# Audit Report

OIG-16-045

SMALL BUSINESS LENDING FUND

Banks Inaccurately Reported Qualified Small Business Lending Gains

May 25, 2016

# Office of Inspector General

## Department of the Treasury

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## Abbreviations

| | |
|---|---|
| Act | Small Business Jobs Act of 2010 |
| Call Reports | Quarterly Financial Regulatory Reports |
| ISR | Initial Supplemental Report |
| JAMES | Joint Audit Management Enterprise System |
| QSBL | qualified small business lending |
| QSR | Quarterly Supplemental Report |
| SBLF | Small Business Lending Fund |
| Treasury | Department of the Treasury |

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# OIG

# Audit Report

***The Department of the Treasury***
***Office of Inspector General***

May 25, 2016

Jessica Milano
Deputy Assistant Secretary for Small Business, Community Development, and Housing

This report presents the results of our audit of Small Business Lending Fund (SBLF) participants' qualified small business lending (QSBL) reported for the quarter ended September 2013. The objective of this audit was to determine the accuracy of QSBL for the quarter ended September 30, 2013, reported by participants for the 1st quarter 2014 dividend rate adjustments. These adjusted rates were the fixed dividend rates owed by participants in effect prior to the automatic rate increases, which are further described in the Background section of this report. Appendix 1 provides more detail on our audit objective, scope, and methodology.

In brief, we found that 71 percent of SBLF participants that we tested made errors in reporting QSBL for the quarter ended September 30, 2013. The net effect of these errors resulted in overreporting QSBL by approximately $14 million, but did not alter the fixed dividend rates for the participants in our sample. Although dividend payments were not affected by the QSBL errors, participants' supplemental reports and the Department of the Treasury's (Treasury) January 2014 *Report on SBLF Participants' Small Business Lending Growth* (Lending Growth Report)[1] were not correct.

[1] Pursuant to Section 4106(3) of the Small Business Jobs Act (Pub. L. 111-240), the Secretary of the Treasury is required to submit to Congress a quarterly written report on how institutions participating in the SBLF program have used the funds they received under the program. The January 2014 Lending Growth Report noted that all 307 institutions that remained in the SBLF program as of September 30, 2013, had increased small business lending by $11.2 billion, over a baseline of $35.1 billion.

We also noted that Treasury's review of bank participants' quarterly supplemental reports (QSRs), which provided the basis for the January 2014 Growth Lending Report, was not sufficiently designed to identify unqualified loans or ensure that QSBL was accurately reported. As such, we are recommending that Treasury management (1) ensure that QSBL errors identified in this report are disclosed in Treasury's July 2016 Lending Growth Report; and (2) strengthen future reviews of SBLF bank participants' QSRs to better identify unqualified loans and improve reporting of QSBL in the Lending Growth Reports.

In a written response, management accepted our recommendations. The commitments made by Treasury as stated in the response meet the intent of our recommendations. With respect to the QSBL errors identified in this report, Treasury will disclose the errors in the July 2016 Lending Growth Report. Regarding future reviews of SBLF bank participants' QSRs, Treasury will work with SBLF participants to improve the reporting of QSBL. However, the response lacked specificity of the planned corrective actions to be taken and timeframes for completing the actions. As such, management will need to identify specific actions and timeframes for completion in the Joint Audit Management Enterprise System (JAMES), Treasury's audit recommendation tracking system. Management's response is included as appendix 2 of this report.

## Background

The SBLF program was created by the Small Business Jobs Act of 2010 (Act) to increase the availability of credit to small businesses. Section 4103(a) of the Act gave the Secretary of Treasury authority to make capital investments in eligible financial institutions in exchange for preferred shares of stock or other financial instruments through September 27, 2011. In return, institutions that received capital investments under the program are required to pay dividends or interest to Treasury. SBLF participants are banks or Community Development Loan Funds.

For SBLF bank participants, the more an institution increased its small business lending over its baseline level, the lower the dividend rate it must pay to Treasury. As established in the Act, the baseline level for measuring changes in small business lending is the average of the amounts reported for each of the 4 calendar quarters ended June 30, 2010. For the first 2.5 years into the program, dividend rates ranged between 1 percent and 5 percent for participants that are C corporations and 1.5 percent and 7.7 percent for S corporations and Mutual Institutions.[2] After 2.5 years, dividend rates for most SBLF banking institutions became fixed based on small business lending increases as of September 30, 2013.[3] After 4.5 years in the SBLF program, which for most bank participants was after the 1st quarter of 2016, dividend rates increase to 9 percent for C corporations and 13.8 percent for S corporations and Mutual Institutions.

To establish the baseline level and initial dividend rates, institutions submitted initial supplemental reports (ISR) to Treasury using small business lending data from their Quarterly Financial Regulatory Reports (Call Reports)[4] and loan records. To report subsequent QSBL, institutions submit QSRs to Treasury. An institution's QSBL is determined by adding the loan balances reported in its Call Report in the categories of: (1) commercial and industrial loans; (2) loans secured by owner-occupied non-farm, non-residential properties; (3) loans to finance agricultural production and other loans to farmers; and (4) loans secured by farmland. This total is then adjusted to exclude loans with an original principal and commitment amount greater than $10 million, loans to businesses with more than $50 million in revenues, and the portions of loans guaranteed by the U.S. government or for which the risk is assumed by a third party. The QSBL total is further adjusted by adding net charge-offs back to the qualified lending volume. For participants that are holding companies, QSBL was determined by combining all of the qualified lending activity of the holding company's insured depository institution subsidiaries. Each quarter,

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2 C corporations are legal entities operating under state law whose profits are taxed to the corporation when earned, and taxed to the shareholders when distributed as dividends. S corporations are entities, as allowed by the Internal Revenue Code, which pass income, losses, deductions, and credits to their shareholders for Federal tax purposes. In so doing, the corporation avoids double taxation on corporate income. Mutual Institutions have no stockholders, and thus, are owned by depositors or policyholders and are generally thrifts and savings and loan associations

3 The rates for four SBLF institutions became fixed based on small business lending increases as of June 30, 2013.

4 These reports vary by type of institution and include Consolidated Reports of Condition and Income, Thrift Financial Reports, Y-9s, Uniform Bank Performance Reports, and Bank Holding Company Performance Reports.

SBLF institutions adjust their qualified lending baseline as appropriate to reflect any qualified loans acquired through acquisitions or mergers with other institutions.

## Finding

### Banks Inaccurately Reported Qualified Small Business Lending Gains

We found that 71 percent of SBLF bank participants in our sample made errors in reporting their QSBL for the quarter ended September 30, 2013. Specifically, 10 of the 14 banks we tested made errors in baseline lending levels and/or lending reported for the 3rd quarter 2013. The net effect of these errors resulted in overreporting QSBL by approximately $14 million, but did not alter the fixed dividend rates for those participants in our sample. Nonetheless, participants' supplemental reports and Treasury's January 2014 Lending Growth Report, submitted to Congress, were not accurate based on the errors identified. The table below provides results of our testing.

**Table: QSBL Errors, QSBL Gains, Fixed Dividend Rates (in thousands)**

| Bank | Errors decreasing QSBL | Errors increasing QSBL | Net value of errors | Banks' Reported QSBL Percentage Gain | Recalculated QSBL Percentage Gain Based on Net Errors | Fixed dividend rate |
|---|---|---|---|---|---|---|
| 1 | $0 | $1,844 | $1,844 | 12.18% | 15.27% | 1.0% |
| 2 | $0 | $4,223 | $4,223 | 12.82% | 13.11% | 1.0% |
| 3 | $(3,008) | $0 | $(3,008) | 14.30% | 12.80% | 1.0% |
| 4 | $0 | $500 | $500 | 12.67% | 12.97% | 1.5% |
| 5 | $(1,457) | $0 | $(1,457) | 11.77% | 10.93% | 1.0% |
| 6 | $0 | $0 | $0 | 11.84% | 11.84% | 1.0% |
| 7 | $0 | $1,592 | $1,592 | 10.79% | 11.43% | 1.0% |
| 8 | $(27,242) | $0 | $(27,478) | 14.24% | 10.61% | 1.0% |
| 9 | $0 | $0 | $0 | 13.68% | 13.68% | 1.0% |
| 10 | $0 | $0 | $0 | 13.10% | 13.10% | 1.0% |
| 11 | $0 | $9,742 | $9,742 | 12.37% | 17.44% | 1.0% |
| 12* | $(134) | $0 | $(134) | 11.44% | 10.96% | 1.5% |
| 13* | $(701) | $211 | $(490) | 13.23% | 12.96% | 1.5% |
| 14* | $0 | $0 | $0 | 11.09% | 11.09% | 1.9% |
| **Total** | **$(32,542)** | **$18,112** | **$(14,430)** | | | |

*Annotates that bank is an S Corporation

(Source: OIG analysis of SBLF participants' data)

### Errors Decreasing/Increasing QSBL

The total value of errors that decreased QSBL was approximately $32.5 million, which resulted from banks overstating qualified lending at September 30, 2013. Overstatement of qualified lending included (1) $27.6 million of loans with original principal and commitment amounts greater than $10 million; (2) $4.5 million of loans with an unqualified business purpose; and (3) $0.4 million of loans which were guaranteed by the U.S. government or for which the risk is assumed by a third party.

Errors that increased banks' QSBL totaled approximately $18.1 million and were the result of overstating baseline levels. Overstatements included loans for an unqualified business purpose and for owner-occupied real estate.

### Recalculated Percentage Gains and Dividend Rates

We recalculated the percentage gain in QSBL based on the net value of errors for the 10 banks that made errors. Five of these banks had a net positive value of errors that resulted in a higher percentage gain in QSBL than originally reported (banks 1, 2, 4, 7, and 11). The remaining five banks had a net negative value of errors that resulted in a lower percentage gain in QSBL (banks 3, 5, 8, 12, and 13). Because the recalculated percentage gains remained in the same percentage range associated with each institution's reported dividend rate, these rates did not change for the 10 banks.

### Lending Growth Reports

As of March 31, 2016, 45 banks remained in the SBLF program. Participants that remain in the SBLF program must continue to submit QSRs to Treasury, which form the basis in preparing the Lending Growth Reports submitted to Congress. To verify the accuracy of information submitted, Treasury reviews the QSRs each quarter for consistency with the Call Reports. As described in the background section of this report, banks complete QSRs using the same loan balances reported on their Call Reports in four categories of lending. From those balances, institutions must deduct certain loans that do not qualify as QSBL and report them separately on their QSRs. Because these unqualified loans are not broken out separately on the Call Reports, Treasury's current review process does not identify all instances of errors made in the reported deductions. As noted for 71 percent of banks in our sample, Treasury could not ensure that the aggregate QSBL was accurately reported by banks when preparing its Lending Growth Report to Congress.

Thirteen (13) of the 14 banks in our sample, which include all those that made errors, have since redeemed their securities and exited the SBLF program as of March 31, 2016. Accordingly, the security purchase agreements expired and these banks are no longer obligated to report to Treasury. Nonetheless, Treasury must continue reporting to Congress on the lending activities of those banks remaining in the SBLF program. While it is expected that the remaining participants will exit the program in the near future, we believe it is prudent for management to strengthen its review process to improve its ongoing reporting as well as future reporting should the SBLF program or similar program be authorized at a later date.

## Recommendations

We recommend that the Deputy Assistant Secretary for Small Business, Community Development, and Housing do the following:

1. Ensure that QSBL errors identified in this report are disclosed in Treasury's July 2016 Lending Growth Report.

   Management Response

   Treasury will disclose QSBL errors identified in this report in the July 2016 Lending Growth Report.

OIG Comment

Management's commitment meets the intent of our recommendation.

2. Strengthen future reviews of SBLF bank participants' QSRs to better identify unqualified loans and improve reporting of QSBL in the Lending Growth Reports.

   Management Response

   Treasury will work with SBLF participants to improve the reporting of QSBL going forward.

   OIG Comment

   We acknowledge management's agreement with this recommendation, although the response lacks specificity as to the planned corrective actions to be taken and the timeframe for implementing them. Management will need to identify actions to be taken and establish timeframes for completion in JAMES.

* * * * *

We would like to extend our appreciation for the cooperation and courtesies extended to our staff during the audit. Major contributors to this report are listed in appendix 3. A distribution list for this report is provided as appendix 4. If you have any questions, please contact me at (202) 927-1011 or William Malloy, Auditor-in-Charge, at (202) 927-8114.

/s/

Theresa A. Cameron
Director, Office of Small Business Lending Fund Program Oversight

Pursuant to Section 4107 of the Small Business Jobs Act, we initiated an audit of qualified small business lending (QSBL) for the quarter ended September 30, 2013. The objective of this audit was to determine the accuracy of QSBL for the quarter reported by participants for the 1st quarter 2014 dividend rate adjustments. These adjusted rates became the fixed dividend rates paid by participants until the automatic rate increases take effect after 4.5 years in the Small Business Lending Fund (SBLF) program.

To accomplish our objective, we conducted fieldwork between May 2014 and October 2015, which comprised the following steps.

- We selected a sample of 14 SBLF bank participants using a risk-based approach that focused on reported percentage increases in QSBL closest to or above 10 percent. These institutions represented the greatest risk of dividend underpayments if significant errors were made in reported QSBL. As such, the results of our testing were not projected to the universe of all banks in the SBLF program at the time of our review.

- We further sampled and tested 1,028 loans from institutions' initial supplemental reports (ISR) and September 2013 quarterly supplemental reports (QSR) based on the largest dollar value of the loans in the populations.

- We obtained Call Reports, ISRs, QSRs, loan files, and other reports from the sampled institutions and performed a series of tests to determine the accuracy of reported QSBL. Three institutions did not provide all necessary records to perform all of the tests; however, we were still able to compare Call Report totals to ISRs and QSRs for those institutions.

- We reviewed applicable laws, regulations, and other relevant documents as follows:
  - Small Business Jobs Act of 2010 (Public Law 111-240; September 27, 2010);
  - Treasury Directive 13-22, "Delegation of Authority for Small Business Lending Fund and State Small Business Credit Initiative Established by the Small Business Jobs Act of 2010" (May 16, 2011);

    - “Instructions for the Initial Supplemental Report for Bank Holding Companies Participating in the Small Business Lending Fund”;
    - “Instructions for the Quarterly Supplemental Report for Bank Holding Companies and Savings and Loan Holding Companies Participating in the Small Business Lending Fund”; and
    - “Community Bank Supervision,” (Comptroller’s Handbook, January 2010).

- We corresponded with key officials at the sampled institutions to obtain information and documentation.

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.

**DEPARTMENT OF THE TREASURY**
**WASHINGTON, D.C. 20220**

May 12, 2016

Theresa Cameron,
Audit Director
Office of the Inspector General
U.S. Department of the Treasury
875 15th Street, NW
Washington, D.C. 20005

Dear Ms. Cameron:

Thank you for the opportunity to review the draft report regarding qualified small business lending (QSBL) reported by Small Business Lending Fund (SBLF) participants for the third quarter of 2013 (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

The Report examines the QSBL reported by participants for the dividend rate adjustments that took place in the first quarter of 2014. We are pleased that the audit findings did not result in any dividend payment adjustments for the participants in your sample.

Treasury accepts the Report's recommendations. With respect to the first recommendation, Treasury will disclose the QSBL errors identified in the Report in Treasury's July 2016 *Report on SBLF Participants' Small Business Lending Growth*. With respect to the second recommendation, Treasury will work with SBLF participants to improve the reporting of QSBL going forward.

Thank you once again for the opportunity to review the Report. We look forward to continuing to work with your office in the future.

Sincerely,

Jessica Milano

Jessica A. Milano
Deputy Assistant Secretary for Small Business,
Community Development, and Housing Policy

Regina Morrison, Audit Manager
William Malloy, Auditor-in-Charge
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**Department of the Treasury**

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Deputy Assistant Secretary for Small Business, Community Development, and Housing
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