AUDIT REPORT

AUDIT OF SBA'S OVERSIGHT OF HIGH-RISK LENDERS

EXECUTIVE SUMMARY

AUDIT OF SBA'S OVERSIGHT OF HIGH-RISK LENDERS

Report No. 20-03

November 12, 2019

What OIG Reviewed

This report presents the results of our audit of the Small Business Administration's (SBA's) oversight of high-risk lenders. The Small Business Act and Small Business Investment Act authorized SBA to provide financial assistance to small businesses through government-guaranteed loans and debentures.

SBA's Office of Credit Risk Management (OCRM) is responsible for the oversight of SBA lenders and its $120 billion 7(a) and 504 loan portfolio. OCRM's mission is to maximize the efficiency of SBA's lending programs by effectively managing program credit risk, monitoring lender performance, and enforcing lending program requirements.

Our objective was to determine whether SBA performed effective oversight of high-risk lenders to identify and mitigate risks. To answer our objective, we interviewed SBA personnel and independent contractors, judgmentally sampled 33 of 402 reviews that OCRM conducted for high-risk lenders in fiscal years (FYs) 2015–2017, examined OCRM reports issued and related corrective actions for those lenders, reviewed SBA's loan systems for the nonperforming loans included in the oversight reports, and reviewed risk plans, reports, corrective actions, and related correspondence to assess OCRM's oversight.

What OIG Found

OCRM did not always perform effective oversight of high-risk lenders to identify and mitigate risks. We found that OCRM did not always conduct planned high-risk lender reviews, recommend adequate and consistent risk mitigation actions, or communicate loan deficiencies they noted during their high-risk lender reviews to SBA approval and purchase loan centers.

Several factors contributed to these conditions. Specifically, OCRM did not have policies and procedures requiring them to document their justification for not conducting planned reviews and identifying and prioritizing additional lenders for review, have a comprehensive database to manage its oversight of high-risk lenders, have clear and specific guidance to outline adequate corrective and enforcement actions, conduct an overall assessment of the high-risk lender review results to ensure analysts recommended adequate and consistent actions, or have a requirement to communicate significant lender review findings and loan deficiencies to SBA's loan centers.

As a result, there is an increased risk that lenders with repeated identified systemic deficiencies will continue to participate in SBA's 7(a) and 504 loan programs, which could jeopardize the integrity of the programs and increase the risk of financial loss to the $120 billion loan portfolio. For example, OCRM identified material deficiencies in 21 defaulted loans, which SBA honored its guaranty by purchasing the defaulted loans. However, we did not find evidence that SBA validated whether the lenders had corrected the deficiencies. Therefore, we question SBA's guaranty purchases of these 21 defaulted loans totaling $13.3 million. Additionally, five lenders that did not receive planned reviews had an average default rate of 19 percent for loans approved and disbursed in FYs 2015–2017. These lenders originated and disbursed $1 billion in loans in which $112.5 million was transferred to liquidation because the loans defaulted.

OIG Recommendations

We made six recommendations that, if implemented, will improve SBA's internal controls, enhance communication, and mitigate losses incurred on loans with material deficiencies.

Agency Response

SBA management agreed with the report finding and recommendations. Management's planned actions will resolve all recommendations, including making recommended policy changes to standard operating procedures and identifying a database and other solutions to oversee lenders. Also, management plans to conduct periodic assessments of high-risk lender review results and risk mitigation actions, implement a quality assurance check to ensure CHRON is notated with lender deficiencies, and review the 21 loans to bring them into compliance. If the loan issues are not remedied, SBA will seek recovery of the guaranties.

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

Final Report Transmittal
Report Number: 20-03

DATE: November 12, 2019

TO: Christopher M. Pilkerton
Acting Administrator and General Counsel

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: Audit of SBA's Oversight of High-Risk Lenders

This report presents the results of our audit of the Small Business Administration's (SBA's) oversight of high-risk lenders. We considered management's comments on the draft of this report when preparing the final report. Management agreed with the finding and all recommendations.

We appreciate the courtesies and cooperation extended to us during this audit. If you have any questions, please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616.

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Introduction

SBA's 7(a) and 504 Loan Programs

The Small Business Act and Small Business Investment Act authorized SBA to provide financial assistance to small businesses in the form of government-guaranteed loans and debentures. Participating lenders and certified development companies (CDCs) enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures. Lenders participating in the 7(a) Loan Program are either federally regulated or supervised by SBA. SBA-supervised lenders include nonfederally regulated lenders that are state-regulated and small business lending companies that are regulated and examined solely by SBA. Most CDCs are nonprofit corporations that are certified and regulated by SBA.

Under the 7(a) Loan Program, SBA offers a 50 to 90 percent guarantee for loan amounts up to $5 million. SBA and the lender share the loss of a defaulted 7(a) loan based on the guaranteed percentage. When a borrower defaults on an SBA-guaranteed loan, the lender can submit the loan to SBA for purchase. SBA reviews the defaulted loan to confirm the lender's compliance with the relevant SBA requirements before purchasing the loan.[1] Under SBA's 504 Certified Development Company Loan Program, a CDC provides financing for up to 40 percent of a borrower's project costs through a 100 percent SBA-guaranteed debenture. SBA is released from liability on the loan guaranty, in whole or in part, if the lender fails to comply with any material SBA loan program requirement.[2] SBA's 7(a) and 504 loan portfolio is approximately $120 billion, which includes more than 3,400 lenders and CDCs.[3]

SBA's Office of Credit Risk Management and Lender Oversight Committee

The SBA's Office of Credit Risk Management (OCRM), which operates under the Office of Capital Access, is responsible for the oversight of SBA's lending partners and the loan portfolio. OCRM's mission is to maximize the efficiency of SBA's lending programs by effectively managing program credit risk, monitoring lender performance, and enforcing lending program requirements. To manage risk, OCRM first monitors lending partners through reviews of its loan and lender monitoring system, which tracks monthly performance of the loans and assigns a credit score for each loan. This results in a purchase rating and initial risk profile for the lending partners.

Next, OCRM uses a composite risk rating methodology that was introduced in fiscal year (FY) 2015 to identify lending partners' specific risk areas and assess their risk levels. This risk rating methodology includes specific risk areas or components that SBA reviews for the lenders. One methodology used for the oversight of 7(a) lenders includes portfolio management, asset management, regulatory compliance, risk management, and special items. The other methodology used for CDCs includes solvency and financial condition, management and board governance, asset quality and servicing, regulatory compliance, and technical issues and mission.

OCRM uses additional factors, such as the size of the lender's portfolio and SBA concentration rates, to assess the level of risk. OCRM develops an annual risk mitigation plan based on these risk review

[1] When a lender requests guaranty payment on a defaulted secondary market loan, SBA must purchase the loan from the secondary market investor. After purchase of the secondary market loan, SBA reviews loan documentation to evaluate the lender's compliance with program rules and regulations.
[2] Title 13 Code of Federal Regulations (CFR), section 120.524, Business Credit and Assistance.
[3] The portfolio reflects the outstanding principal balance of loans that have not yet been charged off as of September 30, 2018.

elements and its prior year's review results. Lending partners that present the highest risk receive full or targeted reviews or safety and soundness examinations as described below:

- **Full Review**—Generally conducted at the lending partner's location. It includes a comprehensive analysis of each composite risk rating component and review of loan files. SBA selects the loans for review on a random or judgmental basis.

- **Targeted Review**—Generally narrow in scope and may be conducted virtually or at the lending partner's location. It includes a review of one or more composite risk rating components or other areas of concern (including program integrity) identified by SBA. It may also include a review of loan files.

- **Safety and Soundness Examination**—Comprehensive examination of all aspects of an SBA supervised lender's operation and is conducted at the lending partner's location, but it may also include a virtual portion. It includes a review of loan files.

Different contract personnel conduct these reviews in conjunction with OCRM's analysts. OCRM's supervisory financial analysts oversee the lender reviews and are divided by regions and types of lending institutions. For example, supervisory financial analysts are divided by federally regulated institutions (West and East), SBA supervised institutions, and CDC institutions. As there is no standardized process for conducting the reviews, the review process and report format is dictated by the preference of each individual team supervisor. At the conclusion of each review, OCRM assesses a lender's operation as one of the following:

- Acceptable – No Action
- Acceptable With Corrective Action(s)
- Marginally Acceptable With Corrective Action(s)
- Less Than Acceptable With Corrective Action(s)

If a finding is identified as a result of the oversight reviews and examinations, corrective actions are required by the lender. According to SBA policy, a finding is "any issue or characteristic identified for which SBA will require the lender to implement, modify, alter, change, or cease conducting a defined action."[4] Also, OCRM deems lenders that are rated as marginally acceptable or less than acceptable to be high risk. All SBA-supervised lenders are considered high risk because they are not federally regulated.

SBA also has a lender oversight committee (LOC) that includes members from different SBA program offices. The LOC is responsible for reviewing and voting on formal enforcement actions recommended by the OCRM director. Also, the LOC reviews reports on lender oversight activities and OCRM's budget, staffing, and operating plans.

SBA's Historical Oversight Authority

In 1999, SBA established an Office of Lender Oversight (renamed the Office of Credit Risk Management in 2007). In 2003, SBA developed a risk-based, off-site analysis of lending partners incorporating credit scoring metrics. Risk ratings from this analysis were not available until 2004. In 2006, SBA issued a standard operating procedure (SOP) that established procedures for on-site, risk-based lender reviews and safety and soundness examinations for 7(a) lenders and CDCs

[4] SOP 51 00, On-Site Lender Reviews/Examinations (September 2006).

participating in the SBA's 504 loan program.[5] SBA issued an SOP in 2008 for 7(a) lender oversight, which included uniform policies and procedures.[6] Further, in 2015, SBA engaged contractor support to expand on its corrective action followup process.

Finally, in 2018, Public Law 115-189 formally established OCRM and the LOC. It requires an employee of OCRM to be present for and supervise any review that is conducted by a contractor on the premise of a 7(a) lender. Under this law, OCRM is also required to submit an annual risk analysis report to Congress.

Prior Audit Work

In 2012, the OIG issued report 12-20R, Addressing Performance Problems of High-Risk Lenders Remains a Challenge for the Small Business Administration. The report's objective was to determine whether SBA took actions to mitigate material lender risks identified in on-site reviews. The audit found that in 8 of 16 sampled lenders, SBA did not always recognize the significance of lender weaknesses and determine the risks they posed to SBA. Additionally, SBA did not link the risks associated with the weaknesses to the lenders' corresponding risk ratings and assessments of operations. Further, SBA did not require lenders to correct performance problems that could have exposed SBA to unacceptable levels of risk. As a result, SBA was at a substantial risk of loss due to the potential for increased defaults. The eight lenders originated $1.3 billion in Recovery Act loans, of which $42 million was in liquidation or charged off. The audit included six recommendations to improve SBA's oversight over high-risk lenders. All recommendations are closed.

Objective

Our audit objective was to determine whether SBA performed effective oversight of high-risk lenders to identify and mitigate risks.

[5] SOP 51 00, On-Site Lender Reviews/Examinations (September 2006).
[6] SOP 50 10(5), Lender and Development Company (August 2008).

Finding: SBA Did Not Always Perform Effective Oversight of High-Risk Lenders to Identify and Mitigate Risks

We found that OCRM did not conduct 108 of its 358, or 30 percent, planned high-risk lender reviews for FYs 2015–2017. OCRM did not provide sufficient rationale to substantiate why they did not conduct the high-risk lender reviews as planned or why they added reviews not included in the initial plan. Additionally, OCRM did not recommend adequate and consistent risk mitigation actions for 28 of the 33 lenders we assessed. Lastly, although OCRM noted material deficiencies in 71 of 76, or 93 percent, of the 7(a) loans they reviewed and SBA purchased, they did not communicate these deficiencies to SBA's loan approval and purchase centers.

Several factors contributed to these conditions. For example, OCRM did not

- have policies and procedures requiring them to document their justification for not conducting planned reviews and identifying and prioritizing additional lenders for review.
- have a comprehensive database to manage its oversight of high-risk lenders to ensure performance of all planned reviews, implementation of risk mitigation actions, and identification of noncompliant lender and systemic material loan deficiencies.
- have clear and specific guidance to outline adequate corrective and enforcement actions for the identified deficiencies.
- conduct an overall assessment of the high-risk lender review results to ensure analysts recommended adequate and consistent actions.
- have a requirement to communicate significant lender review findings and loan deficiencies to SBA's approval and purchase loan centers.

These factors resulted in an increased risk that lenders with repeated identified systemic deficiencies will make ineligible loans and continue to participate in SBA's 7(a) and 504 loan programs, thus jeopardizing the integrity of the programs and increasing the risk of financial loss. For example, we analyzed 32 of 76 defaulted 7(a) loans. We did not find evidence that OCRM had validated whether lenders had corrected the material deficiencies identified by the OCRM reviews on 21 of 32 loans. SBA honored its guaranties on the loans by purchasing the defaulted loans for approximately $13.3 million. Additionally, five lenders that did not receive reviews as planned had an average default rate of 19 percent for loans approved and disbursed in FYs 2015–2017, as of January 31, 2019.[7] These lenders originated and disbursed $1 billion in loans during this period, in which $112.5 million were transferred to liquidation because the loans defaulted.

Deviations From Annual Risk Management Oversight Plans Not Justified

OCRM did not conduct 108 of its 358, or 30 percent, planned high-risk lender reviews for FYs 2015–2017.[8] Instead, they completed 152 lender reviews that they did not identify in their initial risk mitigation plans. SBA stated they completed the 152 reviews instead of the 108 because they identified additional risks for those lenders. However, SBA did not provide support to substantiate how they determined that the lenders posed a greater risk and why they prioritized

[7] The average default rate for loans originated by 7(a) lenders in FYs 2015–2017 was 4.7 percent, as of January 31, 2019.
[8] High-risk lender reviews consisted of full or targeted reviews or safety and soundness examinations.

these lenders over the lenders they initially identified as high risk. See table 1 for planned and completed reviews.

Table 1. OCRM Planned and Completed Lender Reviews[9]

FY	Initially Planned	Initially Planned Completed	Initially Planned, Not Conducted	Unscheduled Reviews Completed
2015	111	34	77	98
2016	63	59	4	27
2017	184	157	27	27
Totals	**358**	**250**	**108**	**152**

Office of Management and Budget (OMB) Circular A-129, Policies for Federal Credit Program and Non-Tax Receivables, states that to evaluate and enforce lender and servicer performance, agencies should conduct on-site reviews, prioritizing such reviews based on performance and exposure. In addition, SBA's policy states that two of the primary objectives of on-site reviews are to

- enhance SBA's ability to gauge the overall quality of SBA lender's 7(a) and 504 portfolio and

- identify weaknesses in an SBA lender's operations before serious problems develop that expose SBA to losses that exceed those inherent in a reasonable and prudent SBA loan portfolio.[10]

Further, SBA Policy Notice 5000-1332 states that SBA uses qualitative and quantitative factors to identify a lender's specific risk areas and assess the level of risk a lender poses to SBA. OCRM uses both on-site and off-site reviews to identify those lenders whose operations expose the SBA to unacceptable levels of risk. As previously noted, OCRM uses a composite risk rating methodology in combination with other factors, such as the size of the lender's portfolio, SBA concentration rates, and prior year's review results to assess the lending partners' level of risk.

OCRM officials provided a number of reasons why planned reviews were not conducted: lenders received analytical reviews, lenders merged or were acquired, limited resources, and issues with OCRM's contract used to conduct lender reviews.[11] OCRM officials also noted that unplanned reviews were conducted because they were periodic reviews based on the time lapse from the prior risk-based review and the need to conduct corrective action testing. However, these two reasons for adding unplanned reviews are part of SBA's criteria for annual risk mitigation planning and therefore should have been included in OCRM's original review plans.

We determined that OCRM did not have policies and procedures to document their justification for (1) not conducting planned reviews or (2) identifying and prioritizing additional lenders for review. In addition, we found that OCRM did not have a comprehensive database to track and monitor lenders they identified for review, review results, and recommended actions. As a result, SBA was exposed to an increased risk of financial loss, and there's no assurance of program integrity because OCRM did not conduct the planned reviews that could have identified and corrected material and systemic performance issues. For example, five of the lenders that did not receive a review as planned have an average default rate of 19 percent. These lenders originated and disbursed

[9] The figures in table 1 represent the number of reviews planned or completed, and some high-risk lenders are included in multiple years.
[10] SOP 51 00, On-site Lender Reviews/Examinations (September 2006).
[11] An analytical review is an automated data run of the key metrics within the composite risk rating model, which SBA uses to determine whether a lender should receive a full or targeted review.

$1 billion in loans in FYs 2015–2017, in which $112.5 million was transferred to liquidation because the loans defaulted.[12]

Inadequate and Inconsistent Risk Mitigation Recommendations

OCRM did not always recommend adequate and consistent risk mitigation actions, which consist of corrective and enforcement actions, for the deficiencies it identified during the oversight reviews of high-risk lenders. We assessed 33 of the 402 reports OCRM issued for the high-risk lender reviews it performed in FYs 2015–2017 and found that OCRM did not recommend adequate and consistent risk mitigation actions for 28 of 33 reviews.

OCRM did not recommend adequate corrective actions, as illustrated by the following examples:

- OCRM identified that a lender had a pattern of deficiency affirming reasonable assurance of repayment, assessing borrower equity injection, and demonstrating and assessing credit unavailable elsewhere. OCRM required the lender to revise its written policies and procedures but did not cancel the guarantees or require the lender to correct the loan deficiencies.

- OCRM identified that another lender had a pattern of deficiency related to requirements for key person risk assessments, insurance, IRS tax verification, site visits, jobs created, and jobs retained. OCRM required the lender to revise its written policies and procedures but did not cancel the guarantees or require the lender to correct the loan deficiencies.

OCRM also did not recommend corrective actions consistently, as illustrated by the following examples:

- OCRM identified 10 lenders without evidence that the borrower could not obtain credit elsewhere. OCRM correctly required one of these lenders to provide evidence that the borrower could not obtain credit elsewhere or they would cancel the guarantee and they required another lender to perform a credit elsewhere analysis. They also required these two lenders to update their policies and procedures. However, OCRM only required the other eight lenders to update their policies and procedures.

- OCRM identified four lenders that did not conduct a loan agent check in the System for Award Management (SAM) to determine if the agent was suspended or debarred. However, OCRM required only two of the lenders to check SAM and update their policies and procedures. For the remaining two lenders OCRM only required them to update their policies and procedures.

For enforcement actions, we found OCRM's application was not always adequate and consistent. For example, two lenders' tax statuses made them ineligible to participate in the program, but OCRM withdrew only one lender's program participation.

SBA is released from liability on the loan guaranty (in whole or in part) if the lender failed to comply with any material SBA loan program requirement; failed to make, close, service, or liquidate a loan in a prudent manner; or took improper action that placed SBA at risk.[13] According to SBA SOP 51 00, one of the objectives of on-site reviews is to ensure that lenders take prompt and

[12] The average default rate for loans originated by 7(a) lenders in FYs 2015–2017 was 4.7 percent. All information as of January 31, 2019.
[13] 13 CFR, section 120.524, Business Credit and Assistance.

effective corrective actions, as appropriate. Also, OMB Circular A-129, Policies for Federal Credit Program and Non-Tax Receivables, states that agencies should establish specific procedures to take appropriate action any time there is significant and/or continuing nonconformance with agency standards and/or failure to meet financial and capital requirements or other eligibility criteria.

Further, 13 CFR §120.1400 states that by making SBA 7(a) guaranteed loans or 504 loans, SBA lenders automatically agree to the terms, conditions, and remedies in loan program requirements. It also stated that SBA may undertake one or more enforcement actions if SBA determines that the grounds applicable to the enforcement action exist. Examples of grounds that may trigger enforcement actions include the following:

- failure to maintain eligibility requirements for specific SBA programs and delegated authorities;
- failure to comply materially with any requirement imposed by loan program requirements;
- not performing underwriting, closing, disbursing, servicing, liquidation, litigation, or other actions in a commercially reasonable and prudent manner; and
- repeated failure to correct continuing deficiencies.

The types of enforcement actions include limiting the maximum dollar amount that SBA will guarantee on the lender's SBA loans or debentures as well as suspending or revoking the lender's delegated authority and participation in the SBA loan program.

We determined that SBA's risk mitigation was inadequate and inconsistent because OCRM did not establish clear and specific guidance to outline the appropriate corrective or enforcement actions for the various identified deficiencies. For example, SBA's requirements use subjective guidance such as "may" and "at discretion," which increases the risk of not having adequate and consistent risk mitigation actions.

We also found that OCRM did not periodically conduct an overall assessment of the high-risk lender review results to ensure analysts recommended appropriate actions and that the actions were consistent amongst the different analysts. OCRM did not have a comprehensive database to manage its oversight of high-risk lenders to ensure performance of all planned reviews, implementation of risk mitigation actions, and identification of noncompliant lender and systemic material loan deficiencies.

Insufficient Communication of High-Risk Lender Review Results to Loan Centers

OCRM rarely communicated the loan deficiencies they noted during their high-risk lender reviews to SBA approval and purchase loan centers. We determined that OCRM identified deficiencies in 76 7(a) loans that defaulted and were purchased by SBA. However, for 71 of 76 of these loans, or 93 percent, OCRM did not communicate the deficiencies to the loan centers. The following examples illustrate OCRM's insufficient communication of loan deficiencies to the loan centers:

- OCRM identified that a lender did not accurately review a required SBA form to determine the appropriate delivery method when originating the loan. OCRM recommended that the lender repurchase the loan from the secondary market and cancel the guaranty. However, OCRM did not communicate the deficiencies to the loan centers. Consequently, SBA honored its guaranty on the loan and purchased the defaulted loan for $111,717 more than a year after the OCRM review.

- OCRM identified that a lender was inappropriately selling loans on the secondary market prior to fully disbursing them to borrowers. Of the seven loans that were purchased and included in the oversight review, OCRM only notated the deficiencies for three in SBA's Capital Access Financial System, which we were told was the only way loan deficiencies could be communicated across SBA.

To determine the impact of these uncommunicated loan deficiencies, we judgmentally selected and analyzed 32 of the 76 purchased loans, based on the types of origination and closing deficiencies. We did not find evidence that OCRM had validated that the lenders had corrected the deficiencies on 21 defaulted loans that SBA had purchased for approximately $13.3 million. Therefore, we questioned $13.3 million in guaranty payments for these defaulted loans, due to inadequate corrective action documentation. For 19 of the 21 loans, OCRM did not communicate the deficiencies to the purchase centers. While we noted that SBA purchased 9 of the 21 loans before OCRM's review, communicating lender issues and loan deficiencies to SBA's loan centers could have mitigated the risk of financial loss. (See appendix II for more detail about these questioned costs.)

According to the Government Accountability Office's (GAO's) Standards for Internal Control in the Federal Government, effective internal control requires that "quality information is communicated down, across, up, and around reporting lines to all levels of the entity to enable personnel to perform key roles in achieving objectives, addressing risks, and supporting the internal control system."[14] Further, OMB establishes policies and procedures for justifying, designing, and managing federal credit programs.[15] OMB Circular A-129 states that agencies shall employ robust diagnostic and reporting frameworks, including dashboards and watch lists, so that all levels at the organization receive the appropriate information to inform proactive portfolio management.

We determined that OCRM rarely communicated loan deficiencies noted during their high-risk lender reviews because OCRM did not have any requirements to communicate significant lender issues and loan deficiencies to SBA's approval and purchase loan centers to inform proactive portfolio management. Some financial analysts notated material deficiencies in SBA's loan system; however, it was not required. A financial analyst stated the only way systemic lender issues or loan deficiencies could be communicated across SBA was through the Loan Comment and Chron List (Chron) section in SBA's Capital Access Financial System. However, there was no way to document systemic issues by a lender as the information could only be entered on a loan-by-loan basis.

Further, financial analysts stated communication of significant deficiencies and actions was limited to high-level summaries delivered in quarterly briefings to the LOC. Also, officials at SBA's approval and purchase loan centers stated that communication from OCRM regarding systemic lender issues and loan deficiencies was either not received or sporadic. It is important to note that loan specialists at the SBA loan purchasing centers are required to review the Chron section of SBA's loan system to determine if OCRM identified any loan deficiencies prior to the purchase of the loans. However, OCRM generally did not provide the loan specialists with this pertinent information from their high-risk lender reviews.

Significantly, we were unable to determine if all corrective actions were implemented because OCRM did not have a comprehensive database to manage its oversight of high-risk lenders. Specifically, each supervisory financial analyst had their own individual tracking methods, such as

[14] GAO 14-704G, Standards for Internal Controls in the Federal Government (September 2014).
[15] OMB Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables (January 2013).

spreadsheets that were inconsistently maintained. Further, OCRM lost access to some of the information when employees left the agency and did not provide their information to OCRM. Communicating material high-risk lender review results and loan deficiencies to the loan approval and purchase centers could assist SBA with preserving its program integrity and mitigate the risk of financial loss.

SBA Actions Taken

During the audit, SBA took the following steps to strengthen its oversight function:

- In compliance with the requirements in the Small Business 7(a) Lending Oversight Reform Act of 2018, SBA issued a proposed rule for public review in the Federal Register from June 21 through August 20, 2019. The proposed rule would update regulations to include SBA's informal enforcement actions for 7(a) lenders, SBA's authority to impose civil monetary penalties on all 7(a) lenders, and an update to the definition of credit elsewhere. OCRM believes the proposed rule will help to ensure consistent risk mitigation recommendations.

- In April 2019, SBA executed a coordination principles agreement with the Office of the Comptroller of the Currency to share information, identify mutual areas of interest, and discuss emerging risk areas. Also, in June 2019, SBA executed a memorandum of understanding with the Federal Deposit Insurance Corporation to enhance the exchange of information, including relevant programmatic matters and best practices.

Conclusion

The 7(a) and 504 loan portfolios have continuously increased, from $102 billion to about $114 billion in FYs 2015–2017 (scope of review), up to $120 billion in FY 2018. Inadequate oversight of high-risk lenders exposes SBA to significant risk that lenders will make ineligible loans that would cause financial loss and affect program integrity. For example, SBA purchased 21 defaulted loans totaling $13.3 million. However, we did not find evidence that OCRM validated that the lenders had corrected the deficiencies on these loans. Additionally, five lenders that did not receive reviews as planned had an average default rate of 19 percent for loans approved and disbursed in FYs 2015–2017. These lenders originated and disbursed $1 billion in loans during this period, in which $112.5 million was transferred to liquidation because the loans defaulted. Improvements to the internal control weaknesses identified in this report are essential to strengthen OCRM's oversight function and ensure it effectively monitors the lending partners' performance and mitigate the risks presented to SBA.

Recommendations

We recommend the Administrator direct the Director for the Office of Credit Risk Management to:

1. Develop and implement policies and procedures to document OCRM's justification for (1) not conducting planned reviews and (2) identifying and prioritizing additional lenders for review.

2. Develop and implement a comprehensive database to manage its oversight of high-risk lenders to ensure performance of all planned reviews, implementation of risk mitigation actions, and identification of noncompliant lender and systemic material loan deficiencies.

3. Develop and implement policies and procedures to provide clear and specific guidance to analysts regarding the appropriate corrective and enforcement actions for identified lenders and loan deficiencies to ensure analysts recommend appropriate and consistent corrective and enforcement actions.

4. Conduct periodic overall assessments of the high-risk lender review results and recommended risk mitigation actions to ensure analysts recommend appropriate and consistent corrective and enforcement actions.

5. Develop and implement policies and procedures that require OCRM to communicate systemic lender issues and material loan deficiencies to the appropriate SBA loan approval and purchase centers to facilitate proactive portfolio management and to mitigate the risk of improper guaranty purchases in the event of default.

6. Determine whether the lenders corrected the deficiencies on the 21 loans purchased for a total of $13.3 million. If not, require the lenders to bring the loans into compliance or, if not possible, seek recovery of the guaranty paid by SBA from lenders.

Analysis of Agency Response

SBA management provided formal comments to the report, which are included in their entirety in appendix III. Management agreed with the finding and all recommendations, and its proposed actions will resolve all the recommendations. Management provided the implementation dates for all recommendations in separate correspondence. We considered management's comments when preparing this final report.

Summary of Actions Necessary to Close the Recommendations

The following provides the status of the recommendations and necessary actions to close them.

1. **Resolved.** Management agreed with our recommendation, stating that it will include the recommended changes in SOP 51 00 by September 19, 2020. Management also stated that OCRM's review plan is only a guide that allows flexibility so that changes can be made as new risk patterns arise among lenders and in the portfolio. As OCRM gathers additional information throughout the year, changes may be required to address newly identified areas of risk. Some of the planned reviews for FY 2015–2017 were not conducted and other, more urgent reviews were performed in their place. The overall number of reviews conducted for FY 2015–2017 exceeded the number of originally planned reviews. OCRM performed nearly 13 percent more reviews than initially planned. Lastly, management stated the result was more effective lender monitoring and oversight.

   As stated in the report, OCRM did not provide support to substantiate how they prioritized the newly identified lenders for review over the lenders they initially identified as high risk. Further, OCRM noted during the audit that periodic reviews based on the time lapse from the prior risk-based review and the need to conduct corrective action testing were reasons for changes to the risk plan. However, we noted that these reasons were already part of OCRM's criteria for annual risk mitigation planning. Therefore, these matters should have been considered in OCRM's original review plans. The report found that five of the lenders that did not receive a review as planned have an average default rate of 19 percent. These lenders originated and disbursed $1 billion in loans in FYs 2015–2017, in which $112.5 million was transferred to liquidation because the loans defaulted. To ensure effective oversight of high-risk lenders and to effectively mitigate the risk of financial loss, OCRM must be able to support and substantiate their rationale for selecting or reprioritizing lenders for review. This recommendation can be closed when management provides evidence that the SOP was updated to address the recommendation.

2. **Resolved.** Management agreed with our recommendation and stated that it is working with the Office of Performance System Management to identify and evaluate database and other technology solutions to facilitate its oversight of lender participants. Management plans to complete final action on this recommendation by September 19, 2020. This recommendation can be closed when management provides evidence that it has implemented a comprehensive database that will provide effective oversight of high-risk lenders.

3. **Resolved.** Management agreed with our recommendation and will include the recommended changes in its SOP 50 53 by September 19, 2020. Management stated that it is important for corrective and enforcement actions to be appropriate and consistent given the particular compliance or performance issues being addressed. This recommendation

can be closed when management provides evidence that the SOP was updated to address the recommendation.

4. **Resolved.** Management agreed with our recommendation and plans to conduct periodic assessments of high-risk lender review results and recommended risk mitigation actions by April 30, 2020. This recommendation can be closed when management provides evidence that the periodic assessments are being conducted and recommended risk mitigation actions are appropriate and consistent.

5. **Resolved.** Management agreed with our recommendation and indicated that its current practice is to document issues in CHRON. Management further stated that it already has tightened its current policies and procedures by implementing a quality assurance check to ensure that staff has recorded deficiencies in CHRON and is using Lender Oversight Committee (LOC) meetings to discuss systemic lender issues. Further, management stated that it has developed an Office of Capital Access (OCA) communication plan to ensure that systemic lender issues and loan deficiencies are recorded in CHRON. Management plans to complete final action on this recommendation by April 30, 2020. This recommendation can be closed when management provides the policies and procedures that implement the quality assurance check, the OCA communication plan as indicated in the response, minutes of the LOC meetings showing the discussion regarding lender deficiencies, and evidence that systemic lender issues and loan deficiencies are being communicated to the loan approval and purchase centers.

6. **Resolved.** Management agreed with our recommendation and plans to review the 21 loans to determine whether the lender corrected the deficiencies. If the deficiencies still exist, management will work with the lender to bring the loan into compliance. If the issues cannot be remedied, SBA will seek recovery of the guaranties. Management plans to complete final action on this recommendation by September 19, 2020. This recommendation can be closed when SBA provides evidence that the lenders corrected the deficiencies or that SBA recovered the appropriate amount from the lender.

Management also provided the technical comments, which are summarized below:

1. The report stated that CDCs are nonprofit organizations. However, the SBA portfolio includes five CDCs that are for profit.

2. The report stated that SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply with any material SBA loan program requirement. This statement should include "of a 7(a) loan."

3. The report stated, "We did not find evidence that OCRM had validated whether lenders had corrected the material deficiencies identified by the OCRM reviews on 21 of 32 loans." OCRM does not re-review loans that were examined during a lender review. OCRM does recognize the importance of communicating the deficiencies discovered during a loan file review to the appropriate loan approval and purchase centers by updating the CHRON.

We updated the report to address management's first two technical comments. Regarding the third technical comment, OCRM is tasked with overseeing SBA's lending partners to identify unacceptable risk profiles and enforce loan program requirements to improve and manage lender performance and mitigate the risk of financial loss. We reiterate our position that to ensure compliance and program integrity and to mitigate the risk of financial loss, OCRM must confirm whether lenders implement corrective actions.

Appendix I: Objective, Scope, and Methodology

Objective

Our audit objective was to determine whether SBA performed effective oversight of high-risk lenders to identify and mitigate risks.

Scope and Methodology

The scope of our audit included 427 high-risk lenders that OCRM identified in FYs 2015–2017. OCRM determined that these lenders represented the highest risk and warranted either full or targeted reviews, or safety and soundness examinations. To accomplish our audit objective, we:

- Reviewed applicable laws, regulations, and SBA SOPs, including 51 00 and 50 53(A). In addition, we reviewed OMB guidance on internal controls and federal programs, and the GAO's Standards for Internal Control in the Federal Government. Further, we reviewed various SBA procedural and information notices related to SBA's oversight of high-risk lenders and other relevant criteria.

- Interviewed SBA personnel responsible for managing the oversight activities of SBA's high-risk lenders, independent contractors that conducted high-risk lender reviews, and SBA personnel in its loan approval and purchasing centers to gain an understanding of their roles and responsibilities.

- Judgmentally selected 33 of 402 high-risk lender reviews OCRM completed in FYs 2015–2017. We reviewed the oversight reports for these 33 reviews to analyze review results and OCRM's actions and identify systemic lender issues and material loan deficiencies.

- Analyzed 338 of 1050 loans that OCRM assessed during their high-risk lender reviews and found deficiencies to determine if SBA purchased any of these loans. We identified 76 7(a) loans SBA purchased as of September 30, 2018. We assessed all 76 loans to determine whether OCRM communicated the identified deficiencies to the appropriate loan centers to inform proactive portfolio management.

- Reviewed the corrective actions and lender responses for 32 of 76 purchased loans with material deficiencies to determine whether OCRM ensured the lenders implemented corrective actions.

- Reviewed SBA's loan accounting system to determine whether any of the 76 purchased loans had a repair or denial of the guaranty.

We conducted this 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 computer-processed data provided by the SBA program and OCRM officials. We also obtained loan data from SBA's Mainframe Loan Accounting System to analyze the loans in our sample. Previous OIG engagements have verified that the information maintained in the Mainframe Loan Accounting System is reasonably reliable. In addition, we conducted reliability tests by comparing the computer-processed data submitted by program officials to source documentation and determined it was reasonably reliable. As a result, we believe the information obtained and used for the purposes of this audit is reliable.

Review of Internal Controls

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. According to OMB, agencies are responsible for establishing and maintaining internal controls to achieve the objectives of effective and efficient operations. We identified internal control weaknesses in SBA's oversight of high-risk lenders. We found that SBA did not always (1) conduct planned high-risk lender reviews that could have identified and corrected performance issues, (2) recommend adequate and consistent risk mitigation actions that could have rectified issues and mitigated SBA's risk of loss, or (3) communicate lender review results to loan centers that could have prevented improper approvals and purchases. We made recommendations in this report to address these internal control weaknesses.

Appendix II: Questioned Costs

Table 2. OIG Schedule of Questioned Costs[16]

Description	Amount[17]	Explanation
1. Inadequate Documentation	$111,717	(1) Cancellation of guaranty from secondary market due to incorrect origination method, (2) No copy of applicable promissory note for each Stand-by agreement in the file, (3) No evidence of updated hazard insurance, (4) Packaging fee greater than $2,500 not itemized on Form 159
2. Inadequate Documentation	$112,270	(1) No copy of applicable promissory note for each standby agreement in the file, (2) No evidence of updated hazard insurance, (3) Packaging fee greater than $2,500 not itemized on Form 159
3. Inadequate Documentation	$55,478	Assignment of lease and landlord's waiver not in loan file
4. Inadequate Documentation	$844,506	Loan size exceeded the $5 million loan size standard
5. Inadequate Documentation	$142,852	Pro Forma Balance Sheet overstated liquidity
6. Inadequate Documentation	$185,205	(1) No evidence of equity injection verification in file, (2) No evidence of flood determination in file, (3) No evidence of hazard insurance in the file, (4) Assignment of lease and landlord's waiver not in loan file
7. Inadequate Documentation	$3,759,242	Lender's analysis of collateral was deficient
8. Inadequate Documentation	$1,944,564	(1) No evidence that borrower met credit elsewhere test, (2) No evidence of a flood determination in file
9. Inadequate Documentation	$113,625	(1) Loan authorization did not correctly indicate the Eligible Passive Company/Operating Company loan structure, (2) Credit memo did not agree with loan authorization, (3) Prohibited loan closing/processing fees charged
10. Inadequate Documentation	$1,401,833	Loan file did not have a copy of the franchise agreement in effect at the time of closing
11. Inadequate Documentation	$344,167	No copy of applicable promissory note for the standby agreement in the file
12. Inadequate Documentation	$609,413	Missing Eligible Passive Company/Operating Company lease agreement
13. Inadequate Documentation	$122,528	Landlord waiver not in the file
14. Inadequate Documentation	$10,491	Franchise eligibility not established
15. Inadequate Documentation	$2,771,643	(1) No evidence lender conducted an analysis of projections, (2) No discussion of capital adequacy
16. Inadequate Documentation*	$122,517	(1) Credit elsewhere statement was insufficient, (2) Credit memo had inconsistencies that should have been questioned by the lender, (3) Lender failed to liquidate loan in commercially reasonable manner

[16] Questioned costs are expenditures that are not supported by adequate documentation at the time of the audit or otherwise do not comply with legal, regulatory, or contractual requirements.
[17] The amount represents SBA's guaranty payment. Proceeds from the liquidation process after SBA's guaranty payment may have reduced SBA's share of the loan losses. The amount does not include any proceeds received by SBA after guaranty payment.

Description	Amount[17]	Explanation
17. Inadequate Documentation	$83,341	(1) Credit memo and loan authorization did not align, (2) No evidence of updated hazard insurance in the lender's file, (3) Inconsistent information on form 912 and credit memo.
18. Inadequate Documentation	$419,931	(1) Lender failed to check/clear agent in SAM, (2) Liquidation actions not documented in the loan file, (3) Inadequate repayment ability assessment
19. Inadequate Documentation	$126,566	(1) Inadequate assurance of repayment ability, (2) Packaging fee greater than $2,500 not itemized on form 159
20. Inadequate Documentation	$25,125	No evidence that borrower met credit elsewhere test
21. Inadequate Documentation	$6,546	No evidence that borrower met credit elsewhere test
Total Questioned Costs	**$13,313,560**	

Source: Generated by OIG based on OIG's analysis of loan and corrective actions information.
* One of the 21 loans was approved by SBA, which could prevent recovery from the lender.

SBA RESPONSE TO AUDIT REPORT

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

TO:	Hannibal M. Ware, Inspector General Office of Inspector General (OIG)
THRU:	William Manger Associate Administrator, Office of Capital Access
FROM:	Susan Streich Director, Office of Credit Risk Management
SUBJECT:	Response to Draft Report entitled "Audit of SBA's Oversight of High-Risk Lenders"
DATE:	October 17, 2019

Thank you for providing the Office of Capital Access (OCA) the opportunity to respond to OIG's Draft Report entitled, "SBA's Oversight of High-Risk Lenders (Project Number 18006), dated September 20, 2019. OIG's audit objective for this report was to determine whether SBA performed effective oversight of high-risk lenders to identify and mitigate risk during the period Fiscal Years 2015 - 2017.

The Office of Credit Risk Management (OCRM) has the following comments with respect to the recommendations:

Recommendation 1 – SBA Agrees

Develop and implement policies and procedures to document OCRM's justification for (1) not conducting planned reviews and (2) identifying and prioritizing additional lenders for review.

OCRM agrees with the recommendation and will include the recommended changes in SOP 51 00, when it is next amended.

We believe it is important to note that the OCRM review plan is only a guide; it allows flexibility so that changes can be made as new risk patterns arise among lenders and in the portfolio. As OCRM gathers additional information throughout the year, changes may be required to address newly-identified areas of risk. As a result, some of the planned reviews for FY 2015 – 2017 were not conducted and other, more urgent reviews were performed in their place. Moreover, the overall number of reviews conducted for FY 2015-2017 exceeded the number of originally planned reviews. In fact, OCRM performed nearly 13% more reviews than initially planned. The result was more effective lender monitoring and oversight.

Recommendation 2 – SBA Agrees

Develop and implement a comprehensive database to manage its oversight of high-risk lenders to ensure performance of all planned reviews, implementation of risk mitigation actions, and identification of noncompliant lender and systemic material loan deficiencies.

OCRM agrees with this recommendation. OCRM is working with the Office of Performance Systems Management (OPSM) to identify and evaluate database and other technology solutions to facilitate its oversight of lender participants.

Recommendation 3 – SBA Agrees

Develop and implement policies and procedures to provide clear and specific guidance to analysts regarding the appropriate corrective and enforcement actions for identified lenders and loan deficiencies to ensure analysts recommend appropriate and consistent corrective and enforcement actions.

OCRM agrees with this recommendation. It is important for corrective and enforcement actions to be appropriate and consistent given the particular compliance or performance issues being addressed. It is also important that SBA guidance regarding such actions be sufficiently flexible to address various types of circumstances. OCRM will include policies and procedures to address this recommendation when SOP 50 53 is amended.

Recommendation 4 – SBA Agrees

Conduct periodic overall assessments of the high-risk lender review results and recommended risk mitigation actions to ensure analysts recommend appropriate and consistent corrective and enforcement actions.

OCRM agrees with this recommendation. OCRM will conduct periodic assessments of high-risk lender review results and recommended risk mitigation actions to ensure analysts recommend appropriate and consistent corrective and enforcement actions.

Recommendation 5 – SBA Agrees

Develop and implement policies and procedures that require OCRM to communicate systemic lender issues and material loan deficiencies to the appropriate SBA loan approval and purchase centers to facilitate proactive portfolio management and to mitigate the risk of improper guaranty purchases in the event of default.

OCRM agrees with this recommendation. It is OCRM's current practice to document loan deficiencies utilizing the CHRON, an electronic, chronological and historical record of actions taken on a specific loan which is part of the Capital Access Financial System (CAFS). This system is accessible only to SBA employees, is tied to the individual loan number, and is commonly utilized by the loan approval and purchase centers. OCRM has already tightened its policies and procedures by implementing a quality assurance check to test completed reviews to ensure the staff has utilized the CHRON to communicate identified loan deficiencies. OCRM also uses the Lender Oversight Committee (LOC) meetings to provide updates on systemic lender-related issues on a quarterly basis. OCRM will continue to ensure its policies and procedures for communication on lender issues will mitigate the risk of improper guaranty purchases in the event of a default. In addition, an OCA-wide Communication Plan, including OCRM, the Office of Financial Program Operations (OFPO), the Office of Performance Systems Management (OPSM) and the Office of Financial Assistance (OFA) has been developed that will ensure communication of systemic lender issues and material loan deficiencies to the loan approval and purchase centers.

Recommendation 6 – SBA Agrees

Determine whether the lenders corrected the deficiencies on the 21 loans purchased for a total of $13.3 million. If not, require the lenders to bring the loans into compliance or, if not possible, seek recovery of the guaranty paid by SBA from lenders.

OCA agrees and will review the 21 loans purchased to determine if the lenders corrected the deficiencies. If deficiencies still exist, OCA will notify the lenders and work with them to obtain documentation to bring the loans into compliance. If the issues are not overcome, OCA will seek recovery from the lenders.

Thank you for giving OCRM the opportunity to comment on OIG's draft report, "Audit of SBA's Oversight of High-Risk Lenders" (Project 18006) and for taking OCRM's comments into consideration.

<u>Addendum to Memorandum</u> - *Response to Draft Report entitled, "Audit of SBA's Oversight of High-Risk Lenders"*

Technical Comments

1. Page 1, paragraph 1 –
    - OIG stated: CDCs are non-profit organizations.
      Note: The SBA portfolio includes five CDCs that are for profit.

2. Page 1, paragraph 2 –
    - SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply with any material SBA loan program requirement.
      Insert: "of a 7(a) loan" - SBA is released from liability on the guaranty of a 7(a) loan, in whole or in part, if the lender fails to comply with any material SBA loan program requirement.

3. Page 4, paragraph 3 –

- OIG stated, "We did not find evidence that OCRM had validated whether lenders had corrected the material deficiencies identified by the OCRM reviews on 21 of 32 loans."
  Note: OCRM does not re-review loans that were examined during a lender review. OCRM does recognize the importance of communicating the deficiencies discovered during a loan file review to the appropriate loan approval and purchase centers by updating the CHRON.