AUDIT REPORT

Improvement is Needed in SBA's Oversight of Lender Service Providers

March 12, 2015 REPORT NUMBER 15-06

EXECUTIVE SUMMARY

Report 15-06

March 12, 2015

Improvement is Needed in SBA's Oversight of Lender Service Providers

What OIG Reviewed

This report presents the results of our audit of the Small Business Administration's (SBA) oversight of lender service providers (LSPs) as loan agents. Oftentimes, due to insufficient resources or inexperience with the complexities of SBA lending requirements, many lending institutions contract with LSPs to provide services in connection with originating, closing, servicing, or liquidating SBA business loans. LSPs allow lenders that historically had not devoted resources to SBA lending to expand access to capital and participate in SBA loan programs.

Our objectives were to determine the extent to which SBA has (1) developed controls to effectively track, evaluate, and enforce loan agent participation and performance; and (2) identified financial and other impacts resulting from the involvement of loan agents in SBA loan programs. We determined that SBA had approved over 900 LSP agreements with more than 90 LSPs since October 1, 2011. We selected and reviewed 33 SBA-approved LSP agreements to determine the nature of the services being performed by LSPs on behalf of the lender under each agreement.

We also met with SBA officials to gain an understanding of the current LSP oversight environment and their perspectives on the risks that LSPs pose to the program. Additionally, SBA's Office of Performance and Systems Management (OPSM) provided an estimate of the SBA portfolio associated with LSPs. To test the accuracy of this data, we interviewed and obtained the portfolios for the three largest LSPs.

What OIG Found

LSPs are deeply involved in all phases of the loan life cycle, including originating, closing, servicing, and liquidating SBA business loans. Because the number of LSPs and their agreements with lenders have significantly increased in recent years, SBA will need to improve its internal controls to ensure LSPs' performance and conduct complies with SBA's requirements.

We found that SBA had not established a method to track LSP portfolio activities, and therefore could not adequately assess potential risks associated with LSP involvement in SBA loan programs. In addition, SBA did not adequately investigate a number of potential violations of SBA policy by lenders and LSPs, such as a lack of approved agreements.

Officials from SBA's Office of Credit Risk Management (OCRM), who are responsible for oversight and risk management of SBA credit programs, were developing plans to increase loan agent monitoring, including LSPs. The plans include provisions in a proposed OCRM support contract to conduct loan agent analysis—including a loan agent risk assessment plan in 2015—and adding significant loan agent activity as a risk area to its on-site review assessment system. While we commend OCRM's intent to increase oversight of loan agents and LSPs, SBA's lack of information at the loan level regarding LSPs is likely to hinder oversight efforts.

OIG Recommendations

We recommended that SBA develop a method to identify LSP participation within SBA loan programs and their associated SBA loan portfolios to evaluate performance. We also recommended that OCRM establish a formal process and procedures to address referrals related to LSPs.

Agency Comments

SBA agreed with our findings and recommendations.

Actions Taken

SBA plans to develop a method to identify LSP participation at the loan level. Additionally, OCRM is creating a process to track, manage, and prioritize lender referrals, including those relating to lender use of LSPs.

U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

Final Report Transmittal
Report Number: 15-06

DATE: March 12, 2015

TO: Ann Marie Mehlum
Associate Administrator, Office of Capital Access (OCA)

SUBJECT: *Improvement is Needed in SBA's Oversight of Lender Service Providers*

This report presents the results of our audit of the Small Business Administration's (SBA) oversight of lender service providers. The objectives of our audit were to determine the extent to which SBA has (1) developed controls to effectively track, evaluate, and enforce loan agent participation and performance, and (2) identified financial and other impacts resulting from the involvement of loan agents in SBA loan programs. This report is the first of two, and focuses on SBA's oversight of lender service providers (LSP) as loan agents and relates solely to our first objective. Our second report will address both objectives as they relate to SBA's oversight of other types of loan agents.

The report contains two recommendations that SBA agreed to implement. Please provide us within 90 days your progress in implementing the recommendations.

We appreciate the courtesies and cooperation extended to us during this audit.

/s/
Troy M. Meyer
Assistant Inspector General for Auditing

Table of Contents

Introduction

The Small Business Administration (SBA) is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of Government-guaranteed loans. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures. Lending institutions and loan applicants sometimes use agents to conduct business with SBA. These agents can include attorneys, accountants, consultants, packagers, or lender service providers.

Our office has observed and investigated fraud by loan agents for many years, which involved hundreds of millions of dollars. In 1995, the House Committee on Small Business held a hearing on fraud by loan agents, where it concluded that the underlying problem with loan agent fraud was that SBA had no system in place to track or identify loan agent activities. In 2007, loan agent fraud was discussed at a hearing entitled "SBA Lender Oversight: Preventing Loan Fraud and Improving Regulation of Lenders" before the Senate Committee on Small Business and Entrepreneurship. Since 2000, our office has identified effective tracking of loan agent activity as a top Management Challenge for SBA. While SBA has made some incremental improvements over time in this area, it does not maintain a searchable system of loan agents to perform its portfolio risk management responsibilities or for our office to perform its oversight and criminal investigative responsibilities.

LSP Involvement in SBA Lending

Oftentimes, due to insufficient resources or inexperience with the complexities of SBA lending requirements, many lending institutions contract with a specific type of loan agent, a lender service provider (LSP), to assist with their SBA loan functions. Federal regulations define an LSP as an agent that carries out lender functions related to SBA business loans or loan portfolios for compensation from the lender.[1] These lender functions include:

- **Originating** is the process by which a borrower applies for a loan, and a lender processes that application up to the disbursement of loan funds.
- **Closing** includes signing required documents, ensuring that all conditions in the loan authorization are met, and the disbursement of loan funds is in accordance with the loan authorization.
- **Servicing** covers everything after disbursement of the funds until the loan is fully paid off. This includes collecting monthly payments, maintaining records of payments and balances, loan modifications, and following up on delinquencies.
- **Liquidating** includes all actions on the loan upon its default and determining that recoveries against the collateral are necessary. This includes performing site visits, securing and selling collateral, and pursuing guarantors on the loan.

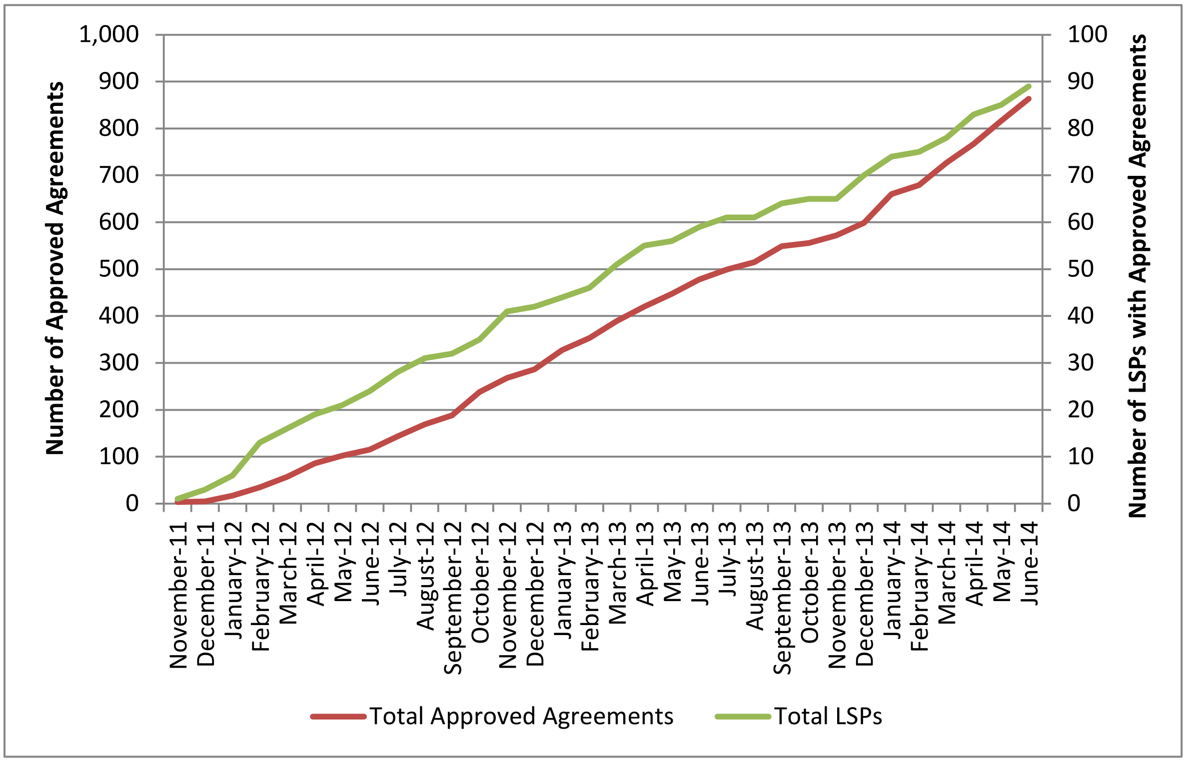
SBA procedures limit the LSP's role to that of assisting lenders, while lenders maintain the ultimate responsibility for ensuring loan quality and compliance with SBA guidelines. These LSPs allow lenders that historically had not devoted resources to SBA lending to expand access to capital and participate in SBA loan programs.

[1] Code of Federal Regulations, Title 13. *Business Credit and Assistance, Part 103*.

Industry Growth

Although LSPs have been in existence since at least 1982, both SBA officials and industry practitioners have noted significant growth in the industry. Since October 2011—when SBA centralized the review and approval of LSP agreements at its Loan Guaranty Processing Center (LGPC)—SBA has approved over 900 agreements.[2] Between September 30, 2012, and June 30, 2014, the number of SBA-approved LSP agreements has increased by nearly 360 percent. In addition, because an LSP may have agreements with multiple lenders, the number of LSPs with approved agreements participating in SBA lending programs during the same time period increased 178 percent (See Figure 1).

Figure 1: Growth of participation of unique LSPs in SBA loan programs (based on approved agreements)



Source: LSP tracking spreadsheet maintained by the LGPC

Similarly, as of June 30, 2014, over 770 lenders—or approximately 28 percent of the active 7(a) lenders—had an approved agreement with at least one LSP.[3] We determined that the individual SBA loan portfolios associated with the three largest LSPs from October 1, 2011 to June 30, 2014, exceeded many of the top 100 active SBA 7(a) Program lenders over that same time period.[4]

[2] Prior to October 2011, when SBA established SOP 50 10 5, *Lender and Development Company Loan Programs* (Version D), SBA procedures required the LSP to enter into an agreement with the participating lender, which was submitted to either SBA's Office of Financial Assistance or SBA district offices for approval. A lack of centralized tracking prior to October 2011 makes it difficult to determine how many agreements were approved.

[3] These agreements were approved between October 1, 2011, and June 30, 2014.

[4] Based on the number of their approved agreements as of July, 22, 2014.

Prior Work

An OIG report on loan agents in the Section 7(a) Program noted that loan functions traditionally performed by lenders were being performed by loan agents at a growing rate.[5] While the increase in the use of loan agents has helped small businesses gain access to capital, the report also noted the concern that as more loan agents become lender service providers, poor lender oversight may create an environment susceptible to fraud. This report included multiple recommendations for improving SBA oversight of loan agents, including establishing (1) a loan agent registration process and monitoring system, and (2) benchmarks that, if exceeded, would trigger closer SBA examination of a loan agent's performance. In their response, SBA officials at the time shared the concerns identified in the report and stated that they were in basic agreement with its recommendations. These recommendations were not implemented—due in part to a legal opinion from the Office of General Counsel stating that SBA did not have statutory authority to implement a registration system. However, SBA does require that lenders and LSPs disclose their relationships and submit agreements for SBA review and approval.

A 2013 OIG report found that SBA lacked a process for monitoring and addressing risk in its loan portfolio. To help SBA balance the need to make capital available to small businesses while mitigating risk for borrowers and taxpayers, OIG recommended that SBA: (1) implement a portfolio risk-management program that analyzes risk across portfolio segments, (2) use data from the portfolio risk-management program to support risk-based decisions in its loan programs, and (3) develop a process within the portfolio risk management program to ensure additional controls are implemented to mitigate identified risks, where necessary.[6] The Agency implemented a portfolio risk management program and stated that it "will continue […] to identify additional program risk, specifically as related [to] loan agents and lender service providers." OCRM has implemented a portfolio risk management program; however two recommendations—to use data to support risk-based decisions and to develop a process to implement controls to mitigate risks—remain open, but are scheduled to be implemented.

Objectives

Our objectives were to determine the extent to which SBA has (1) developed controls to effectively track, evaluate, and enforce loan agent participation and performance, and (2) identified financial and other impacts resulting from the involvement of loan agents in SBA loan programs. This report is the first of two, and focuses on SBA's oversight of lender service providers (LSP) as loan agents and relates solely to our first objective. Our second report will address both objectives as they relate to SBA's oversight of other types of loan agents.[7]

---

[5] OIG Inspection Report 98-03-01, *Loan Agents and the Section 7(a) Program* (March 31, 1998). This report later served as the basis for the SBA Management Challenge on loan agents.
[6] OIG Report 13-17, *The SBA's Portfolio-Risk Management Program can be Strengthened* (July 2, 2013).
[7] Other loan agents include, but are not limited to, packagers and referral agents.

Finding 1: SBA Had Limited Controls To Track Lender Service Provider Loan Portfolios

OMB Circular A-129 establishes policies and procedures for justifying, designing, and managing Federal credit programs and for collecting non-tax receivables.[8] It also sets the principles for designing and improving the efficiency and effectiveness of Federal credit programs. The Circular states that agencies must have monitoring, diagnostic, and reporting mechanisms in place to provide senior-level policy officials and credit program managers a clear understanding of a program's performance. Such mechanisms should include the regular collection, analysis, and reporting of key information and trends and also be sufficiently flexible to deliver any analysis necessary to identify and respond appropriately to developing issues in the portfolio.

According to the Office of Credit Risk Management (OCRM), which is responsible for oversight and risk management of SBA credit programs, the increased reliance on third parties to assist with traditional lender functions in SBA loan programs is an area of growing concern. OCRM has estimated that approximately 20 to 25 percent of 7(a) Program loans may involve LSPs. Further, these officials believed that LSPs and their portfolios should be tracked in order to support SBA oversight functions. Accordingly, as part of its portfolio risk management program, OCRM said it will focus on identifying program risks, especially the risks related to loan agents and LSPs.

LSPs charge lenders for their services in the loan application process. If a loan is approved, LSPs have the potential to be involved in additional areas, such as secondary market sales, servicing, and closing or liquidation. It is therefore in an LSPs' best interest for loan applications to be approved—which can pose a risk should LSPs deviate from SBA guidance in order for loans to be approved. While lenders have the ultimate responsibility for the loans, some lenders may not maintain sufficient expertise or resources to provide oversight of LSP activities. In recent audit work, multiple loan specialists at the LGPC have expressed concerns regarding one LSP that applied pressure on the LGPC to approve loans and had loose interpretations of SBA guidance.[9] Further, recent audit work has identified areas where LSPs applied significant influence on lender underwriting and credit decisions for loans that did not comply with SBA requirements for creditworthiness. The borrowers ultimately defaulted on these loans within 12 months.

While we commend OCRM's intent to increase oversight of loan agents and LSPs, SBA's lack of information at the loan level regarding LSPs is likely to hinder oversight efforts. We found that SBA did not have a reliable way to determine which SBA loans—or how many—involve LSPs. Until it does, SBA cannot accurately track loan portfolios to identify and mitigate risks that accompany LSP involvement.

Agency Portfolio Estimates

Personnel at SBA's Office of Performance and Systems Management (OPSM) attempted to gather reliable information to identify active LSP portfolios based on the existing data elements collected by SBA. OPSM estimated that 5,615 SBA loans—with gross approval of over $3 billion for 7(a) loan applications received between October 2011 and June 2014—involved an LSP. However, because SBA does not have sufficient loan-level data, we found that OPSM's estimate was inaccurate. By comparing OPSM's estimate of LSP-involved loans with the actual LSP portfolios of four LSPs—

[8] OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables* (January 2013).
[9] OIG Report 14-13, *Significant Opportunities Exist to Improve the Management of the 7(a) Loan Guaranty Approval Process* (June 6, 2014).

including the three largest LSPs[10]—we found that OPSM overstated certain LSP portfolios because it assumed that all loans made by lenders that had active agreements included services provided by an LSP. For example, OPSM estimated one LSP's portfolio to be 1,722 loans for 7(a) loan applications received between October 1, 2011 and June 30, 2014, when only 171 of the 1,722 loans were actually serviced by that LSP. For the 1,551 loans that were erroneously identified by SBA, the total loan amount was overstated by approximately $681 million.

OPSM's estimate also did not identify all loans with LSP involvement. For example, one LSP provided their actual portfolio from October 1, 2011, to June 30, 2014, which included 432 loans—60 percent of which were not identified by OPSM. Another LSP provided their portfolio from October 1, 2011, to June 30, 2014, which included 301 loans—57 percent of which were not identified by OPSM. (See Table 1)

Table 1. Example comparisons of LSP-provided portfolio to the SBA-identified portfolio

LSP	LSP Provided Loans	Loans Identified By SBA	Loans Not Identified By SBA	$ Not Identified By SBA
LSP 1	432	171	261	$149,989,812
LSP 2	301	130	171	$93,441,072

Lender Service Provider Tracking

Because SBA historically has not gathered adequate data to effectively determine which loans involve LSPs, SBA's ability to identify LSP portfolios is limited. Prior to 2011, SBA required LSPs to enter into an agreement with the participating lender, which was to be submitted to either SBA's Office of Financial Assistance or SBA district offices for approval. As a result, information was decentralized and more difficult to track. Since October 2011, SBA has centralized this process by requiring that LSP agreements be submitted to the LGPC for review and approval. Additionally, the LGPC official responsible for this function began maintaining a list of the approved agreements. Centralizing this function to one location has generally strengthened oversight. However, SBA cannot identify loans with LSP involvement if they had entered into an LSP agreement prior to 2011. We found that a significant number of these loans prior to 2011 are still actively being serviced by LSPs. For example, active LSP portfolios we obtained included 975 loans with application dates prior to October 1, 2011, with gross approvals in excess of $445 million.

We also found that SBA had not established a control to indicate LSP involvement at the loan level. Instead, SBA requires that an agreement between the lender and the LSP be submitted for its review and approval. SBA Form 159, *Fee Disclosure Form and Compensation Agreement*, provides loan-level information and the disclosure of compensation paid to other types of loan agents. On October 1, 2009, SBA clarified that lenders were not required to complete SBA Form 159 when compensating LSPs, as long as the lender had an approved LSP agreement in place. However, without a similar control for compensation to LSPs, identifying LSPs at the loan level and tracking them at the portfolio level has become more difficult.

[10] We determined the size of LSPs by the number of their approved agreements. The three largest LSPs represented 29 percent of the approved agreements. The LSPs we interviewed provided total servicing portfolios of approximately $1 billion, with average loan amounts ranging from nearly $500,000 to over $1 million.

Although SBA procedures limit LSPs' role to that of assisting lenders, and the lenders maintain the ultimate responsibility in ensuring loans comply with SBA guidance, multiple LSPs we interviewed noted that lenders did not perform these oversight functions. Based on our review of a limited sample of approved LSP agreements, we determined that 85 percent supported that LSPs were performing all four critical loan functions: origination, closing, servicing, and liquidation—increasing the need and importance for oversight of LSPs.

SBA officials noted that it was their intent to hold the lenders accountable for monitoring the LSPs that they have agreements with. As of June 30, 2014, the largest LSP had agreements with more than 90 lenders and 47 percent of the LSPs had agreements with more than 5 lenders. While we agree the primary responsibility for monitoring LSPs rests with the lenders, only SBA is in a position to aggregate LSP portfolios and evaluate performance to identify risk or any concerning trends.

Recommendations

1. We recommend that the Office of Capital Access develop a method to appropriately identify lender service provider participation within SBA loan programs and their associated SBA loan portfolios to evaluate performance.

Finding 2: SBA Did Not Adequately Investigate Potential Violations of SBA Policy

SBA procedures for supervision and enforcement of SBA 7(a) lenders establishes that the purpose of monitoring and oversight activity is to maximize the efficiency of SBA lending programs by effectively managing program credit risk, monitoring lender performance, and enforcing loan program requirements.

During our audit, we found that when referrals were made to OCRM about participating lenders and LSPs potentially operating outside of SBA program requirements, no actions were taken. The SBA official responsible for reviewing and approving LSP agreements stated that when she noted an LSP may be actively participating without required agreements in place—which violates the Code of Federal Regulations—she referred these LSPs to OCRM. We obtained a list of 13 LSPs performing services for 24 lenders without having approved LSP agreements in place that had been referred to OCRM.

OCRM officials stated that they did not investigate these referrals because there was not a formal process or procedure in place to handle them. Additionally, OCRM officials noted that the resources necessary to adequately research and address concerns with the referred LSPs were allocated to higher-priority issues. As a result, LSPs were participating in SBA loan programs without agreements in place and with minimal assurance that they complied with SBA program requirements.

We note that in some instances, SBA did take appropriate actions against LSPs when concerns were brought to their attention.[11] However, in these instances, the concerns came from other sources within SBA, rather than the SBA official responsible for reviewing and approving LSP agreements—which SBA has not sufficiently addressed. To preserve the integrity of its programs, SBA should consistently investigate referrals of potential violations of SBA program requirements.

Recommendations

2. We recommend that the Office of Credit Risk Management establish a formal process and procedures for addressing referrals related to lender service providers.

Analysis of Agency Response

SBA management provided formal comments, which are included in their entirety in Appendix II. The following provides a summary of management's comments and the actions necessary to close the report.

The Agency agreed with both of our recommendations and the need to be able to identify LSP participation within SBA loan programs in order to better evaluate loan portfolio performance. OCA stated that it is fully committed to mitigating risks associated with lender use of LSPs and that it had taken steps to address many of our concerns. The Agency also provided additional

[11] For example, SBA's Office of General Counsel contacted one LSP that was misrepresenting itself as an SBA lender. The LSP subsequently disclaimed on their website that they were not an SBA lender. In another instance, OCRM issued an on-site review report requiring corrective action to one lender that relied on the services of an LSP without an approved agreement in place and could not demonstrate that it maintained day-to-day responsibility of its SBA loan program operations.

information relating to the growth of approved LSP agreements and the controls in place. Specifically, SBA noted that it screens E-Tran access requests by LSPs against the LGPC database of approved LSP agreements, which helps to ensure that loan guaranty applications are being submitted only by authorized parties. Further, SBA has instructed its LGPC loan specialists to communicate only with the lender, rather than the LSP, if there is not an approved LSP agreement in place. These actions, in conjunction with SBA's FY 2014 requirement for electronic submission of loan applications, have reduced the number of lenders and LSPs without an SBA-approved agreement.

To further illustrate its commitment to LSP oversight, SBA included recent examples where OCRM has made efforts to improve the oversight of lender risk related to the use of loan agents, including LSPs. For example, in FY 2014, OCRM placed a large SBA lender under increased supervision for its use of an LSP that did not comply with SBA requirements. Additionally, OCRM issued a Proposed Rule for Agent Suspension and Debarment to strengthen SBA's ability to take enforcement actions against agents, including LSPs, in the business loan programs. OCRM plans to continue to address LSP and other loan agent risk in FY 2015.

We commend OCRM on its recent efforts to improve its oversight of LSPs and the planned efforts by OPSM to develop a method to indicate LSP involvement at the loan level. Finally, the Agency provided a technical comment related to its requirements for the Form 159, as it related to LSPs. We considered SBA's technical comment and made appropriate revisions to the report.

Summary of Actions Necessary to Close the Report

1. **Develop a method to appropriately identify lender service provider participation within SBA loan programs and their associated SBA loan portfolios to evaluate performance.**

   OCA stated that OPSM will determine the system requirements for adding one or more fields in E-Tran, as necessary, to input LSP identification. This recommendation can be closed upon OCA's implementation of an adequate system to identify LSP participation at the loan level.

2. **Establish a formal process and procedures for addressing referrals related to lender service providers.**

   OCRM stated they are in the process of creating a referrals docket to track, manage and prioritize lender referrals, including those relating to lender use of LSPs. OCRM proposed resolution of this recommendation by September 30, 2015. This recommendation can be closed upon SBA providing evidence supporting that the referrals docket has been implemented and referrals are being adequately tracked, managed and addressed.

Appendix I: Scope and Methodology

Our objectives were to determine the extent to which SBA has (1) developed controls to effectively track, evaluate, and enforce loan agent participation and performance and (2) identified financial and other impacts resulting from the involvement of loan agents in SBA loan programs. This report is the first of two, and focuses on SBA oversight of LSPs as loan agents and relates solely to our first objective. Our second report will address both objectives as they relate to SBA oversight of other types of loan agents.

To answer our objectives, we reviewed Section 7(a) of the Small Business Act, CFR Title 13, and Office of Management and Budget Circular A-129.[12] In addition, we reviewed various versions of SBA's Standard Operating Procedures (SOPs) including 50 10 5 and 50 53.[13, 14] We also reviewed Government Accountability Office standards and Office of Management and Budget guidance. Further, we met with OMB officials to discuss the interpretation of OMB Circular A-129. We also obtained and analyzed SBA's approved LSP agreement tracking spreadsheet, SBA's estimated LSP portfolio, and the historical loan portfolios provided by the four LSPs that we interviewed. Finally, we interviewed SBA officials responsible for LSP oversight and enforcement within the Agency.

We selected and reviewed a random sample of 33 SBA-approved LSP agreements. The agreements we sampled were selected from a universe of 901 approved agreements as July 22, 2014. We reviewed the agreements to determine the nature of the services being performed by the LSP on behalf of the lender under each agreement. In addition, we reviewed the agreements to ensure that the information contained on the agency's approved LSP agreement tracking spreadsheet was reasonably reliable. Finally, we reviewed a subset of the LSP agreements to verify they contained the language required by SBA.

We conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Use of Computer-Processed Data

We relied on information from SBA's Mainframe Loan Accounting System (LAS), and an excel spreadsheet, documenting approved LSP agreements, to select our random sample of LSP agreements and to analyze SBA's LSP portfolio. Previous OIG engagements have verified that the information maintained in LAS is reasonably reliable. In addition, we conducted reliability tests on the data contained in the excel spreadsheet. For example, we verified that the data was within the scope of our requests and did not include data errors. Further, data elements associated to the reviewed loans were verified against the sampled LSP agreements. As a result, we believe the information is reliable for the purposes of this audit.

[12] OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables (*January 2013).
[13] SOP 50 10 5, *Lender and Development Company Loan Programs* (Versions A, B, C, D, E & F effective 3/01/2009, 10/01/2009, 10/01/2010, 10/01/2011, 06/01/2012 and 01/01/2014 respectively).
[14] SOP 50 53 (A), *Lender Supervision and Enforcement* (effective June 1, 2012).

Review of Internal Controls

SBA's internal control systems SOP provides guidance on implementing and maintaining effective internal control systems, as required by OMB Circular A-123.[15] OMB Circular A-123 provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls.[16]

To assess internal controls during the audit, we assessed the control environment in which SBA tracked, evaluated, and enforced LSP participation and performance. We interviewed SBA officials with the responsibility for LSP oversight. We found weaknesses in SBA's tracking of LSP involvement in SBA loans. Additionally, we found that SBA had not established a process to address potential violations of SBA policy by banks and LSPs. Cumulatively, the weaknesses we identified diminished SBA's ability to oversee LSP involvement in SBA lending programs.

Prior Coverage

Small Business Administration—Office of Inspector General Reports

Evaluation Report 13-17, *The OIG's Portfolio Risk Management Program Can be Strengthened* (July 2, 2013).

Inspection Report 98-03-01, *Loan Agents and the Section 7(a) Program* (March 31, 1998).

[15] SOP 00 02, *Internal Control Systems* (January 1986).
[16] OMB Circular A-123, *Management's Responsibility for Internal Control* (December 21, 2004).

Appendix II: Agency Comments

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

DATE: February 26, 2015

TO: Troy M. Meyer
Assistant Inspector General for Auditing

FROM: Ann Marie Mehlum
Associate Administrator, Office of Capital Access

Brent M. Ciurlino
Director, Office of Credit Risk Management

SUBJECT: Response to Draft Audit Report – Improvement is Needed in SBA's Oversight of Lender Service Providers

Thank you for the opportunity to review the draft audit report. The report outlines the OIG's concerns regarding the increasing number of Lender Service Providers (LSPs) and their involvement in all phases of the SBA loan life cycle, including origination, closing, disbursement, servicing, and liquidation.

The OIG draft report stated that SBA had approved approximately 900 LSP agreements since October 2011. The report also stated that SBA had not established a method to track LSP portfolio activities, and therefore cannot adequately assess potential risks associated with LSP involvement in SBA loan programs. The report determined that SBA did not adequately investigate a number of potential violations of SBA policy by lenders and LSPs, such as a lack of approved agreements.

The Office of Capital Access (OCA) is fully committed to mitigating risks associated with lender use of LSPs. Specifically, SBA screens E-tran access requests by LSPs against the Loan Guaranty Processing Center's (LGPC) database of approved LSP agreements. This helps to ensure that loan guaranty applications are being submitted only by the lender or an LSP with an approved agreement. Further, SBA has instructed LGPC Loan Specialists to communicate only with the lender, rather than the LSP, if there is not an approved LSP agreement. These actions, in conjunction with SBA's FY 2014 requirement that lenders submit all loan applications electronically, have resulted in a significant increase in the number of LSP agreement submissions by lenders, reducing the number of lenders and LSPs without an SBA approved agreement. As a result, the number of lenders without SBA approved agreements has been reduced from 24 lenders cited in the draft audit report to 10 lenders. OCRM will issue Corrective Action letters to these 10 lenders and follow-up to ensure that appropriate action is taken.

In addition, the Office of Credit Risk Management (OCRM) has begun taking individual supervisory actions to address risks associated with LSP use. For example, in FY 2014, OCRM placed a large SBA lender under increased supervision for: (i) failure to execute and submit to SBA an LSP agreement compliant with SBA Loan Program Requirements and (ii) other non-compliance associated with LSP use. (This lender subsequently obtained SBA approval of its LSP agreement.) OCRM has also worked to address several other lender-LSP related matters. Notably, on October 17, 2014, OCRM issued a Proposed Rule for Agent Suspension and Debarment to strengthen SBA's ability to take enforcement actions against agents, including LSPs, in the business loan programs. Over 130 comments were received during the comment period, which closed on February 14, 2015. OCA has begun the process of reviewing and assessing the comments.

OCRM plans to continue to address LSP and other loan agent risk in FY 2015. For lenders with LSP agreements, OCRM's revised risk based review protocols include a review of the agreement to identify the scope of LSP loan-related activities. In its Full Reviews, OCRM will examine a sample of loans related to LSPs to determine compliance with Loan Program Requirements. These oversight activities will continue as part of OCRM's ongoing efforts to improve the oversight of lender risk related to the use of loan agents, including LSPs.

In formally responding to the draft audit report, we would also like to provide this technical comment: The draft states that in 2009, SBA eliminated the requirement for lenders to complete SBA Form 159 for compensation to LSPs. However, 13 CFR § 103.5 already provided that LSPs submit an LSP agreement describing the services and compensation charged to the lender, rather than submit an agent Compensation Agreement (Form 159). The change made to SOP 50 10 5 in October 2009 was simply to clarify within the SOPs that because SBA reviews the LSP agreement, LSPs were not required to use the Form 159.

Management's response to the recommendations contained in the report follows:

1. That OCA develop a method to appropriately identify lender service provider participation within SBA loan programs and their associated SBA loan portfolios to evaluate performance.

OCA agrees with the OIG recommendation regarding the need to be able to identify LSP participation within SBA loan programs in order to better evaluate loan portfolio performance. The Office of Portfolio and System Management (OPSM) within OCA will determine the system requirements for adding one or more fields in E-tran, as necessary to input LSP identification.

2. That OCRM establish a formal process and procedures for addressing referrals related to lender service providers.

OCRM agrees with the OIG recommendation regarding the need to establish a formal process and procedures for addressing referrals related to LSPs. OCRM is in the process of creating a Referrals Docket to track and manage lender referrals, including those relating to lender use of LSPs. OCRM will prioritize these referrals by compliance and portfolio risk and will conduct targeted lender reviews to determine any required corrective action.