeking consent to sell loans.

Expected Returns and Experience with Prior Sales Drive Lender Participation

Based on our discussions with 7(a) lenders and SBA district officials, we identified two primary factors that drive lender participation in the sales: whether the net returns from the sale are likely to exceed those from liquidation, and whether proceeds from a previous sale met expectations. Lenders' consent to sell 7(a) loans must be given voluntarily, and most lenders sell these loans only after trying to liquidate them. Three SBA district officials and two lenders said that in the early sales, SBA lenders did not have all the information they wanted about expected returns from selling loans and therefore preferred not to sell them. A lack of control over the loan sale process, timing of the sales, and distribution of the proceeds can influence lenders' expectations of net returns from selling loans rather than liquidating. Lenders have no role in determining in which pools their loans will be sold or whether bids are acceptable. Also, lenders must wait until SBA's bid day to sell loans, and the value of non–real estate collateral generally declines as time passes. Finally, proceeds from SBA sales do not arrive until almost 2 months after the sale, giving lenders greater incentives to begin loan liquidation in order to try to recover money more quickly.

Lenders who have already begun investing resources in liquidation believe they will maximize returns by continuing with their liquidation strategy. Lenders are prepared to sell loans when they believe that their net returns from investing resources in liquidation will no longer provide satisfactory returns in comparison with selling loans. SBA officials confirmed that most 7(a) loans that lenders agree to sell have little value left in them.

According to SBA district office officials, some lenders have stopped participating in loan sales because the proceeds from a previous sale did not meet their expectations, and we spoke with one lender who confirmed this statement. We also learned that some lenders who had stopped participating in sales had not completed loan collection actions, such as seizing collateral. Another disappointed lender we interviewed decided to return to SBA loan sales, but only to sell loans after completing collection efforts.

SBA Created Borrower Protections Addressing Loan Servicing and Disaster Assistance

Unlike lenders, SBA's borrowers have little control over what happens to their loans if SBA decides to sell them. However, SBA has built in some safeguards to protect the integrity of the programs that provided the loans. SBA's loan programs, including loan servicing, are designed to help the borrower stay in business or recover financially from a disaster. To protect the public policy goals associated with these programs, SBA's loan sales agreements with purchasers require certification that the investors are qualified to purchase and service the loans and will follow prudent loan servicing practices. The loan sales agreement also prevents purchasers from unilaterally changing the terms and conditions of the loans.

SBA made additional policy decisions concerning disaster loans. The agency does not sell some disaster loans, including those issued to borrowers currently residing in a federally declared disaster area and those that are less than 2 years old. SBA decided it would sell disaster loans only if they were more than 2 years old, because disaster loans typically require more servicing in the first 2 years and sometimes must be increased to cover exigencies, such as occurs with revised physical damage estimates.

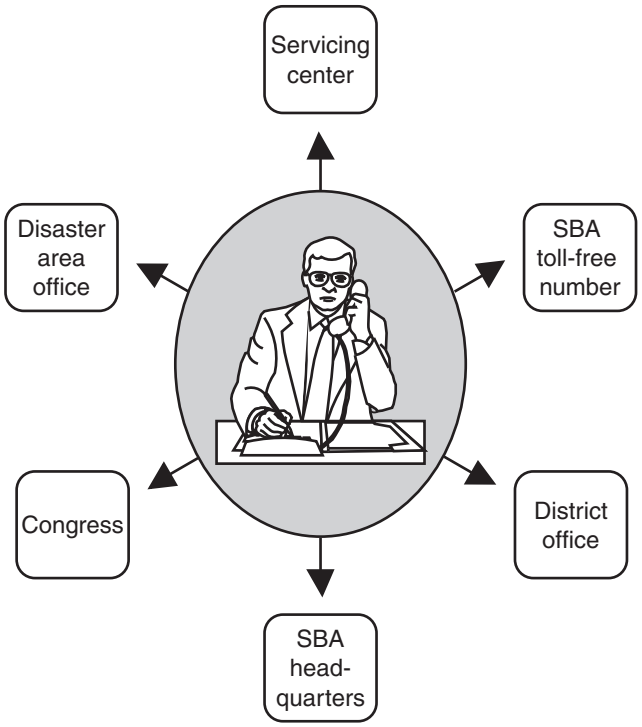
Information on Borrowers Is Incomplete Because SBA's Process for Documenting and Tracking Borrower Inquiries and Complaints Has Weaknesses

We were unable to validate the way in which borrowers have reacted to the loan sales, because SBA could not provide a reliable estimate or information on the number of borrowers who had contacted them about their sold loans. Complete and reliable information on borrower complaints is important, because SBA officials told us that they contacted purchasers when a borrower complained about a servicing action to collect additional information and determine whether a purchaser was breaching the borrower protections. For example, in one case in which SBA was receiving many complaints about one particular purchaser, SBA found some evidence to suggest that the purchaser's servicing employees were overly aggressive or rude with some borrowers. In response, SBA forwarded the specific complaints to the purchaser and requested that the purchaser improve its handling of new loans.

One reason why SBA's tracking system is ineffective is that borrowers with questions or complaints can call or write to several different SBA offices, or to a representative from Congress (fig. 3). Some SBA field office officials told us that SBA does not provide them with clear guidance on how to respond to or document such complaints. Officials from seven district offices, three servicing centers, and two disaster area offices told us that they had received calls and letters from borrowers who had concerns about

loans that had been sold. But the methods of documenting inquiries and complaints varied across offices, except for congressional letters, which were consistently forwarded to SBA headquarters.

Figure 3: Outlets That SBA Borrowers Use for Inquiries and Complaints about Loan Sales



Source: GAO.

In August 2001, SBA began providing a toll-free number for borrowers to call with questions or complaints about loan sales.[25] Borrowers were informed about the toll-free number in a letter telling them how to contact the new owner of their loan. However, field office staff did not receive any guidance regarding the purpose and use of the toll-free number. Santa Ana

[25]The Real Estate Settlement Procedures Act (RESPA) requires that loan servicers provide either a toll-free or collect call number for home loan borrowers to call about servicing problems before and after the loan is sold. 12 U.S.C. § 2605 (b), (c) (2000 § Supp. 2002). The act does not specify how long the toll-free number should be operational following the transfer of servicing.

liquidation and loan servicing center staff who answer calls to the toll-free number told us that initially they thought the number was only provided for answering borrowers' questions, and therefore they did not record inquiries or complaints called in to this number. Therefore, we were unable to collect a reliable sample of inquiries and complaints from this source.

We also could not validate the number of inquiries and complaints received at headquarters. SBA officials at headquarters told us that, overall, SBA had received about 300 inquiries or complaints from borrowers. However, when we were provided with a database of these inquiries and complaints, there were only 155. When we asked how SBA came up with the number 300, officials told us that it was an estimate.

We also reviewed 50 complaints from a servicing center, the only field office with whom we talked that could provide a record of phone calls and letters from borrowers whose loans had been sold, to compare them with the inquiries and complaints at headquarters. Forty-five complaints involved problems with purchasers during the servicing transfer period—for instance, some borrowers said that payment had not been posted, and others had difficulty in modifying the terms of their loans. However, we found that only 3 of the borrowers listed in 50 complaints from the servicing center were reflected in the 155 borrower inquiries or complaints we reviewed at SBA headquarters. An SBA official at headquarters told us that the office had received some of the complaints from the center, but acknowledged that they had not included these complaints in the files we had reviewed.

Though we were unable to determine how many borrowers have contacted SBA about their sold loans, we reviewed 133 of the 155 written inquiries and complaints documented at headquarters, along with SBA's written responses, to identify the types of questions and problems borrowers may have when their loans are sold. Our analysis showed that almost half (65) were inquiries and concerns about their loans being sold, requests to buy their own loans, or pleas to not have their loans sold. However, 47 of the borrowers complained about a purchaser's servicing action. SBA responded in writing to the written inquiries and complaints we reviewed at headquarters. More information on our review of these inquiries and complaints is presented in appendix II.

SBA's Accounting for Loan Sales and the Remaining Portfolio Was Flawed

SBA sold almost 110,000 loans with an unpaid principal balance of about $4.4 billion in five loan sales from August 1999 through January 2002. We reviewed the budgeting and accounting for these loan sales and found errors that could significantly affect the reported results in the budget and financial statements. Specifically, SBA (1) incorrectly calculated loan sales losses reported in the footnotes to its financial statements; (2) did not appropriately consider the effect of loan sales on its estimates of the cost of the remaining portfolio, which could significantly affect its budget and financial statement reporting; and (3) had significant unexplained declines in its subsidy allowance for the disaster loan program. Despite these errors and uncertainties, SBA's auditor gave unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements. We discussed these issues with SBA's auditors, who indicated that they are currently assessing the cause of the unusual balance in the subsidy allowance account and, if necessary, plan to reevaluate their audit opinions on the fiscal years 2000 and 2001 financial statements. Until SBA performs further analyses to determine the full impact of these errors and uncertainties, the financial effect of its loan sales and the reliability of current and future subsidy rates will remain unknown.

SBA Improperly Calculated Losses on Loan Sales

Accounting records related to loan sales indicated that losses exceeded $1.5 billion. However, this amount is overstated because of errors in the way that SBA calculated the losses. Because of the lack of reliable financial data available, we were unable to determine the financial effect of loan sales on SBA's budget and financial statements. These errors raise serious concerns about the information related to the results of loan sales included in the footnotes to the annual financial statements provided to OMB and the Congress for decisionmaking purposes.

For accounting purposes, the gain or loss on a loan sale represents the difference between the net book value (the outstanding loans receivable balance less the subsidy allowance)[26] of the loans sold and the net sale

[26]The subsidy allowance account represents the subsidized portion of direct loans and defaulted guaranteed loans assumed by the federal government. It is subtracted from the loans receivable balance on the balance sheet to arrive at the net loan amount expected to be repaid.

proceeds.[27] The accounting gain or loss differs from the hold value calculation, discussed earlier, which indicates that the sales resulted in a benefit to the government of about $606 million. This difference exists because the benefit calculation—the difference between the hold value and the net sales proceeds—is not designed to take into consideration changes in interest rates from the time the loans were disbursed to the date of the sale, while the accounting gain or loss, if properly computed, does take these changes into account. The footnotes to SBA's fiscal years 1999 and 2000 financial statements reported accounting losses of $75 million and $600 million, respectively, on its loan sales. SBA did not separately disclose in its financial statements the losses calculated on the two loan sales that took place during fiscal year 2001. According to SBA's accounting records, the first five sales have resulted in total losses of more than $1.5 billion.

We reviewed the methodology SBA used to calculate the results of its loan sales for accounting purposes and found significant errors that caused SBA to overstate losses. When calculating whether loans are sold at a gain or at a loss, agencies must estimate the portion of the subsidy allowance to allocate to each loan sold in order to calculate the net book value for those loans. Since SBA's calculation of the net book value of the sold loans exceeded the net proceeds from the sales, losses were calculated. Our review of these calculations found that SBA's estimates did not consider all the appropriate cash flows when allocating the subsidy allowance to the sold loans. For example, when calculating the gains or losses for the disaster loan program, SBA failed to allocate a portion of the subsidy allowance for financing costs associated with lending to borrowers at below-market interest rates.

In addition, SBA incorrectly allocated the subsidy allowance for the previously defaulted 7(a) and 504 loan guarantees. SBA used its estimated net default cost, which considers first the probability of default and then the estimated recovery rate after default. For example, if a $10,000 guaranteed loan has an estimated default rate of 10 percent and an estimated recovery rate of 50 percent, the subsidy allowance allocated by SBA would be $500 ([$10,000 x .10] x .50). However, since sold guaranteed loans have already defaulted, SBA should have used only the estimated

[27]OMB Circular A-11 defines net sales proceeds in the context of loan sales as the amounts paid by purchasers less all seller transaction costs (such as underwriting, rating agency, legal, financial advisory, and due diligence fees) that are paid out of the gross sales proceeds rather than paid as direct obligations by the agency.

recovery rate for these loans, meaning that the subsidy allowance allocated would be $5,000 ($10,000 x .50). Figure 4 illustrates the difference in the calculated gain or loss resulting from this error. The left column, based on SBA's methodology, shows that the loan was sold for a $3,000 loss, while the right column appropriately allocates the allowance based on expected recoveries and results in a $1,500 gain.

Figure 4: Gain / Loss Calculation on Previously Defaulted Sold Guaranteed Loans

Dollars

SBA's method		Correct method	
Previously defaulted loan guarantee	$10,000	Previously defaulted loan guarantee	$10,000
Less allowance based on net defaults (defaults less recoveries)	500	Less allowance based on portion not expected to be recovered	5,000
Net book value	9,500	Net book value	5,000
Net sale proceeds	6,500	Net sale proceeds	6,500
Loss	**($3,000)**	**Gain**	**$1,500**

Source: GAO analysis.

SBA's errors in calculating the losses on disaster loans and on previously defaulted sold guaranteed loans, both resulted in overestimates of the net book value of the sold loans and the losses that SBA reported in the footnotes to its fiscal years 1999 and 2000 financial statements. Because of the way in which the results of loan sales are incorporated into the budget and the financial statements, the reestimates, if done properly, should have corrected the effect from these errors. However, as discussed below, we found that the reestimates were not reliable.

Subsidy Cost Reestimates Are Unreliable

SBA did not conduct key analyses of either the loans sold or its remaining loan portfolio in order to determine the impact of the sales on its reestimates of program costs for its remaining loans. OMB's budget guidance directs agencies to make reestimates for all changes in cash flow assumptions in order to adjust the subsidy estimate for differences between the original estimated cash flows and the actual cash flows. SBA officials acknowledged that analyses of the impact of loan sales on its historical averages should be done. However, according to SBA officials, the agency has lacked the appropriate historical data and resources to do these necessary analyses. Because SBA did not assess the effect that loan

sales would have on its historical averages of loan performance, such as when loans default or prepay, the agency does not know whether these averages, which can significantly affect the estimated cost of a loan program, reasonably predict future loan performance. As a result, information in both the budget and financial statements related to the reestimated cost of SBA's loan programs cannot be relied upon.

SBA is generally required to update or "reestimate" loan program costs annually. OMB Circular A-11 directs agencies to do reestimates for all changes in cash flow assumptions. Thus, reestimates should include all aspects of the original cost estimate, including prepayments, defaults, delinquencies, and recoveries. These reestimates are done to adjust the subsidy cost estimate for differences between the original cash flow projections and the amount and timing of cash flows that are expected based on actual experience, new forecasts about future economic conditions, and other events that affect the cash flows.

Even after selling about $4.4 billion of loans, nearly half of its loan portfolio, SBA has not analyzed the effect of loan sales on the estimated cost of the remaining loans in its portfolio. SBA officials told us that loans are selected for sale based on certain criteria, such as where the loan is located or serviced, the type of collateral, or whether the loan is performing. Since the loan selection process is not random—that is, all loans do not have an equal chance of being selected—it is likely that the loans sold will have different characteristics from those of the portfolio's historical averages prior to sales. Consequently, the characteristics of the remaining loans may also differ substantially from the portfolio historical averages prior to the sales. For example, during our analysis of the loans that were sold, we determined that 84 percent of the $3.8 billion of disaster loans sold were performing—meaning that payments were not more than 30 days delinquent. Selling mostly performing loans could conceivably leave a disproportionate level of nonperforming loans in SBA's portfolio. Because SBA has not analyzed the effect of loan sales on its reestimates of the remaining portfolio, it does not know if the percentages of remaining performing and nonperforming loans are different from the historical averages prior to the sales. A change in these percentages could indicate that expected defaults in the remaining portfolio could be higher or lower than current assumptions, based on historical data, suggest.

Another important loan characteristic is the average stated loan term. This term is the contractual amount of time the borrower has to repay the loan. SBA's estimated costs of the disaster loan program are based on historical

average loan term assumptions of 16 years for business disaster loans and 17 years for home disaster loans. Based on our review of the disaster loans sold in the first five sales, the average loan term was about 25 years. However, SBA continued to use the average loan term assumptions of 16 and 17 years in its reestimates without doing the appropriate analysis to determine whether these assumptions were still valid. Because of the large number of loans sold, it is unlikely that the average loan terms for the remaining loans are still 16 and 17 years, if in fact these are valid estimates of the overall presale averages. Assuming that these assumptions are valid, by selling longer-term loans, the average loan terms for the remaining portfolio would be shorter. As a result, if there are no changes in any other assumptions, the reestimated cost of the disaster loan program would be less, since SBA would be subsidizing below-market rate loans for a shorter period of time.[28] Given the significant volume of loans sold since 1999, it is important that SBA assess whether the characteristics of the remaining portfolio are similar to the characteristics of the loans used to calculate the averages used in the credit subsidy estimates. Relatively minor changes in some cash flow assumptions—such as higher or lower default and recovery rates, or changes in loan terms—can significantly affect the estimated cost of the loan program and, therefore, the program's budget.

We attempted to determine the effect of loan sales on the cost estimates of the remaining portfolio. However, SBA could not provide us with timely, basic information about the composition of its loan portfolio before and after each sale, including the amount of loans that were current on payments, delinquent, or in default. According to SBA, this information was not readily available because of systems limitations and reconciliation problems. Shortly before we concluded our work, SBA provided some information about the quality of its portfolio before and after some of the loan sales. However, because a gap of several months occurred between the pre- and post-loan sales analyses, the data could not be reliably used to determine the effect that loan sales were having on the quality of the remaining portfolio.

The Subsidy Allowance Account Was Misstated

During our review of the accounting for loan sales, we noted that the subsidy allowance account for the disaster loan program had an unusually

[28]The fact that the average loan term of the loans sold to date, which represents over half the loan portfolio, is 25 years could also mean that the 16- and 17-year assumptions of the average loan term were too short.

low balance. For a subsidized loan program, the subsidy allowance account is generally the amount of expected losses on a group of loans related to estimated defaults and financing costs from making below–market rate loans. In effect, the subsidy allowance is the cost associated with the loans that SBA does not expect to recover from borrowers. For financial reporting purposes, the subsidy allowance reduces the outstanding loans receivable balance to determine the amount that SBA expects to collect from borrowers, known as the net loans receivable balance (or net book value), which is shown on the balance sheet.

Table 2 summarizes the disaster loan program's reported outstanding loans receivable balance, the subsidy allowance balance, the net book value, and the subsidy allowance as a percentage of the loans receivable balance for fiscal years 1998 through 2001. The subsidy allowance compared with the loans receivable balance decreased significantly in fiscal years 2000 and 2001, to the point of showing that the remaining portfolio of the disaster program was expected to generate a profit. SBA could not provide support for the balance or explain the reason for this anomaly.

Table 2: Loan Receivable Balances of SBA's Disaster Loan Program

Dollars in millions

Disaster loan program	Fiscal year 1998	Fiscal year 1999	Fiscal year 2000	Fiscal year 2001
Loans receivable outstanding	$5,634	$5,659	$5,305	$3,293
Less / (plus): Subsidy allowance balance	$1,230	$929	$505	($77)
Net book value	$4,404	$4,730	$4,800	$3,370
Subsidy allowance as a percentage of loans receivable balance	21.8%	16.4%	9.5%	(2.3%)

Source: SBA.

While Table 2 shows a rapid decrease in the subsidy allowance over the 2-year period between fiscal years 2000 and 2001, most of the decrease actually occurred in fiscal year 2000, but was masked by an adjustment made during the fiscal year 2000 financial statement audit. Before SBA had made the audit adjustment, discussed below, the subsidy allowance for the disaster program was about $91 million for fiscal year 2000. This balance was $838 million, or about 90 percent, less than the $929 million balance for

fiscal year 1999, while loans receivable outstanding decreased by only $354 million, or about 6 percent. SBA could not explain why the subsidy allowance reduction occurred.

In order to restore the subsidy allowance to a more reasonable balance at the end of fiscal year 2000, in agreement with its auditors, SBA increased the subsidy allowance balance by recording an audit adjustment that was essentially meant to reflect the expected impact of loan sales on the reestimates prepared in fiscal year 2000, which did not factor in the effects of loan sales.[29] This increased the reported cost of the disaster loan program by $414 million. Since the amount of the adjustment was based on SBA's erroneous calculations of loan sales losses, previously discussed, the amount of the adjustment was incorrect. During fiscal year 2001, SBA reversed the audit adjustment and revised its reestimates to include cash flows related to loan sales. Our review of the fiscal year 2001 disaster loan program reestimates indicated that loan sales increased the reported cost of the program by about $292 million.[30] However, this amount is also likely misstated because, as previously mentioned, the reestimates did not consider the specific characteristics of the loans sold or the loans remaining in the portfolio.

The unexplained decline in the subsidy allowance continued in the fiscal year 2001 financial statements, where SBA reported a negative balance in the subsidy allowance for the disaster loan program. As illustrated in table 2, this balance no longer reduced the amount SBA expected borrowers to repay—it actually increased the expected repayments from borrowers and indicated that the loan program was profitable. However, because the program is subsidized, with estimated default and financing costs exceeding the amount of interest borrowers are expected to pay, it should not be showing an expected profit. Based on SBA's most recent reestimates, the subsidy cost of this program ranges from 17 percent to 33 percent, and thus the balance for the subsidy allowance account appears to be significantly misstated. As in the prior year, SBA could not explain the

[29]Theoretically, had the reestimates factored in the loan sales, the subsidy allowance account would have been appropriately adjusted, regardless of any errors made in recording the calculated accounting losses.

[30]The effects of loan sales on the reestimated cost of a loan program differs from the results of loan sales based on the hold value because the reestimates, similar to the accounting gains or losses of a loan sale, are influenced by changes in interest rates from the time the loans were disbursed to the date of the sale.

unusual balance. SBA officials told us they were currently working with their auditors to determine the cause of these unusual balances.

While neither we nor SBA could determine the specific cause of this unusual balance, several possibilities exist. As previously mentioned, a failure to consider the characteristics of the loans sold or of those remaining in SBA's portfolio could contribute to the unusual balance. Another possibility is that SBA could have incorrectly reduced its subsidy allowance account balance by writing off loan amounts that are still collectible. This would mean that both the loans receivable outstanding balance and the subsidy allowance account would be misstated, but not the net book value. Yet another possibility is that SBA may have underestimated the cost of its disaster loan program because the cash flow assumptions used to estimate the subsidy cost did not reflect the true characteristics or performance of its loan portfolio. If SBA had underestimated its losses on disaster loans, it would not have put enough into the subsidy allowance account to cover these losses, and the subsidy allowance would be depleted as loans were written off against it until there was a negative balance. This could mean that SBA did not request an appropriation large enough to cover the cost of the loan program, and that the difference would be made up through the reestimates, which are covered by permanent indefinite budget authority. It is also possible that a combination of these and other errors may have occurred. Regardless of the reason, because SBA does not currently know why the anomalies are occurring, the disaster loan program's subsidy estimates for the budget and financial statements cannot be relied on.

Despite the significant, unexplained decline in the subsidy allowance and the errors in calculating the losses on loan sales, SBA received an unqualified or "clean" audit opinion on its fiscal years 2000 and 2001 financial statements. An unqualified audit opinion indicates that the balances in the financial statements are free of significant errors, known as material misstatements. As previously mentioned, SBA's auditor attempted to adjust the anomalies in the subsidy allowance during the fiscal year 2000 financial statement audit. However, the adjustment was based on the previously described erroneous loss calculation. For the fiscal year 2001 audit, SBA's auditor performed a number of audit procedures related to the disaster loan program subsidy allowance account. For example, the auditor evaluated the methodology and formulas used to calculate reestimates, assessed data used to calculate key cash flow assumptions, and reviewed various internal controls over the subsidy estimation process. However, this work did not appear to focus on determining the cause of the unusual

negative balance of the account, which, contrary to the fact that this is a subsidized loan program, would indicate that these loans were expected to generate a profit. The auditor's workpapers indicated that the auditor had agreed, in discussions with SBA management, that if the "methodology and data were materially correct, we [the auditor] would conclude that the resulting subsidy reserve [allowance] would be materially correct for financial statement reporting purposes." The workpapers also indicated that, "whatever the results of the reestimates are, as long as the methodology is sound and supportable, we [the auditor] would not consider the balance [of the subsidy allowance] anything other than 'natural.'"

Although SBA's auditor may have recognized some of the errors we identified, it did not determine the cause of the unusual balance and propose the necessary audit adjustments, nor did it modify its audit report as appropriate. In such situations, when auditors cannot determine whether a balance is fairly stated because sufficient reliable supporting documentation is not available, audit standards call for auditors to qualify their opinion or issue a disclaimer of opinion.[31] We discussed these issues with SBA's auditors and they indicated that they are currently assessing the cause of the unusual balance in the subsidy allowance account and, if necessary, plan to reevaluate their audit opinions on the fiscal years 2000 and 2001 financial statements.

Loan Sales Have Reduced SBA's Loan Servicing Volume, but Other Operational Benefits May Be Overstated

SBA reported that loan asset sales had benefited the agency's operations by reducing loan servicing, and that this reduction in loan servicing volume should help allocate resources to other areas necessary to achieving SBA's mission and help the agency to manage its loan portfolio more effectively. Though we found that loan servicing volume had declined for SBA disaster home loan centers, the effect on regular business loans was less clear. Furthermore, despite these reductions in loans servicing volumes, SBA had not yet redeployed staff to more mission-critical activities, such as lender oversight and business outreach. SBA has also reported that the loan sales have prompted borrowers to pay their loans in full, revealed inconsistencies in the application of the agency's servicing procedures, and highlighted weaknesses in its information system. We found some support to show that the loan sales had produced portfolio management

[31]Statements on Auditing Standards, AU §508, paragraphs 22 and 23.

efficiencies. But we also found that some of the benefits SBA had reported began before the loan sales program, or could have been caused by other factors.

Reductions in Loan Servicing Volumes Have Been Greatest for Disaster Loans

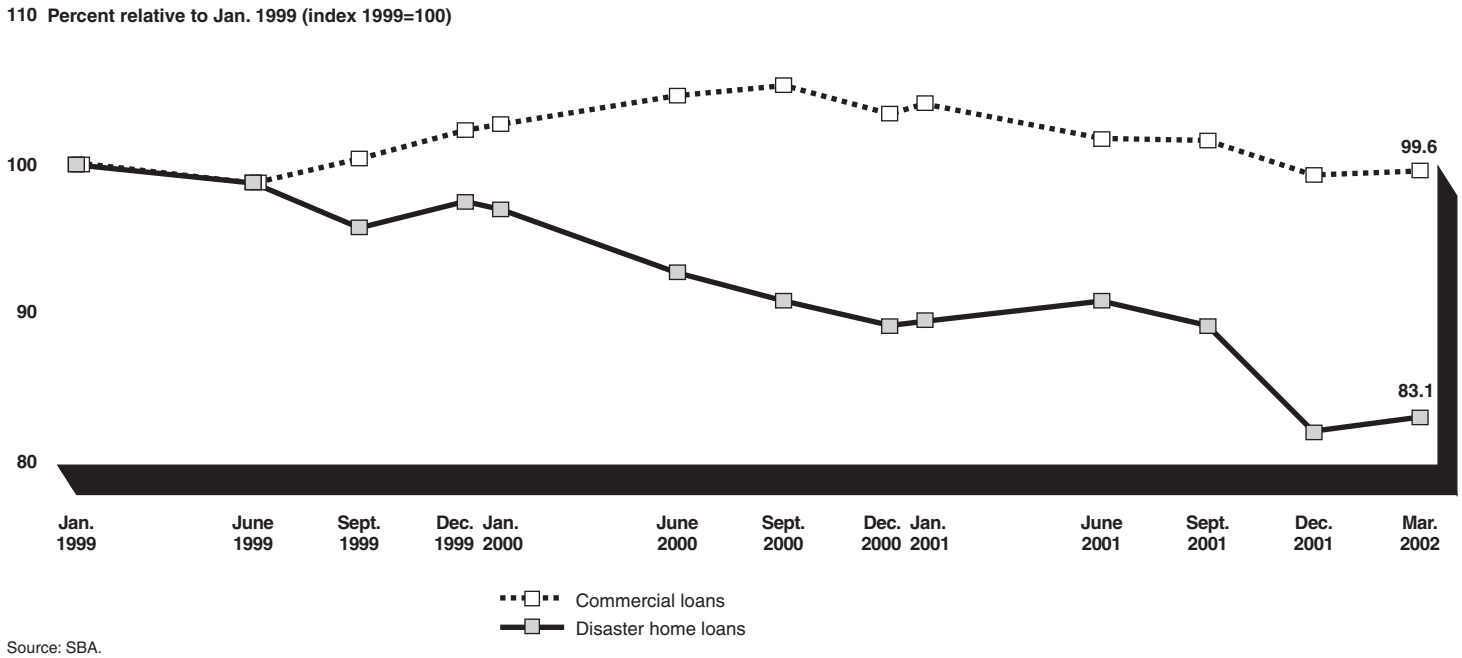
The loan asset sales have reduced SBA's servicing and liquidation workload for disaster loans at the disaster home loan servicing centers, but they have had little impact on regular business loans, such as 7(a) loans, at the commercial servicing centers and district offices. SBA had stated that reductions in loan servicing and liquidation workloads would be one of the loan sales program's most significant benefits, as the growth in loan volume and the continuing decline in staff had compromised its ability to adequately service a growing portfolio. During the 1990s, SBA's portfolio of 7(a) business and disaster loans grew dramatically. For example, from 1990 through 1996, SBA's annual volume of 7(a) loan approvals increased from 19,907 to 52,729. Disaster assistance loan approvals varied from year to year, depending on the number and severity of disasters. However, in 1994 SBA's loan approvals for disaster assistance loans increased to over 125,000, primarily because of the Northridge earthquake in California—a significant jump from the levels of the previous 4 years, when loan approvals ranged from about 12,000 to 59,000. Servicing and liquidating loans account for large operating expenses for SBA, reaching approximately $85 million a year, according to SBA's fiscal year 2001 Accountability and Performance report. Servicing and liquidating loans currently involve approximately 186 employees at six servicing centers and employees at 70 district offices, who also perform other loan management functions.[32]

SBA's disaster home loan servicing centers have seen a much greater reduction in the number of loans they service than have the commercial loan servicing centers. According to SBA's limited analysis, the number of loans serviced at SBA's disaster home loan servicing centers decreased by 17 percent from January 1999 through March 2002 (fig. 5), and SBA's analysis of the servicing centers shows that if more loans are sold, SBA may be able to reduce and consolidate its loan servicing resources for

[32]SBA has four disaster home loan servicing centers, located in New York City, New York; Birmingham, Alabama; El Paso, Texas; and Santa Ana, California, which service only disaster home loans. SBA also has two commercial loan servicing centers, located in Little Rock, Arkansas, and Fresno, California, which service 7(a) and development company loans as well as disaster business loans.

disaster home loans. However, SBA's analysis also shows that the number of loans at SBA's commercial loan servicing centers fell by less than 0.5 percent over the same time period. Though the sales have reduced the number of disaster business loans, most of the loans in the commercial loan servicing centers are from the 7(a) program and are not put up for sale until they default. SBA officials told us that lenders do not always consent to sell the 7(a) loans that SBA would like to sell. Moreover, one commercial loan director explained that servicing performing loans can require as much if not more work than can nonperforming loans, as businesses frequently seek additional financing and therefore want to modify the terms of their loans. For this reason, the growth of the 7(a) program has offset the number of loans sold in the commercial loan centers.

Figure 5: Change in Loan Servicing Volume at the Disaster Home Loan and Commercial Loan Servicing Centers

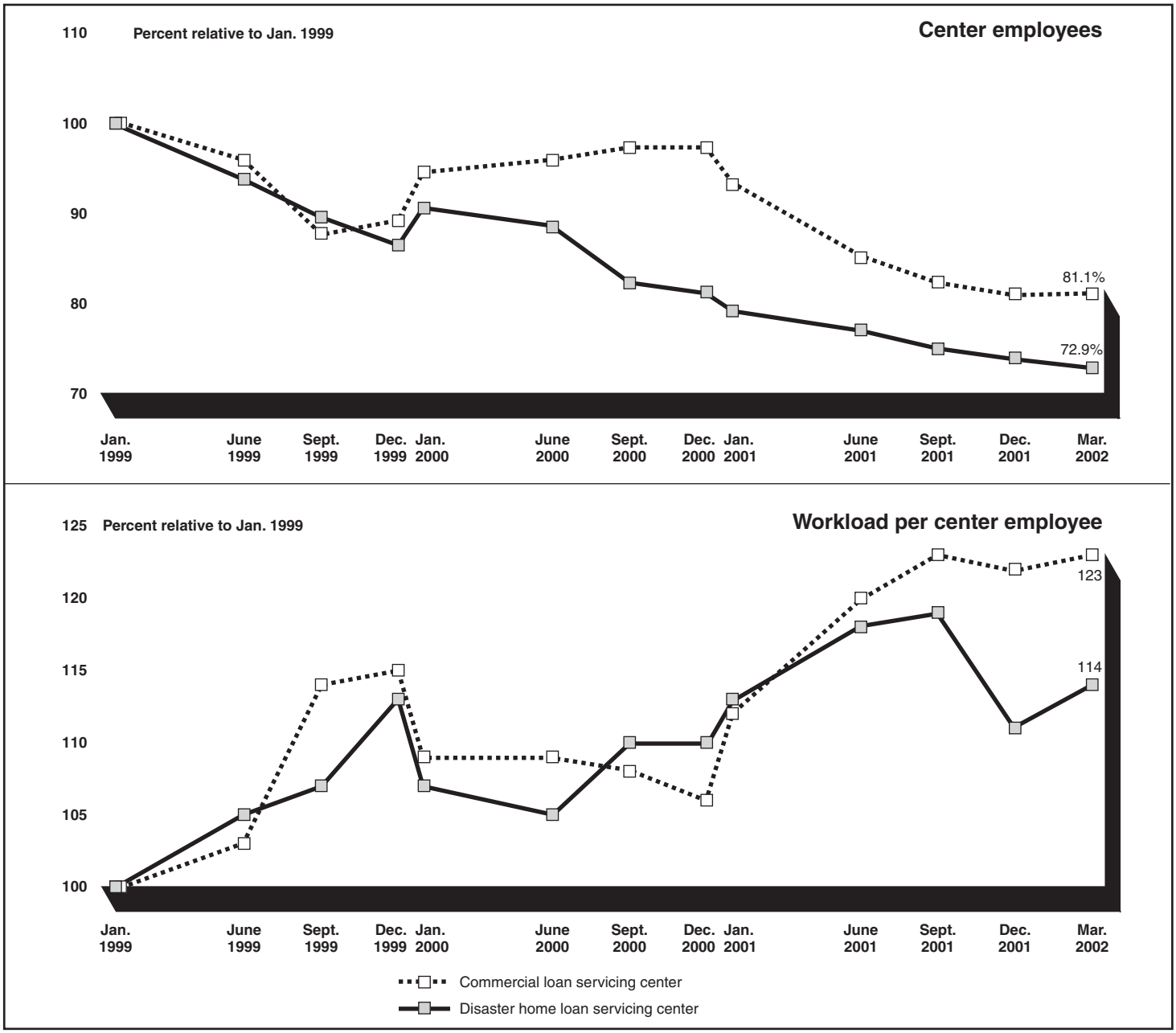


Source: SBA.

Since the loan sales began, SBA has been able to reduce the number of employees at the servicing centers (fig. 6). However, one of the problems SBA hoped to address with loan asset sales was to reduce its loan servicing volume to a level that matches its staffing capacity. Since the implementation of the loan sales, the number of loan servicing staff has

fallen faster than have loan volumes for most of SBA's loan servicing centers. According to SBA officials, the reduction in employees at SBA is driven more by employee departures, retirements, and the hiring freeze than by reductions in servicing volumes form the loan sales. As a result, the number of loans serviced per employee increased on average by 14 percent at the disaster home loan centers and by 23 percent at the commercial centers (fig. 6). Only one of the disaster home loan servicing centers has experienced a reduction in the number of loans serviced per employee. The disparity between staff attrition and loan volumes is especially problematic at SBA's commercial loan servicing centers, where the number of loan servicing employees has fallen by 19 percent and loan volumes have remained unchanged. The analysis we reviewed did not address how these employee reductions or any other operational effects may translate into cost savings.

Figure 6: Changes in Number of Employees and Workload per Employee at Servicing Centers



Source: SBA.

Officials from most of the seven district offices that we visited had mixed views about the effect of the loan sales on their own loan servicing portfolios. Some district office officials told us that the first two sales had significantly reduced their portfolios, and that subsequent sales continue to reduce the number of disaster loans they have to liquidate. When a disaster loan is more than 90 to 150 days delinquent, the servicing center can forward it to the appropriate district office for possible liquidation. District offices may also liquidate defaulted 7(a) and development company loans, or may assist lenders in doing so. However, loan sales have had a much smaller effect on the SBA's 7(a) portfolio at the district offices we visited. District office officials with whom we spoke said that they have had to continue assisting lenders with liquidation or liquidate loans themselves, in addition to reviewing loans for possible sale. The data we reviewed on the district offices' portfolio of loans in liquidation status for the most part supported what the district officials had told us. For example, the South Florida district office portfolio of disaster assistance loans shrank from 768 loans in September 1997 to 92 loans in August 2002. But all of the district offices we included in our review had experienced growth in the number of defaulted 7(a) loans that they were helping lenders to service or liquidate, or that they were monitoring.

The Effects of Loan Sales on Workforce Realignment Have Been Mixed

The role of loan asset sales in facilitating SBA's workforce realignment may be smaller than was initially expected. SBA had reported that loan asset sales would help the agency move employees out of loan servicing positions to more mission-critical positions, such as lender oversight and outreach to small businesses. But since most of the loans sold have been from the disaster home loan servicing centers, the overall reduction in loan volume has not translated into job reassignments for district office staff. Officials from two district offices wondered how they would benefit from the reduction in workloads at the disaster home loan servicing centers, since the center employees are funded by appropriations for disaster assistance, and most of the district offices are funded by appropriations for business loan programs. Most officials from the district offices and servicing centers told us that they have not been able to reassign servicing and liquidation staff to nonservicing activities such as lender oversight or outreach to small businesses. Moreover, training opportunities to prepare for reassignment have been limited, with only the South Florida district office telling us that they have participated in such training.

However, loan sales may facilitate SBA's long-term efforts to consolidate its loan servicing and liquidation functions into fewer service centers. SBA

recently reported in its draft 5-year workforce transformation plan that it would consolidate its loan servicing and liquidation functions into fewer service centers. This plan also stated that SBA intends to continue its loan asset sales program, to reduce the agency's overall loan portfolio and workload at some locations.

Loan Sales Have Affected the Ways in Which SBA Manages Its Loan Portfolio, but So Have Other Factors

According to SBA officials, the process of selling loans, particularly the intensive due diligence process and the field office review of loans selected for the sales, makes loan servicing more timely and consistent across the agency. For example, when defaulted loans are selected for sale, agency staff must determine whether anything collectible remains on the loan. If not, the loan is charged off. In these cases, SBA recognizes a loss on the loan and removes it from the receivable accounts. And if SBA is in the process of working out a compromise with a borrower on a loan that is selected for sale, the impending sale prompts agency staff and borrowers to complete the compromise before the sale date. The process of reviewing loans before they are sold undoubtedly provides some benefit to the agency in terms of bringing inconsistencies to light and forcing decisions on some loans. However, we also found that the loan sales alone were probably not responsible for all the benefits SBA reported.

In May 2002, SBA testified that of the loans selected for the first four sales, over 9,880 loans totaling about $382 million had been paid in full, 702 loans totaling $107 million had entered into compromise agreements, and 7,549 loans totaling about $632 million had been charged off. SBA provided data to us showing that since the loan sales began in 1999, the percentage of loans paid in full ranged from 10.35 to 11.30 percent, and that the percentage of loans written off had ranged from 4.97 to 5.98 percent. However, SBA data also showed that before the loan asset sales—from fiscal year 1997 through fiscal year 1998—the rate of loans paid in full and charged off had already been increasing. For example, the percentage of loans paid in full increased from 8.8 percent in fiscal year 1997 to 10.46 percent in fiscal year 1998. Thus, some of the positive effects of the loan sales reported by SBA could have been caused by other factors, including changes in the economy such as lower interest rates, which would prompt people to refinance their mortgages. Officials at SBA's Birmingham disaster home loan servicing center told us that borrowers who refinanced their mortgages often consolidated their loans and paid off their disaster loans, even though their disaster loans had low interest rates.

Other benefits of the sales cited in SBA's official statements or by SBA officials included the highlighting of inconsistencies in the ways that field staff applied SBA's servicing procedures, and the identifying of weaknesses in the agency's information systems. For example, SBA officials at headquarters told us that as a result of inconsistencies found in the loan files during preparations for the sales, SBA had held a meeting of all the servicing center managers to discuss the inconsistencies and to clarify policies and procedures for loan servicing. Though field office staff told us that they had not substantially changed the ways in which they serviced loans because of problems uncovered by the sales, some employees provided examples of how they had modified some of their work processes. For example, officials at one servicing center told us that they had begun to check the accuracy of certain items, such as maturity date, when a new loan file arrived.

Similarly, SBA officials told us that the due diligence process for the loan sales had revealed that the agency's information management system for its loan portfolio did not include data that investors value, such as updated information on types of collateral and lien positions. These variables were being included in plans to upgrade the agency's information systems. However, field office employees at one of the servicing centers told us that they had complained about the fact that these items were not included in SBA's information systems long before the loan sales began. Whether the loan sales will have an actual impact on improving SBA's information systems is still unclear. At the time of our review, SBA was still having its field offices and due diligence contractor compile information on the loans from the paper files and had not yet upgraded its information systems to capture information such as the current status of collateral and lien positions.

Conclusions

SBA had never sold loans in bulk loan sales before undertaking the current program. SBA's loan sales are being closely watched, because OMB plans to expand similar sales to other federal credit programs, such as those provided by the Departments of Agriculture and Education. The impact of SBA's sales on the agency and the scope of the benefits they provide to the government can help OMB in providing guidance on similar sales programs in the future. The sales have had some success in attracting investors, giving lenders a choice in disposing of defaulted loans, and reducing SBA's servicing workload for disaster assistance loans. But other effects are difficult to measure, because SBA lacks a comprehensive system to document and track all borrower inquiries and complaints after loans are

sold; faulty accounting and reporting methods obscure the actual financial and budgetary impact of the loan sales; and a thorough analysis of benefits and other effects on agency operations has not been done.

The lack of a comprehensive process for identifying borrower inquiries and complaints suggests that SBA may be unable to adequately enforce borrower protections. From the limited inquiries and complaints we were able to review, some borrowers had clearly experienced servicing problems after SBA sold loans to investors. While SBA did track and follow up on some inquiries and complaints, it did not have a comprehensive process to collect and document the complaints received at the field offices. As a result, the agency may not know how many complaints have actually been registered or whether some private lenders' actions are in conflict with SBA's public policy goals.

Since SBA incorrectly calculated the losses on its loan sales and lacks reliable financial data, we were unable to determine the financial impact of SBA's loan sales on its budget and financial statements. Further, because SBA did not analyze the effect of loan sales on its remaining portfolio, its reestimates of loan program costs for the budget and financial statements may contain significant errors. Until SBA corrects these errors and determines the cause of the precipitous decline in the subsidy allowance account, SBA's financial statements will likely be misstated, and the audit opinion on past financial statements may be incorrect. Further, the reliability of the current and future subsidy cost estimates will remain unknown. These errors and the lack of key analyses also mean that congressional decisionmakers are not receiving accurate financial data to make informed decisions about SBA's budget and the level of appropriations the agency should receive.

Finally, some of the operational benefits of the loan sales have not yet been realized, or may be overstated. Most of the reductions in loan servicing volume have occurred at SBA's disaster home loan servicing centers. SBA's commercial servicing centers and district offices that primarily serve small businesses are still involved in servicing loans, primarily because SBA has not been able to sell as many defaulted 7(a) loans, because lenders do not always consent to sell these loans and SBA employees continue to assist lenders or take over the servicing from lenders when a loan becomes delinquent. As a result, SBA has not been able to free up the resources it had hoped to reallocate to mission-critical areas, such as outreach to small businesses. Though SBA has conducted limited analysis on the impact of loan sales on its servicing centers and portfolio activity, a more thorough

evaluation is needed to determine the agencywide effects of the loan sales and the cost savings to the agency.

It would be imprudent to continue SBA loan asset sales in the absence of reliable and complete information on the accounting and budgetary effects of the sales. A successful loan sales program is not solely about maximizing proceeds and attracting investors: it is also a means of improving an agency's ability to achieve its mission and to best serve the American people. Moreover, as OMB continues to encourage loan asset sales, it is important that agencies embarking on new loan asset sales programs have the capability to properly carry out and account for these activities.

Recommendations

We make several recommendations to the Administrator of the Small Business Administration, in order to provide accurate and reliable information about how the sales affect SBA's borrowers, financial statements, budget, and operations.

To ensure that SBA has complete information to enforce borrower protections in its loan sale agreements and has reliable information to report to Congress on how borrowers are reacting to the sales, we recommend that the Administrator develop procedures for documenting and processing inquiries and complaints from borrowers, and provide guidance to the field offices about implementing them.

To address the errors and weaknesses in SBA's accounting and budget reporting, we recommend that the Administrator take the following actions before conducting additional loan asset sales:

- Correct the errors in SBA's loss calculations for loan sales one through five, and adjust the fiscal years 2000 and 2001 financial statements.
- Perform the necessary analyses to assess the effect of loan sales on the reestimates, to determine whether the cash flow assumptions in SBA's model reasonably predict future loan performance.
- Perform the necessary analyses to determine and correct the cause of the unexplained decline in the subsidy allowance account, and make the relevant adjustments to the fiscal years 2000 and 2001 financial statements, as appropriate.

We also recommend that the Inspector General, in conjunction with SBA's financial statement auditors, assess the impact of any identified errors in the financial statements and determine whether previously issued audit opinions for the fiscal years 2000 and 2001 financial statements need to be revised.

Finally, to provide Congress and SBA with a better understanding of the impact of loan sales on SBA's operations, we also recommend that the Administrator conduct a more comprehensive evaluation of the loan sales' impact on the agency and the cost savings from the sales.

Agency Comments

We requested comments from SBA, SBA's Inspector General, and Cotton and Company, SBA's independent financial statement auditor, on a draft of this report. The Chief Financial Officer for SBA, the Acting Inspector General, and Cotton and Company provided their comments in writing, which are presented in their entirety in appendixes III, IV, and V, respectively.

SBA generally agreed in its comments with the overall findings and recommendations in this report. In response to our recommendation on tracking borrower inquiries and complaints, SBA stated that the agency is preparing guidance for distribution to all field offices that will clarify how borrower inquiries and complaints are to be handled. This guidance will include information on SBA's toll-free number. In addition, SBA stated that it is establishing a designated electronic mail account for use by all SBA employees, to record borrower comments and forward them to headquarters; developing a database to track borrower inquiries and complaints and any other inquiries generated by the sale of loans; and improving the documentation and tracking of inquiries and complaints made through its toll-free number.

In its comments regarding our findings and recommendations on the accounting and budgetary anomalies, SBA stated that it is actively engaging a contractor to help resolve these issues and has worked extensively with its independent auditor to identify causes and options for resolving the issues we identified. Additionally, SBA stated that the accounting and budgetary guidance is general in nature and requires interpretation.

SBA did not respond specifically to our recommendation to conduct a more thorough analysis of the impact of loan sales on agency operations.

SBA requested that we delay issuance of the report until March 2003. By then, it hoped to have determined the causes of the accounting and budgetary problems, and to be able to propose an appropriate methodology for resolving them. Though we appreciate the desire to provide a plan of action for addressing these problems in our final report, it is not our policy to delay issuance of our reports until problems we have identified are resolved. SBA also stated that the report did not portray the complexity and unique problems faced in implementing the loan sales program. We agree that SBA faced a complex and difficult endeavor when it implemented the loan sales program. In the introduction to the report, we stated that SBA had never before conducted bulk loan sales. Furthermore, the first section of our report is intended to reflect the complexity of the loan sales process and includes a detailed discussion of what is involved in conducting a sale, including a time line that shows that the process can take almost a year to complete. This section and the background section also describe the variety and number of loans sold. SBA also noted that the report did not reflect the fact that SBA responds in writing to all written inquiries and complaints from borrowers; therefore, we added a statement in the report reflecting the fact that SBA had responded in writing to the written inquiries and complaints we reviewed at headquarters.

The Inspector General also agreed with our recommendations and is working with Cotton and Company and SBA management to determine the magnitude of the errors in SBA's fiscal years 2000 and 2001 financial statements. The Inspector General stated that Cotton and Company has informed the IG's office that the audit opinion on the fiscal years 2000 and 2001 financial statements should no longer be relied upon, as they may be materially incorrect because of the errors identified in this report. The comments also stated that Cotton and Company plans to withdraw its unqualified audit opinion on those financial statements, and to issue disclaimers of opinion.

Cotton and Company, SBA's independent financial statement auditor, agreed with our findings and did not specifically comment on our recommendations. However, Cotton and Company also stated that the report would be more fair and balanced if we further elaborated on the inherent risks and complexities associated with accounting estimates and loan sales. Cotton and Company also stated that it believes there is a lack of comprehensive implementation guidance on credit subsidy and loan sale cost estimates. Additionally, Cotton and Company stated that (1) our prior reviews of its work did not identify the problems discussed in this report,

and (2) we did not determine the specific causes of these errors. Further, Cotton and Company elaborated on some of the audit work it had done.

We agree with Cotton and Company's and SBA's statements that accounting for and auditing estimates of loan program costs and loan sales are complex, and we describe these complexities in the background section of this report.

Regarding the adequacy of existing guidance on preparing and auditing credit subsidy estimates and loan sales, we used guidance that currently exists in OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*; SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees* (effective fiscal year 1994); Technical Release 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act* (issued July 31, 1999; and Statement of Auditing Standard 57, *Auditing Accounting Estimates* (effective January 1989), in performing our assessment of SBA's accounting for loan sales and the credit subsidy estimates. These documents provide considerable guidance to agencies while still providing the flexibility necessary to be applicable to a wide variety of credit programs. For example, Appendix B to SFFAS No. 2 contains technical explanations and illustrations related to estimating loan program costs and loan sales—including guidance for calculating changes in a loan's book value, guidance for calculating the gain or loss, and the impact that loan sales have on various financial statement accounts, such as the allowance for subsidy. Further, Technical Release 3 provides guidance on auditing estimates of loan program costs, including assessing internal controls and inherent risks, as well as suggested audit steps and analytical review procedures.

While further elaboration may be helpful, the errors we identified in the financial statements and the related footnotes were primarily related to fundamental flaws in the application of existing guidance rather than to insufficient guidance. In addition, the anomalies in the disaster loan subsidy allowance account were known to Cotton and Company, and SBA provided no viable explanation for these anomalies.

Regarding prior GAO reviews of Cotton and Company's related audit work, these reviews were part of our governmentwide consolidated financial statement audit and were designed to focus on issues that could be significant to the consolidated financial statements of the federal government. Because the materiality of the consolidated financial statements far exceeds the level of what is material to SBA, these reviews

were far less detailed than what was conducted for this report. Further, loan sales were not significant to the governmentwide financial statements and, therefore, were excluded from the scope of the prior GAO reviews. However, it should be noted that prior GAO reviews of Cotton and Company audit work at SBA going as far back as 1997 raised concerns about its audit scope and methodology in the credit subsidy area, and offered suggestions for improvement on both a formal and an informal basis.

Although we did identify specific errors in the calculation of the loss on loan sales reported in the financial statements, we agree that we did not identify the cause of the negative balance in the disaster loan subsidy allowance account. We were unable to identify the cause because SBA lacked some of the fundamental information necessary to enable us to do so. This missing information, which should have been made available for the financial statement audit, included an aging of the delinquent and defaulted loans by year of loan commitment, detailed reconciliations of the allowance for subsidy, and an analysis of the impact that loan sales had on the estimated performance of the remaining loan portfolio. Because this type of information was not available at the time of our review or of Cotton and Company's audit, it was not possible either for us, Cotton and Company, or the SBA to determine the cause of the anomalies in the disaster loan subsidy allowance account. We understand that SBA is now working on preparing this information.

Regarding the elaboration of audit work that Cotton and Company provided, we saw this work when we reviewed the auditor's workpapers, and we provided a summary of this work in the body of the report.

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

Please contact us at (202) 512-8678 if you or your staff have any questions. Additional contacts and staff acknowledgments are listed in appendix VI.

Sincerely yours,

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

Linda M. Calbom, Director
Financial Management and
Assurance

Scope and Methodology

In preparing this report, we focused on the first five of SBA's six loan asset sales. The unpaid principal balance of the loans sold in these sales represents about 87 percent of all the loans SBA sold from August 1999 through August 2002. The sixth sale was not completed in time to be included in our analysis because purchasers do not begin servicing the loans and accounting adjustments are not complete until several weeks after the sale date.

To describe SBA's loan sale process, we reviewed a variety of documents related to planning and conducting a loan sale, including strategic plans, guidance, and procedures. We also collected data on the types of loans sold and the proceeds that SBA received from the sales, and we interviewed SBA officials and contractors. Our interviews with SBA officials took place at headquarters and at several SBA field offices that participate in the loan sales process, including two disaster home loan servicing centers, one commercial loan servicing center, and seven district offices. We selected a mix of large and small field offices around the country, based on the size of the loan portfolio and the number of loans sold. An additional consideration for three of the district offices we selected was their proximity to the finance center and the three servicing centers we visited. We also interviewed the financial adviser who advises SBA on its overall strategy for selling loans; the financial advisers hired to conduct the first, third, and fifth sales; and the due diligence contractor for the first four sales.

To confirm that SBA's loan sale process was working as described, we reviewed the loan information in the bidder information packages and interviewed investors. To confirm that SBA was providing relatively complete data to investors, we evaluated the loan data provided to potential investors in the bidder information packages. Specifically, we tested the data's completeness for several key fields, such as interest rate, outstanding balance, and maturity date. For investor feedback about the loan sale process, we interviewed six investors and reviewed 42 responses to surveys conducted by SBA's Transaction Financial Advisers of investors who had participated in sales four and five. We selected a mix of large and small investors with a variety of experiences with the sales, including investors who had won, lost, or just requested information but declined to bid. In our interviews we asked investors to evaluate aspects of SBA loan sales, including data they had received about loans for sale, communications they had had with SBA and its contractors, the loan sales process, and the organization of loan pools. We also asked whether the investors planned to participate in future sales. Although we attempted to

contact a cross section of investors, the comments we received cannot be generalized to a larger group.

To determine how SBA loan asset sales affect 7(a) lenders, we reviewed the lenders' role in the loan sale process and interviewed officials representing lenders that had participated in at least one sale. We selected a mix of 12 small and large lenders based on 7(a) lending volume, asset size, and location. In our interviews we asked lenders to evaluate their experience with SBA's loan sale process, describe how they made the decision to participate in the sales, and discuss their level of satisfaction with the proceeds. Although we attempted to contact a cross section of lenders, their comments cannot be generalized to a larger group. We did not interview any certified development companies that make 504 loans, because the only 504 loans that were sold did not require consent from the lender. To obtain additional feedback on SBA's loan sale process, we spoke with officials representing the National Association of Government Guaranteed Lenders and the National Association of Development Companies, which represent SBA 7(a) lenders and certified development companies that make 504 loans, respectively.

To determine how borrowers reacted when their loans were sold, we reviewed borrower inquiries and complaints documented by SBA and the process for documenting and processing these inquiries and complaints. To determine the types of inquiries and complaints borrowers have, we reviewed 133 of 155 borrower inquiry and complaint letters filed at headquarters since the first loan sale in August 1999. We collected information that included the date and type of inquiry or complaint (for example, questions about a loan sale or complaints about a servicing action by a purchaser) and the name of the purchaser (if available). We prepared a summary of SBA's written response. We also interviewed SBA officials at headquarters and field offices (three servicing centers, seven district offices, and two disaster area offices) about the types of inquiries and complaints they receive from borrowers and about SBA's process for handling these complaints. In addition, we asked staff at field offices whether they had forwarded borrower complaints to headquarters or documented the complaints. We reviewed a nonstatistical sample of complaints from the third, fourth, and fifth sales drawn for us by staff at one of the disaster home loan servicing centers to determine whether the information in borrower complaints received at field offices was accurately represented in headquarters records. Specifically, we compared the names on the complaints we received from the disaster home loan servicing center with the names on the complaints at headquarters. We also reviewed

the complaints logged through the toll-free number, but these data were limited because SBA staff did not begin logging the complaints from this number until April 2002.

To evaluate SBA's budgeting and accounting for loan sales, we assessed SBA's compliance with various budget and accounting guidance, including OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*; Statement of Federal Financial Accounting Standard Statement No. 2, *Accounting for Direct Loans and Loan Guarantees*; and U.S. Government Standard General Ledger, *Account Transactions*. Specifically, we analyzed SBA's cash flow models to reestimate subsidy costs for the disaster loan program and the 7(a) and 504 loan guarantee programs, in order to determine the effect of loan sales on the cost of each program for the budget. We evaluated characteristics of loans sold as compared with cash flow assumptions used to reestimate the costs of SBA's loan programs. To assess SBA's estimates of hold values for loans sold, we reviewed an external validation of the hold model used for sales one through three that was prepared by an SBA contractor, who concluded that the calculations were accurate and reasonable. Since SBA changed to a more sophisticated hold model after sale three,[33] we also reviewed the methodology and assumptions in SBA's revised model used to estimate hold values for loans sold in sales four and five, and we found the approach to be reasonable. However, we did not audit the data used to calculate the hold values for each sale, and therefore did not conclude on the reasonableness of the hold values for any of the sales. We reviewed SBA's accounting related to the balances of the loans sold, proceeds and costs of the sales, and calculations of gains or losses on sales to determine whether SBA considered all appropriate cash flows in these calculations. We discussed SBA's budgeting and accounting procedures for loan sales with SBA and OMB officials, Federal Accounting Standards Advisory Board staff, and SBA's independent auditors. We also reviewed SBA's audited financial statements for fiscal years 1999 through 2001 and examined workpapers from SBA's auditor for fiscal years 2000 and 2001.

Finally, to assess the ways in which SBA benefited from loan sales, we reviewed official statements, including testimony, press releases, and other

[33]SBA's revised hold model was first used to estimate hold values for sale four. Hold values from this more sophisticated model were calculated at the loan level rather than based on a loan pool approach or averages. The revised model's calculations were based on actual data from all loans selected for sale rather than on a sample of data from the loans selected for sale.

documents that cited benefits related to loan servicing reductions, staff realignment, and loan portfolio management efficiencies. To confirm these benefits, we reviewed and analyzed trend data on SBA's loan servicing workloads to determine how the loan sales had affected SBA's loan servicing workloads and staffing. We reviewed and analyzed data on loan activity, including prepayments and charge-offs, before and after the loan asset sales began. We also interviewed SBA officials at headquarters and field offices to obtain their views on how SBA has benefited from the sales. We did not independently verify the accuracy of the loan servicing and loan portfolio data provided by SBA, because we were interested only in the trends before and after the loan sales began.

We performed our review from January 2002 through October 2002 in Washington, D.C., and several other locations across the country, listed below, in accordance with generally accepted government auditing standards.

SBA Field Locations We Visited

District Offices

Birmingham, Alabama
Little Rock, Arkansas
Santa Ana, California
Los Angeles, California
Denver, Colorado
Miami, Florida (telephone interview)
Philadelphia, Pennsylvania

Loan Servicing Centers

Birmingham, Alabama (disaster home loan servicing)
Santa Ana, California (disaster home loan servicing and liquidation)
Little Rock, Arkansas (commercial loan servicing)

Denver Finance Center

Denver, Colorado

Disaster Area Offices

Niagara Falls, New York (telephone interview)
Fort Worth, Texas (telephone interview)

Types of Borrower Inquiries and Complaints Received by SBA

We reviewed 133 of the 155 inquiries or complaints SBA had documented from August 1999 through April 2002, to identify the types of concerns and problems borrowers faced when their loans were sold.[34] From our review, we determined that borrowers generally contact SBA about loans that have been sold for one of two reasons:

- they have a question or concern about why SBA is selling their loan, or they want to purchase their loan rather than have SBA sell it to the private sector; or
- they want to modify their loan and have a complaint about the purchaser's procedures or treatment.

Almost half (65) of the 133 letters from borrowers that we reviewed at headquarters involved questions about why loans were being sold, requests to buy a loan discounted lower than the unpaid principal balance, or pleas that the loan not be sold. Forty-seven letters referred to purchasers' servicing actions. Twenty-three of these letters involved disagreements or frustration with servicing decisions the new purchaser had made, such as refusing to subordinate or release collateral,[35] or imposing a fee to complete a servicing action such as subordination. Another 18 letters came from borrowers who wanted to defer payments or change the amount of their monthly payment because of financial problems, and felt they were not getting appropriate treatment from the purchaser of their loan. Six of the letters complained about problems that occurred while SBA was transferring the loan to the purchaser. For example, some borrowers found that purchasers had not properly applied their loan payments during the servicing-transfer period. Nineteen of the remaining 21 letters came from borrowers who wanted SBA to subordinate, release collateral, or compromise on a loan's payment or terms, and who were told that SBA had sold the loan and thus could no longer service it.

[34]We tried to review all of the inquiries and complaints documented at headquarters and stored in two binders. However, we did not include in our review additional follow-up letters from the same borrowers. Furthermore, the database that SBA created after our review included inquiries and complaints after April 2002, when we had reviewed the inquiries and complaints at headquarters. Therefore, our 133 complaints did not match exactly the 155 complaints in SBA's database.

[35]"Subordination" occurs when a lender allows a new or existing loan to take a superior lien to another loan. For example, a borrower with an SBA disaster home loan may want SBA or a lender to subordinate the disaster loan to a new or refinanced home mortgage.

Comments from the Small Business Administration

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

December 13, 2002

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

Ms. Linda M. Calbom
Director
Financial Management and Assurance
U.S. General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Dear Ms. D'Agostino and Ms. Calbom:

The purpose of this letter is to provide SBA's comments on the draft GAO report titled, "Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain" (Report). The Report identifies a range of complex accounting and budgeting issues associated with SBA's Loan Sales Program. While we generally concur with the GAO's findings and recommendations, especially the need to better assess the financial impact of SBA's Loan Sales Program, we wish to point out that current senior SBA management (including the new Chief Financial Officer (CFO) team that the current SBA Administrator has put in place) became aware of these issues and were working to solve them prior to learning of the findings of the GAO audit. We are making every effort to resolve these issues by the end of March 2003; therefore, we respectfully request that GAO not finalize the Report until SBA completes this process. Given that GAO itself could not identify the cause of the accounting and budget anomalies, but instead suggested that additional analysis is needed, we are concerned that readers may reach potentially premature and inaccurate conclusions regarding these issues. In addition, we believe the Report should clearly state that there is no indication that SBA intentionally misrepresented the loan sale results on its financial statements.

GAO recommendations regarding financial and budgetary issues

The Report identifies apparent inconsistencies between the results produced by the financial models used in connection with SBA's Disaster Loan Program and its Loan Sales Program. The former management of the Office of the CFO was aware of these seeming inconsistencies but was unable to resolve them. SBA's fiscal year 2000 and

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2001 financial statements included footnotes disclosing the book losses and discussing the Loan Sales Program. In the Spring of 2002, the current Administrator replaced the management team in the Office of the CFO. The new management team was given clear direction to review and modify operations, including to assess the financial and budgetary impact of the Loan Sales Program. The Administrator directed the new management team to ensure that the Office of the CFO consistently produce timely, thorough, and accurate financial information that can reliably be used to support the Agency's programs and decision-making.

Shortly after coming onboard, the new CFO team recognized the importance of the loan sales budgeting and accounting issues, including the potential impact of the sales on the subsidy rate for the Disaster Loan Program. Under the CFO team's direction, SBA has undertaken a rigorous review of all aspects of the issues, including those raised in the Report. Specifically, we are looking at the methodology and assumptions in the disaster loan subsidy model and hold model, the characteristics (including performance) of the loans sold versus those remaining in the portfolio, the value of the remaining portfolio, and the detailed accounting transactions that have been recorded for each cohort. This is a top priority of the Agency and we are devoting much of our internal staff's time to ensuring that the issues are satisfactorily resolved. In addition, we are engaging a contractor with the expertise necessary to advise us regarding these complex matters. We have also worked extensively with our independent auditor over the past few months to analyze the potential causes of the inconsistencies and to identify options for resolving the situation.

We are concerned that the Report fails to take into account or appreciate the complex and unique problems faced and solved in implementing the Loan Sales Program. These include the diverse nature of the SBA loan portfolio that did not lend itself well to traditional sale methods, the need to create a market for the portfolio, as well as a host of attendant legal problems. It should also be noted that the loan sales process begins between nine months to a year prior to the actual bid date for each sale.

The following provides some background and context that we believe is relevant but not included in the Report and also details SBA's past efforts to resolve the issues identified in the Report. SBA has been a government-wide leader in asset sales, as one of the few credit agencies to conduct them under the credit reform guidelines. The SBA Loan Sales Program presents unique challenges because of the diversity of types of loans that are sold and the large number of loans that have been sold in each of the sales. As GAO noted in its exit meeting with SBA, this is not an area where extensive official implementation guidance has been developed. The guidance that exists from the Office of Management and Budget (OMB), the Federal Accounting Standards Board (FASB), and others is general in nature and requires interpretation for specific application and implementation.

SBA repeatedly sought the assistance of reputable outside experts to interpret and apply the available guidance. SBA's loan sales process, including the budgeting and accounting components, was developed with the support and guidance of well qualified and recognized outside contractors. The contractors who worked on various aspects of the process included KPMG Consulting, Ernst & Young, Cushman & Wakefield, Merrill Lynch, and others. In addition, OMB and GAO have been involved in various aspects of the Loan Sales Program. Throughout the history of the Program, it appears that SBA has followed all the guidance that was available.

Indeed, such guidance and the available expertise have not been able to resolve the unique problems presented by the Loan Sales Program. For example, SBA retained PricewaterhouseCoopers, an independent accounting firm, to look at the accounting and budgeting issues relating to the Loan Sales Program. Officials from OMB were also engaged to assess these issues. The results of the reviews were inconclusive – the hold model, subsidy model, and accounting procedures were found to be sound individually, but the inconsistencies between them remained.

As stated above, the Agency's current management is working diligently to resolve these inconsistencies and the other issues noted in the Report that were left unresolved in the past.

GAO recommendation regarding programmatic issues

The Report recommends that SBA develop a comprehensive process for documenting and tracking borrower inquiries and complaints in order to guide SBA field personnel, to enforce borrower protections in the loan sale agreement, and to report accurately to Congress. SBA has already taken a number of steps to improve this process and the Report should reflect the fact that SBA has responded in writing to every written complaint or inquiry submitted by a borrower, lender or member of Congress.

Often these complaints and inquiries arise when a borrower requests an accommodation from the purchaser that is outside the terms of the underlying loan documentation. When a loan is sold, the borrower and guarantors retain all the rights and obligations that they had when SBA and the participating lender owned and serviced the loan. The purchaser does not have any power to change the terms of the loan without the borrower's consent. SBA cannot enforce these rights and protections on behalf of the debtor, any more than SBA can collect the loan on behalf of the purchaser. What SBA can do (and does) is ensure that the purchasers can adhere to the servicing standards in each loan sale agreement. In order to accomplish this, SBA accepts bids only from entities that have demonstrated experience in the servicing of the types of loans SBA sells and that follow standard commercial loan servicing practices. In addition, when our assistance is requested, SBA attempts to work with the parties to reach a resolution.

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Furthermore, the Agency currently is preparing a Procedural Notice for distribution to all Field Offices, Servicing Centers and Disaster Area Loan Offices that will clarify how borrower inquiries and/or complaints are to be handled so that a uniform process is utilized. This Notice will also describe the (800) customer information line in the Santa Ana Commercial Loan Servicing Center. It will explain the purpose of the line, information available and types of borrowers that should be transferred to that number.

In addition to the Procedural Notice, SBA is:

- Establishing a designated electronic mail account for use by all SBA employees to record borrower comments and forward them to the Asset Sales Team in Headquarters for documentation, tracking and possible response.

- Developing a relational database maintained by the Asset Sales Team at Headquarters to track borrower complaints, borrower inquiries, Congressional inquiries, Freedom of Information Act requests or any other inquiries generated due to the sale of loans.

- Implementing additional enhancements to the Santa Ana Disaster Home Loan Customer Inquiry tracking system for recording borrower complaints and inquiries.

Conclusion

As you are aware from your own experience in reviewing the Loan Sales Program, the causes of the budgetary and accounting issues raised in the Report have proven to be difficult not only to identify but also to resolve. As we noted above, we are hopeful of resolving these issues in the next few months. Accordingly, we reiterate our request that you withhold publication of a final version of the Report until we have concluded our review and have provided you with our methodology for resolving these issues.

We appreciate the opportunity to comment on the Report. We look forward to providing you more information on the resolution of the issues raised in the Report as soon as possible.

Sincerely,

Thomas A. Dumaresq
Chief Financial Officer

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Comments from the Inspector General of the Small Business Administration

U.S. Small Business Administration
Washington, D.C. 20416

OFFICE OF INSPECTOR GENERAL

December 13, 2002

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

Ms. Linda M. Calbom,
Director
Financial Management and Assurance
U.S. General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Dear Ms. D'Agostino and Ms. Calbom:

We have reviewed the General Accounting Office's (GAO) draft report GAO-03-87, "*Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain.*" GAO's report identified significant errors in the Small Business Administration's (SBA's) accounting and budgeting for loan sales which may have affected the fair presentation of its Fiscal Year (FY) 2000 and 2001 financial statements. Accordingly, GAO recommended that the Inspector General, in conjunction with SBA's financial statement auditors, assess the impact of any identified errors in the financial statements and determine whether previously issued audit opinions for FY 2000 and 2001 need to be revised. Further, GAO made several recommendations to SBA's Administrator to provide accurate and reliable information about how the sales affect SBA's financial statements, budget, and operations.

We agree with both the recommendation addressed to our office as well as those recommendations addressed to the Administrator. With respect to the recommendation addressed to our office, we are continuing to work with Cotton and Company LLP (Cotton) and SBA management to determine the magnitude of the errors in SBA's FY 2000 and 2001 financial statements and resulting impacts of those errors. Additionally, Cotton has informed our office that the opinions on the FY 2000 and 2001 financial statements should no longer be relied upon as these statements may be materially incorrect due to the errors noted in your report. Accordingly, Cotton plans to withdraw their unqualified opinions on those financial statements and issue disclaimers of opinion.

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Our office is working with Cotton and SBA to ensure affected parties are notified and appropriate actions are taken.

We recognize that the recommendations addressed to the Administrator are necessary to ensure that the issues noted in your report do not continue to have a detrimental effect on SBA's loan sale program. As acknowledged in the subject report, many of the errors GAO identified need further analysis to determine the impact on the accuracy of the financial statements. SBA and Cotton have been attempting to evaluate the magnitude of these errors, but have yet to determine the extent of any material misstatements in the FY 2000 and 2001 financial statements. We will work with the Administrator to ensure these errors are quantified and the underlying problems are adequately addressed.

Should you or your staff have any questions, please contact Robert G. Seabrooks, Assistant Inspector General for Auditing, at (202) 205-7203.

Sincerely,

David R. Gray

for Peter L. McClintock
Acting Inspector General

cc: Hector Barreto, Administrator
Lloyd Blanchard, Chief Operating Officer
Thomas Dumaresq, Chief Financial Officer
Ronald Bew, Associate Deputy Administrator for Capital Access
Herbert Mitchell, Associate Administrator for Disaster Assistance
Charles Hayward, Partner, Cotton and Company LLP

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Comments from Cotton and Company

COTTON & COMPANY LLP

auditors • advisors

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December 13, 2002

Ms. Linda Calbom
Director
Financial Management and Assurance
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Subject: GAO-03-87, Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain

Dear Ms. Calbom:

We have reviewed the draft report cited above. We wish to comment on the text under the caption SBA's Accounting for Loan Sales and the Remaining Portfolio Was Flawed and on related material elsewhere in the draft report. Among other things, these portions of GAO's report state that SBA made errors in budgeting and accounting for loan sales that could have significantly affected reported results in its budget and financial statements. GAO's report also conveys that Cotton & Company as SBA's auditor gave unqualified audit opinions on SBA's Fiscal Years (FY) 2000 and 2001 financial statements, and that we are reevaluating those opinions.

We agree with these statements. GAO's report will, however, provide a more fair and balanced presentation of the facts and have a more positive effect if it also explains the:

- Need for and inherent risk associated with accounting estimates.
- Inherent complexities in making credit reform estimates, particularly loan sale cost estimates.
- Lack of comprehensive implementation guidance provided to agencies in these complex areas.

The need to strengthen authoritative implementation guidance is equal in importance to issues noted in the draft GAO report. Further, the importance of these points is illustrated by the fact that many organizations and experts, including GAO, previously reviewed SBA's estimation procedures year after year and did not identify an important weakness in SBA's disaster loan model. That weakness made the output of that model unreliable when substantial loan sales were undertaken and contributed substantially to issues raised in the draft report. These matters are addressed in more detail in the balance of this letter.

GAO's report should also make clear that no evidence exists that the financial statements were intentionally misstated.

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Accounting Estimates, While Necessary, Are Inherently Uncertain

The auditing profession, through its guidance, has long recognized that accounting estimates are both necessary and carry a higher degree of risk than accounting information that consists solely of factual data. Credit reform requires program managers to estimate the cost of loans based on assumptions about loan performance. In this instance, SBA is required to make assumptions about both the terms of loans that will be made to individuals and businesses that have suffered losses from natural disasters and about performance of these loans over time.

Such estimates could be made in many ways. OMB circulars and FASAB accounting standards provide broad standards and principles stated in conceptual terms. Auditors must, however, judge the reasonableness of credit-reform estimates underlying financial statements in a context where little or no practical guidance exists to help agencies make them.

In the absence of published guidance, SBA, in consultation with others, made a determination about specific requirements for a cash flow model and developed one based largely on historical data. SBA's model, once developed, subsequently was critically evaluated at various times as follows:

- SBA contracted with a number of reputable outside experts to provide independent validations of the models. Those experts provided reports of their results (which we evaluated without exception) that did not mention the issues GAO now notes.
- OMB staff annually reviewed and approved the models prior to each year's budget submission.
- GAO reviewed our work papers and the models and gave us advice on testing the models (which we adopted).
- Cotton & Company, as part of the financial statement audit, reviewed the models according to auditing standards for accounting estimates.

How the Accounting Estimates Were Audited

Recognizing the necessity and inherent uncertainty in accounting estimates, we performed substantial evaluations of SBA's estimating methods and tested their results. In the audit for FY 2000, we found that book value losses on disaster loan sales were not included in the disaster loan subsidy reestimates. To account for this cost, we recommended that the financial statements include an imputed subsidy reestimate of $468 million, which was the estimated amount needed to cover these losses as SBA had computed them. SBA accepted this recommendation and recorded an adjustment within its financial statements.

In FY 2001 audit, we found that cash flow estimates included, for the first time, effects of loan sales, but that these reestimates were substantially smaller than expected based on previous work. To resolve this apparent inconsistency and determine if it had caused the debit balance in the allowance for subsidy cost, we requested that SBA perform additional analysis of its subsidy estimates. That additional analysis generally confirmed that the subsidy estimates were consistent with balances in the financing account.

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We believe that our audit work met professional auditing standards. Indeed, GAO itself reviewed our work in these areas and, prior to the subject report, did not bring this matter to our attention. Moreover, GAO's draft report states that Cotton & Company, during its audit of SBA's FY 2001 financial statements:

> ...performed a number of audit procedures related to the disaster loan program subsidy allowance account. For example, the auditor evaluated the methodology and formulas used to calculate reestimates, assessed data used to calculate key cash flow assumptions, and reviewed various internal controls over the subsidy estimation process.

The procedures GAO cites constitute the principal auditing procedures required for auditing accounting estimates.

Post-Audit Discovery of Limitations in the Accounting Estimates

We realize now that the methods used to estimate the disaster loan cash flows have an important limitation. A key premise of the cash flow model is that one illustrative loan can serve as an effective proxy for all loans made to individuals, and another illustrative loan can do the same for businesses. At the time that the single proxy premise was adopted, loan sales were not anticipated. The effect of loan sales on this premise was not considered until recently, even though OMB, GAO, outside consultants, and Cotton & Company reviewed and thoroughly evaluated the cash flow model.

General agreement now exists that the premise became inadequate when substantial loan sales began. It did so because a single proxy loan cannot produce realistic cash flows when the:

- Portfolio is diverse.
- Cost of any loan increases with the loan term (terms vary from 1 to 30 years).
- Average term of loans sold is several years longer than that of the original portfolio.

Moreover, a single proxy cannot simultaneously represent loans sold and loans kept. This led to imprecise estimates in both categories and contributed substantially to the issues noted in the GAO report. Until SBA revises its model, the effect of imprecise estimates on the financial statements cannot be measured. As a result, we cannot determine if they have a material effect on the financial statements.

Because of the subsequent discovery that SBA's estimates in the FYs 2000 and 2001 financial statements may not be materially correct, we have concluded that our unqualified opinions on those financial statements should no longer be relied upon. We are taking steps in conformance with auditing standards and with SBA's assistance to withdraw those opinions and issue disclaimers of opinion on those financial statements.

Recommendations

The fact that extensive reviews took place without disclosing this problem suggests that there is insufficient information about how the concepts related to loan sales should be applied in practice. The main sources of guidance are OMB Circular A-11 and the FASAB accounting standards (SFFAS Nos. 2 and 18 and Federal Financial Accounting and Auditing Technical Release No. 3). These documents focus on broad budgetary and accounting concepts and do not discuss implementation issues in a systematic way. Technical Release 3, which provides substantial and practical guidance in many areas, does not include guidance regarding standards for cash flow estimates involving loan sales or the treatment of loan sales generally.

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Among other things, additional guidance is needed regarding:

- How the book value of loans should be determined when cash flow estimates are not made on a loan-by-loan basis (which is the most common case).
- Minimum requirements of cash flow estimates to meet loan sale requirements.
- The relationship between the calculation of a hold value for loan sales and routine subsidy calculations for other purposes.

These are important topics, and they are central to the measurement of the cost of federal credit programs in general and the cost of loan sales in particular. We encourage further discussion of this subject and will welcome the opportunity to make specific suggestions.

Looking forward, three things need to be done:

- In the short term, agencies should be advised to determine if cash flow models they used for initial subsidy estimates are adequate for estimating the cost of loan sales. Such an advisory may help other agencies avoid the problems identified in your report.
- OMB and FASAB need to provide guidance on how the concepts laid out in OMB circulars and FASAB accounting standards should be applied in practice.
- SBA needs to improve the cash flow model for disaster loans.

We commend GAO's effort in evaluating these complex and cutting-edge issues. Actions taken as a result of this evaluation and report will be valuable to other agencies and should improve the overall usefulness of federal financial statements. Thank you for the opportunity to review the report and provide our views.

Very truly yours,

COTTON & COMPANY LLP

By: Chas Hayward

Charles Hayward, CPA, CFE, CGFM, CISA

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GAO Contacts and Acknowledgments

Contacts

For questions regarding this report, please contact Davi D'Agostino at (202) 512-8678 or Linda Calbom at (202) 512-9508.

Acknowledgments

Additional staff making major contributions to this report were Dan Blair, Marcia Carlsen, Jay Cherlow, Heather Dunahoo, David Eisenstadt, Edda Emmanuelli-Perez, Katie Harris, DuEwa Kamara, Kay Kuhlman, and Paul Thompson.

Glossary

The following is a group of terms commonly used in credit budgeting and accounting. The definitions for many of these terms are equally applicable to direct loans and loan guarantees.

Cash flows

Payments or estimates of payments to or from the government over the life of a loan or group of loans. For direct loans, these may include loan disbursements, repayments of principal, payments of interest, prepayments, fees, penalties, defaults, and recoveries on defaulted loans.

Cash flow assumptions

All known and forecasted information about the characteristics and performance of a loan or group of loans used to estimate future loan performance. Examples include estimates of loan maturity, borrower interest rates, default and delinquency rates, and the timing of cash flow events, such as defaults and collections on defaulted loans.

Credit reform

Refers to the collective requirements as set forth in (1) the Federal Credit Reform Act of 1990, which generally requires that agencies calculate and record the net present value cost of credit programs to the government included in the budget, (2) the Statement of Federal Financial Accounting Standard No. 2, *Accounting for Direct Loans and Loan Guarantees*, and (3) OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*.

Gross proceeds

Total amount received from investors as a result of the loan sales.

Hold value

The estimated value of loans to the government if held to maturity or resolution, stated on a net present value basis and discounted with interest rates from the most recent President's budget at the time the estimate is prepared. The hold value is a more detailed loan value analysis than the credit subsidy estimate, because it specifically considers the cash flows and characteristics of the loans for sale and is calculated on a loan-by-loan basis.

Market value estimate	An estimate of the anticipated proceeds from investors on loans for sale based on current market trends and conditions, and the characteristics of the loans being sold. A contractor who assists SBA with the loan sales prepares the estimate.
Net book value	An amount calculated by subtracting the subsidy allowance from the outstanding loans receivable balance for a loan or group of loans.
Net proceeds	Gross proceeds received from a loan sale less seller transaction costs associated with conducting the sale (such as fees for underwriting, rating agency work, legal advice, financial advice, and due diligence) that are paid out of the gross sales proceeds rather than paid as direct obligations by the agency.
Present value	The worth of the future stream of returns or costs in terms of money paid immediately. In calculating present value, prevailing interest rates provide the basis for converting future amounts into their "money now" equivalents.
Reestimates	Revisions of the subsidy cost estimate based on information about the actual performance of loans or other estimated changes in future cash flows resulting from changes in economic conditions, other events, and improvements in the methods used to estimate future cash flows.
Subsidy allowance	Financial statement reporting account used to recognize the costs of a loan program that are not expected to be recovered from borrowers, including default costs and financing costs arising from subsidizing below-market rate loans.
Subsidy cost	The estimated long-term cost to the government of direct loans or loan guarantees, calculated on a net present value basis, excluding administrative costs. The subsidy cost is the present value of disbursements by the government (loan disbursements and other payments) minus estimated payments to the government (repayments of

	principal, payments of interest, other recoveries, and other payments) over the life of the loan.
Unpaid principal balance	Amount of outstanding loan principal owed by borrowers (also known as the loans receivable balance).
Unqualified opinion	An auditor's opinion that states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity, in conformity with generally accepted accounting principles.

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