SBA INSPECTOR GENERAL AUDIT REPORT

AUDIT OF THE SBA'S COMMUNITY ADVANTAGE PILOT PROGRAM

REPORT NUMBER 20-08 | MARCH 18, 2020

Executive Summary

Audit of SBA's Community Advantage Pilot Program

Report No. 20-08

March 18, 2020

What OIG Reviewed

This report presents the results of our audit of the Small Business Administration's (SBA's) Community Advantage (CA) pilot program. The CA pilot began in February 2011, under the 7(a) loan program, to expand access to capital in underserved markets. The pilot provides access to 7(a) loan guaranties as high as 85 percent for loans up to $150,000 and 75 percent for loans over $150,000, up to $250,000. SBA designated underserved markets as Low-to-Moderate Income (LMI) communities, businesses where more than 50 percent of the full-time workforce is low-income or resides in LMI census tracts, Empowerment Zones and Enterprise Communities, HUBZones, new businesses, businesses eligible for SBA Veterans Advantage, and Promise Zones.

Our objectives were to determine if SBA's CA pilot program expanded capital to benefit small businesses in underserved markets and if SBA established internal controls to mitigate the risk of loss. To answer our objectives, we interviewed SBA officials; reviewed applicable regulations, policies, procedures, and guidance; and analyzed CA and 7(a) loan data. Our scope was fiscal years (FYs) 2011 through 2018.

What OIG Found

SBA's CA pilot program increased the number of lenders participating in SBA's 7(a) loan program by approving 137 CA lenders. However, opportunities exist for SBA to enhance the program to ensure it effectively expands capital to benefit small businesses in underserved markets. The CA pilot was duplicative of the 7(a) loan programs, charged higher interest rates than non-CA 7(a) loans, and the management and technical assistance (M&TA) provided was limited and did not mitigate the risk of loss. As a result, CA borrowers in the underserved markets are projected to pay about $49.4 million more than they would have for the non-CA 7(a) loans, and loans with M&TA performed worse than those loans without M&TA.

We determined that all the borrowers for CA loans in our scope were also likely eligible for 7(a) loans. Additionally, CA lenders only provided M&TA on 34 percent of CA loans and did not report complete M&TA information. Also, loans with M&TA had a default rate of 15 percent, while the loans without M&TA had a default rate of 13.5 percent.

Further, we determined that the default rate for CA loans approved between FYs 2011 and 2016 exceeded 14 percent. Over the same period, the default rate for similarly sized non-CA 7(a) loans was 8.7 percent.

Lastly, while SBA generally established internal controls to mitigate the risk of loss, it did not always monitor and mitigate identified risk timely. SBA's 2015 CA performance analysis found that loans with Small Business Scoring Service (SBSS) scores below 140 increased risk to the CA pilot. However, SBA did not conduct additional analyses on the CA loan performance based on SBSS scores until 2018. During this time lapse, 35 loans with SBSS scores under 140 were approved and later defaulted. SBA purchased these defaulted loans for about $2.1 million. We question about $51.5 million, which include the reasonableness of the $49.4 million in projected cost and the $2.1 million SBA guaranty purchases.

OIG Recommendations

We made six recommendations, which include evaluating options to facilitate the program's ability to effectively expand access to capital in underserved markets, strengthening controls, reducing the burden on CA borrowers, and improving the quality of loans.

Agency Response

Management agreed with recommendations 1, 2, and 6; partially agreed with 4 and 5 and disagreed with recommendation 3. Management's planned actions, which are discussed in the report resolved recommendations 1, 2, and 6. Its proposed actions for 4 and 5 did not fully address the recommendations and we did not reach resolution on recommendation 3. In accordance with our audit follow-up policy, we will attempt to reach agreement with management on the three unresolved recommendations. If not, we will notify the audit follow-up official of the disputed issues.

Office of Inspector General
U.S. Small Business Administration

Final Report Transmittal
Report Number: 20-08

DATE: March 18, 2020

TO: Jovita Carranza
Administrator

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: Audit of SBA's Community Advantage Pilot Program

This report presents the results of our audit of the Small Business Administration's Community Advantage pilot program. We considered management's comments on the draft of this report when preparing the final report. Management agreed with recommendations 1, 2, and 6; partially agreed with recommendations 4 and 5 and disagreed with recommendation 3.

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.

Cc: William Manger, Associate Administrator, Office of Capital Access
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John Miller, Deputy Associate Administrator, Office of Capital Access
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Table of Contents

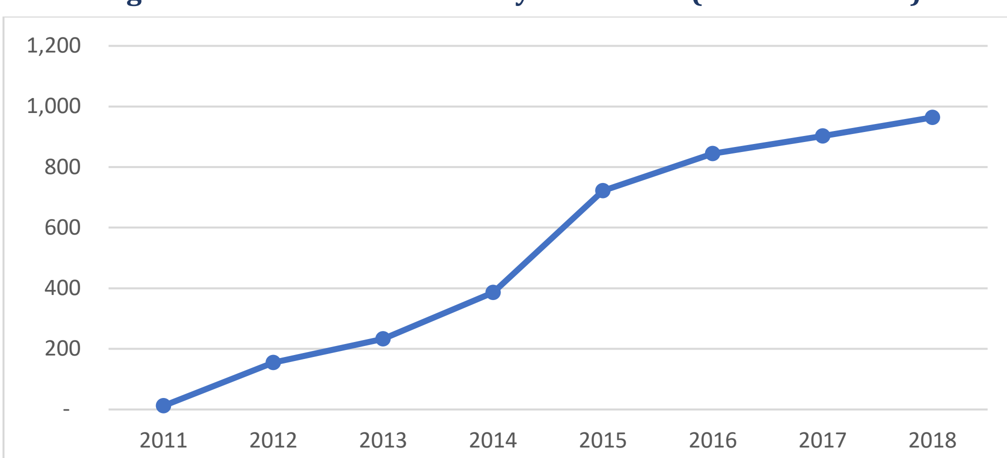
Introduction

The Small Business Administration (SBA) implemented its Community Advantage (CA) pilot program in February 2011. The goals for the pilot program are to increase access to credit for small businesses located in underserved areas; expand points of access to the SBA 7(a) loan program by allowing nontraditional, mission-oriented lenders to participate; provide management and technical assistance (M&TA) to small businesses as needed; and manage portfolio risk. The program provides 7(a) loan guaranties as high as 85 percent for loans up to $150,000 and 75 percent for loans over $150,000, up to $250,000.

While CA loans are in some ways similar to small 7(a) loans, there are distinct differences. For instance, CA loans do not allow revolving lines of credit, and lenders must maintain a minimum loan loss reserve account for their CA loan portfolio, have a maximum interest rate of prime+6, and encourage M&TA when appropriate. However, M&TA it is not required for each individual loan.

CA lenders are mission-oriented lenders, such as Community Development Financial Institutions, Certified Development Companies, and SBA microlenders, and are generally authorized to charge a higher interest rate than other lenders making similarly sized 7(a) loans. CA lenders are not eligible to participate in other 7(a) programs and are required to make at least 60 percent of their CA loans in underserved markets. SBA designated underserved markets as Low-to-Moderate Income (LMI) communities, businesses where more than 50 percent of the full-time workforce is low-income or resides in LMI census tracts, Empowerment Zones and Enterprise Communities, HUBZones, new businesses, businesses eligible for SBA Veterans Advantage, and Promise Zones. As this is a pilot program, SBA did not issue CA regulations. The policies and procedures for this program are outlined in the Community Advantage Participant Guide. For fiscal years (FYs) 2011 to 2018, CA lenders approved 4,906 loans totaling more than $648 million.[1] Additionally, the CA pilot program has significantly increased in volume with 64 percent of the loans being approved in the last 3 FYs. Specifically, in FYs 2016 through 2018, 3,149 CA loans were approved totaling $421 million, which represented a 79 percent increase in the number of loans and 85 percent increase in the approved amounts from the initial 5-year period total of 1,757 loans for $227 million. (See figure 1.)

Figure 1: Volume of CA Loans by Fiscal Year (FYs 2011–2018)

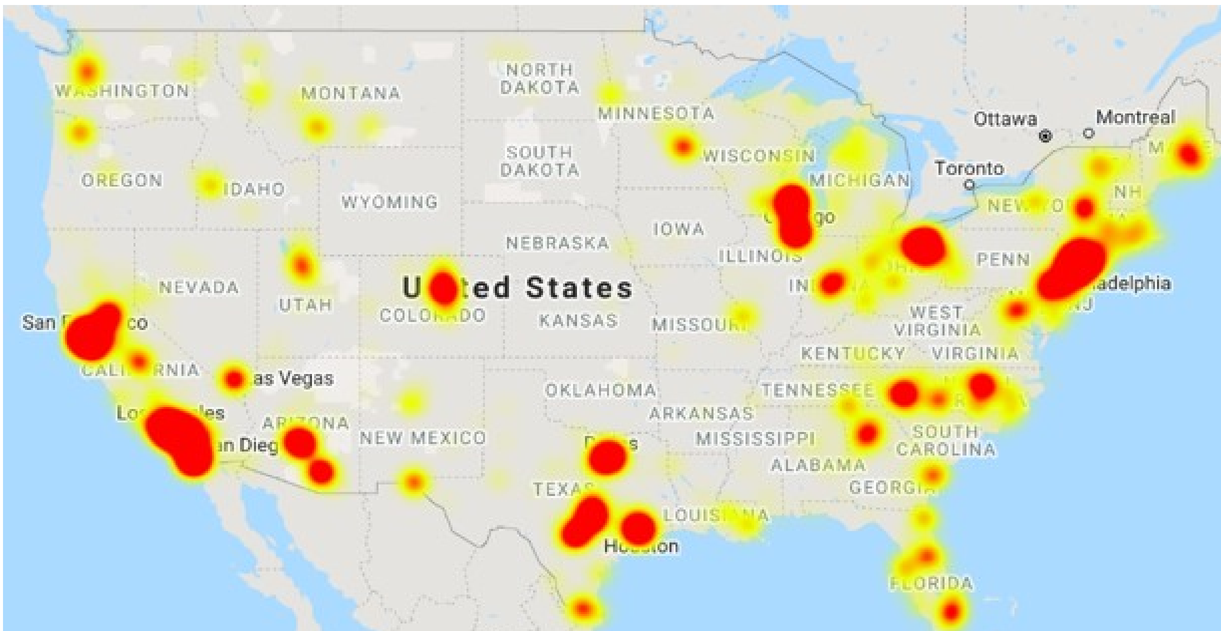


Source: SBA's Mainframe Loan Accounting System.

[1] As of March 31, 2019, 4,218 of the 4,906 loans had been disbursed to the borrowers.

The 4,906 CA loans approved between FYs 2011 and 2018 were made to borrowers in 49 states. However, the distribution of CA loans was heavily concentrated to a limited number of states. Specifically, 2,858 of the 4,906, or 58 percent, of the approved CA loans were made in California, Texas, New York, Ohio, and New Jersey. In comparison, only 34 percent of similarly sized non-CA 7(a) loans during the same period were made in these states. The 10 states with the highest concentration of CA loans received nearly 76 percent of the loan volume compared to less than 48 percent concentration in the 10 states on similarly sized non-CA 7(a) loans. (See figure 2.)

Figure 2: Heat Map of CA Loan Distribution (FYs 2011–2018)



Source: Heat map developed by OIG based on data from SBA's Mainframe Loan Accounting System.

In FY 2018, SBA conducted an analysis on the performance of CA loans versus similarly sized 7(a) loans that focused on the cumulative purchase rate for defaulted loans instead of default performance.[2] For CA loans, the cumulative purchase rate for defaulted loans purchased between FYs 2011 and 2015 was 6.3 percent. For similarly sized 7(a) loans and 7(a) loans to specific underserved markets, the cumulative purchase rate for defaulted loans was between 2.6 percent and 2.8 percent.

Based on this assessment, SBA implemented changes to the CA pilot program for FY 2019. For example, SBA restricted new lenders from entering the program, increased the loan loss reserve requirements for CA loans sold on the secondary market, and increased the minimum acceptable credit score for CA loans from 120 to 140. SBA extended the pilot program through September 2022 to identify the impact of these changes.

Prior Work

OIG report 10-12, Assessment of the Community Express Pilot Loan Program, identified significant deficiencies with the program's effectiveness in increasing loans to new market groups and

[2] SBA defines cumulative purchase rate as all purchases of defaulted loans from loans approved in the same fiscal year, divided by all disbursement dollars of loans approved in that same fiscal year.

highlighted the high purchase and charge-off rates. While intended to increase loans to new market groups, between FYs 2000 and 2008, Community Express loans comprised only 12 percent of the growth in overall loan volume and 6 percent of loan dollars disbursed to new market groups. In comparison, other 7(a) programs made 88 percent of the loan growth and 94 percent of the dollars disbursed to new market groups. The recommendations were not implemented because SBA terminated the Community Express pilot loan program on April 30, 2011.

Objectives

Our objectives were to determine if SBA's Community Advantage pilot program expanded capital to benefit small businesses in underserved markets and if SBA established internal controls to mitigate the risk of loss.

Finding 1: Community Advantage Pilot Program Increased Lender Participation but Opportunities Exist to Effectively Expand Capital to Underserved Markets

We determined that SBA's CA pilot program increased the number of lenders participating in SBA's 7(a) loan program; however, opportunities exist for SBA to enhance the program to effectively expand capital to benefit small businesses in underserved markets. Specifically, the CA pilot was duplicative of the 7(a) loan programs, charged higher interest rates than non-CA 7(a) loans, and the M&TA was limited and did not mitigate the risk of loss. As a result, CA borrowers in the underserved markets are projected to pay about $49.4 million more than they would have for the non-CA 7(a) loans and loans with M&TA performed worse than those loans without M&TA. In addition, the CA pilot program loan portfolio has exhibited more risk than similarly sized 7(a) loans. We determined that the default rate for CA loans approved between FYs 2011 and 2016 exceeded 14 percent.[3] Over the same period, we determined that the default rate for similarly sized non-CA 7(a) loans was 8.7 percent.

From FY 2011 to FY 2018, SBA approved 137 lenders to participate in the CA pilot program. Also, concurrent with the implementation of the CA pilot program, SBA launched the Small Loan Advantage (SLA) initiative. SLA allowed existing preferred lenders to make 7(a) loans with basically identical terms as CA loans. However, the interest rates for the 7(a) loans under SLA were lower, and the lenders were not required to assess the borrowers' need or provide M&TA. Higher interest rates are restrictive in terms of providing access to capital. We determined that all the borrowers for CA loans in our scope were also likely to be eligible for SBA 7(a) loans. However, each lender is responsible for determining the level of qualification needed for loan approval. Additionally, CA lenders only provided M&TA on 34 percent of CA loans, and they did not report complete information regarding the type of assistance provided. Further, loans with M&TA performed worse than those loans without M&TA, with default rates of 15 percent and 13.5 percent, respectively.

The Community Advantage Pilot Program is Duplicative of Comparable 7(a) Loan Programs

Based on our comparative analysis, we found the CA pilot program was duplicative of SBA's non-CA 7(a) loan programs. (See table 1.)

Table 1: SBA 7(a) Loan Program Term Comparison

	Community Advantage	7(a) Small Loan†	Regular 7(a)	SBA Express
Maximum Loan Amount	$250,000	$350,000	$5,000,000	$350,000
Maximum SBA Guarantee Percentage	85% for loans up to $150,000, 75% for loans greater than $150,000‡	85% for loans up to $150,000 and 75% for loans greater than $150,000	85% for loans up to $150,000 and 75% for loans greater than $150,000	50%

[3] For the purposes of our analysis, we define the default rate as the number of defaulted loans in a given period, divided by all approved loans in that same period that have since disbursed. Defaulted loans represent those loans that were transferred to liquidation by the lender.

	Community Advantage	7(a) Small Loan†	Regular 7(a)	SBA Express
Maximum Variable Interest Rate (Loans $50,000 and Below)	Prime+6%	Prime+4.75%	Prime+4.75%	Prime+6.5%
Maximum Variable Interest Rate (Loans Greater than $50,000)	Prime+6%	Prime+2.75%	Prime+2.75%	Prime+4.5%
Maximum Maturity	25 years	25 years	25 years	25 years; Lines of credit limited to 5 years
Revolving Lines of Credit	No	No	No	Yes
Eligibility Determination	SBA or Delegated	SBA or Delegated	SBA or Delegated	Delegated

†The 7(a) Small Loan program was originally the SLA initiative.
‡The CA pilot allows for a 90 percent guarantee for international trade loans.

In addition, both CA and the 7(a) Small Loan program currently require a minimum acceptable credit score of 140. For CA loans with scores under the minimum score, the CA lender may contact SBA's 7(a) Loan Guaranty Processing Center (LGPC) with a full credit write-up for consideration. Previously, CA required a minimum acceptable score of 120.[4] We determined that less than 10 percent of the disbursed CA loans between FYs 2011 and 2018 received scores below 140. While these loans would not meet the minimum acceptable score for the 7(a) Small Loan program, a 7(a) lender could have made the loans by performing a full financial analysis of repayment ability. Based on the terms presented above and our review of SBA requirements, we concluded that the majority of borrowers for CA loans in our scope were also likely eligible for SBA non-CA 7(a) loans. Further, the borrowers representing the less than 10 percent of CA loans with scores less than 140 were also likely eligible for non-CA 7(a) loans, which would have required additional financial analysis. We found that opportunities exist for SBA to enhance the CA program to effectively expand capital to borrowers in underserved markets for new businesses, HUBZones, and veterans.

New Businesses: 54 percent (2,259 of 4,218) of CA loans under $250,000 were made to new business or start-ups, compared to the 34 percent (86,579 of 252,584) of non-CA 7(a) loans under $250,000. While the percentage shows that most of the CA loans were made to new businesses, the number of new business loans made under the 7(a) program was far greater than those made under the CA program. The CA loans to new businesses only represented 3 percent of similarly sized 7(a) loans to new businesses. Additionally, we found these borrowers were also eligible for existing 7(a) loans that offered lower interest rates. Further, with an average of over 10,000 non-CA 7(a) new business loans for under $250,000 funded every year, we do not believe that borrowers who only meet the new business definition should be considered underserved.

[4] SBA established the use of the SBSS score in the CA pilot on October 1, 2014. The minimum credit score for CA loans was 120. Effective October 1, 2018, SBA increased the minimum credit score to 140.

HUBZones: 10 percent of CA loans were made to businesses operating in HUBZones, compared to 18.2 percent of all non-CA 7(a) loans under $250,000. The Office of Capital Access (OCA) began geocoding HUBZones in FY 2017; therefore, we only analyzed data for FYs 2017 through 2018. Overall, 197 CA loans were made to businesses operating in HUBZones during these 2 years, compared to 12,279 7(a) loans. The CA loans to businesses operating in HUBZones only represented 2 percent of similarly sized loans to HUBZones.

Veterans: 7 percent of CA loans were made to veterans, compared to 5.3 percent of all non-CA 7(a) loans under $250,000, between FYs 2011 and 2016. The data shows that there were more CA loans made to veterans; however, we found that these veterans were also eligible for the existing similar 7(a) loans that offered lower interest rates. We also noted performance issues on these CA loans to veterans when compared to the 7(a) loans. For FYs 2011 through 2016, the CA loans to veterans defaulted at a 18 percent rate, compared to the 10 percent default rate for non-CA 7(a) loans under $250,000.

We were unable to analyze the impact of the CA program for the remaining underserved markets because loan level data was not available prior to the implementation of the CA pilot program for these underserved markets. Further, the underserved market data was not fully tracked on CA loans until FY 2014 when the CA addendum was made electronic. This addendum is only collected for CA loans. Additionally, some of the underserved markets did not have a sufficient number of loans for reliable analysis. For example, of the 4,906 approved CA loans in our scope, only 14 were for underserved borrowers in Promise Zones.

SBA officials indicated that while CA borrowers could meet all the 7(a) eligibility requirements, they may not be deemed qualified for a 7(a) loan by a traditional 7(a) lender because each lender is responsible for determining what level of qualification is needed for loan approval. Additionally, in responding to our CA lender survey, 27 of 55 CA lenders indicated that they believed they had more flexibility to approve loans that 7(a) lenders would not approve based on their individual credit requirements. SBA does not require CA borrowers to apply for or be denied a 7(a) loan prior to applying for a CA loan. Therefore, the data to corroborate these statements is limited. We recognize there is some merit to these statements; however, based on our reviews and prior audits of 7(a) loans, we believe that many of the borrowers that received CA loans could also have received 7(a) loans at a significantly reduced cost.

Community Advantage Loans Interest Rates Were Higher, Resulting in an Additional $49 Million in Projected Costs to the Underserved Borrowers

On December 16, 2011, after the approval of only 28 CA loans, SBA changed the maximum ceiling interest rate from prime+4 to prime+6.[5] Per SBA standard operating procedures, regular 7(a) interest rates range from prime+2.75 to prime+4.75.[6] According to OCA, the increased interest rate aligned with the low end of commercial rates and was comparable to SBA Express and microloan rates. As a result, CA borrowers' monthly payments were significantly higher than the monthly payments for similarly sized non-CA 7(a) loans, and the projected cost was $49.4 million more than the projected cost for non-CA 7(a) loans. We question the reasonableness of the underserved borrower bearing an addition $49.4 million in projected cost. See Appendix II for projected cost details.

[5] Community Advantage Participant Guide, December 2011.
[6] SOP 50 10 5 (Various), Lender and Development Company Programs.

To determine this projected cost, we compared monthly payments based on the maximum 7(a) loan interest rates to actual rates being paid on CA loans and found that CA borrowers' monthly payments were significantly higher. (See table 2 for examples of the monthly payments and additional projected interest.)

Table 2: Examples of Monthly Payments and Interest Rate Cost

Example Number	Loan Amount	CA Monthly Payment	7(a) Monthly Payment	Total Term CA Interest	Total Term 7(a) Interest	Additional Interest Cost to Borrower
1	$250,000	$2,055	$1,649	$366,608	$244,752	$121,856
2	$150,000	$1,390	$1,060	$266,872	$168,051	$98,822
3	$198,100	$1,765	$1,496	$529,602	$448,893	$80,709
4	$250,000	$1,930	$1,688	$578,862	$506,406	$72,456
5	$217,500	$1,643	$1,401	$492,852	$420,408	$72,444
6	$222,000	$1,825	$1,605	$547,548	$481,389	$66,159
7	$195,000	$2,066	$1,699	$371,837	$305,759	$66,078
8	$225,000	$1,917	$1,645	$460,116	$394,702	$65,414
9	$250,000	$1,971	$1,767	$591,339	$530,085	$61,254
10	$250,000	$1,807	$1,611	$542,106	$483,225	$58,881

For several underserved borrowers, the burden of the variance in the payments was substantial and likely contributed to the default on their CA loans. The borrowers presented in table 3 represent examples of underserved borrowers whose CA loans defaulted.

Table 3: Examples of Interest Rate Impact on Defaulted Underserved Borrowers

Loan Amount	CA Monthly Payment	7(a) Monthly Payment	Increased Monthly Payment Percentage	Months From Initial Disbursement to Default
$250,000	$1,943	$1,710	13.7	27
$250,000	$3,201	$2,807	14.0	25
$213,506	$1,857	$1,684	10.3	32
$250,000	$3,100	$2,776	11.7	31
$140,000	$1,281	$1,099	16.5	33

Source: OIG analysis of SBA's Mainframe Loan Accounting System.

Overall, 4,119 of the 4,906 loans approved between FYs 2011 and 2018 received interest rates that exceeded the maximum non-CA 7(a) loan interest rates, resulting in about $49.4 million in projected cost to the borrowers. It is important to note that not all CA lenders charged the maximum interest rate of prime+6. The average interest rate on the 4,119 loans was prime+4.4.

Table 4: Interest Rate Impact of CA Rates Compared to Regular 7(a)

Number of CA Loans	CA Loans With Interest Rates Exceeding the Maximum 7(a) Interest Rate	Additional Projected Interest Cost to Borrowers
4,906	4,119	$49,394,358

As indicated in SBA's CA pilot origination documentation, in order to charge prime+4 or higher, SBA had to waive existing regulations. SBA management at the time indicated that the pricing aligned with the low end of commercial rates in the size range for borrowers likely to fit the CA profile. Additionally, they indicated that the rate change was comparable to SBA Express rates and microloans. However, we determined that generally, interest rates for 7(a) loans below $250,000, excluding SBA Express, would be limited to prime+2.75, which is less than the CA interest rate.[7]

Management and Technical Assistance Was Limited and Did Not Mitigate the Risk of Loss

Based on our analysis, only 34 percent of CA loans that were disbursed between FYs 2011 and 2018 received M&TA. Of the loans that indicated the borrower was provided M&TA, nearly half received the assistance from outside resource partners, not the CA lender. These resource partners included women's business centers, small business development centers, and SCORE.

Additionally, 8.7 percent of the loans that received M&TA did not contain information to identify the type of assistance provided. SBA encourages M&TA for CA loans when appropriate; however, it is not required for each individual loan. Also, SBA requests information regarding whether lenders provided M&TA and the type of assistance provided via its CA addendum.[8] The following supplemental fields were available for the lenders to document the type of technical assistance provided:

- One-on-one counseling (<3 hours, 3–5 hours, or >5 hours)
- Telephone counseling (<3 hours, 3–5 hours, or >5 hours)
- Web-based tutorials (<3 hours, 3–5 hours, or >5 hours)
- Group training (<3 hours, 3–5 hours, or >5 hours)

The lack of M&TA and incomplete reporting of the type of M&TA provided occurred in part because CA lenders had limited experience in SBA 7(a) lending. Additionally, SBA did not require lenders to provide M&TA and did not provide criteria for lenders to use in assessing the technical assistance needs of borrowers. Per SBA requirements, in order to become CA lenders, the lenders are not allowed to participate in the other 7(a) programs. Further, our survey of CA lenders indicated that some CA lenders felt they did not receive adequate initial or recurring training from SBA.

As a result, the loans where borrowers received M&TA defaulted at a rate higher than those that did not receive M&TA. Specifically, loans approved between FYs 2011 and 2016 that received M&TA had a 15 percent default rate, compared to a 13.5 percent default rate on loans that did not receive M&TA. Further, SBA is unable to determine which types of M&TA best meet the needs of the borrowers and the corresponding impact on loan performance.

A prior audit of the Community Express pilot program identified significant deficiencies in lenders providing the required M&TA. To differentiate the CA pilot program from its predecessor, SBA decided to give CA lenders the ability to determine if they should provide M&TA to CA borrowers. Lastly, SBA did not require lenders to complete the supplemental fields indicating the quantity and type of M&TA provided to borrowers. The initial SBA Form 606 for the establishment of the pilot indicated that SBA recommended that the Community Express program expire and be replaced

[7] Due to significant differences between CA and the SBA Express programs, we excluded the SBA Express rates from our analysis. Express rates exceed the CA and standard 7(a) rates for loans under $50,000 based on the lender bearing more risk due to the significantly lower guarantee. See table 1 for additional comparison.
[8] Community Advantage Participant Guide, December 2011.

with a product for community-oriented, mission-oriented lenders, such as Community Development Financial Institutions, Certified Development Companies, and SBA microlenders. SBA stated that data from the mission-oriented lending sector indicated that they have figured out how to successfully blend higher-touch underwriting with appropriate M&TA and servicing flexibility.

SBA believed M&TA was a primary benefit of the CA pilot program. However, because SBA did not provide the inexperienced lenders guidance to assess the M&TA needs of borrowers or require that M&TA be provided for each loan, the perceived benefits were not realized.

The Community Advantage Pilot Loan Portfolio Exhibited More Risk Than Comparable 7(a) Loans

Since its inception, the CA pilot program loan portfolio has exhibited more risk than similarly sized 7(a) loans. Our analysis determined that the default rate for CA loans approved between FYs 2011 and 2016 exceeded 14 percent. Over the same period, we determined that the default rate for similarly sized non-CA 7(a) loans was 8.7 percent. Specifically, 330 of the 2,352 disbursed CA loans that were approved between FYs 2011 and 2016 defaulted. In comparison, 16,010 of the 184,984 disbursed similarly sized non-CA 7(a) loans defaulted.

In FY 2018, SBA conducted an analysis on the performance of CA loans versus similarly sized 7(a) loans that focused on the cumulative purchase rate for defaulted loans instead of default performance.[9] For CA loans the cumulative purchase rate for defaulted loans purchased between FYs 2011 and 2015 was 6.3 percent. For similarly sized 7(a) loans and 7(a) loans to certain underserved markets, the cumulative purchase rate for the defaulted loans was between 2.6 percent and 2.8 percent.

Based on this assessment, SBA implemented changes to the CA pilot program for FY 2019. For example, SBA restricted new lenders from entering the program, increased the loan loss reserve requirements for CA loans sold on the secondary market, and increased the minimum acceptable credit score for CA loans from 120 to 140. SBA extended the pilot program through September 2022 to identify the impact of these changes. Based on the timing of the noted changes occurring after our scope period, we were unable to assess the impact of the changes.

Recommendations

We recommend the Administrator to direct the Associate Administrator of Office of Capital Access to:

1. Evaluate options that facilitate the Community Advantage pilot program's ability to effectively expand access to capital in underserved markets.

2. Evaluate whether it is feasible to align the maximum interest rates charged under the CA pilot program with comparable 7(a) program rates, excluding SBA Express.

3. Provide criteria to lenders to assist them with assessing the borrowers' M&TA needs.

[9] SBA defines cumulative purchase rate as all purchases of defaulted loans from loans approved in the same fiscal year, divided by all disbursement dollars of loans approved in that same fiscal year.

4. Establish methods to assess whether lenders have the expertise needed to provide M&TA to underserved borrowers and to address any lender deficiencies regarding M&TA.

5. Require lenders to complete the data fields related to the M&TA provided and enhance the annual CA performance analysis by including the evaluation of the performance associated with the various types of M&TA.

Finding 2: SBA Did Not Continue to Monitor Identified Risks to Ensure Timely Mitigation of the Risk of Financial Loss

We found that while SBA generally established internal controls such as quarterly desktop lender reviews, risk based on-site lender reviews, and comprehensive CA portfolio analysis to mitigate the risk of financial loss, it did not always monitor and mitigate identified risk timely. Specifically, we found that the 2015 CA performance analysis indicated that loans with Small Business Scoring Service (SBSS) scores below 140 increased risk to the CA pilot program. However, SBA did not conduct additional analysis on the CA loan performance based on SBSS scores until 2018. During this time lapse, an additional 35 loans with SBSS scores under 140 were approved and have since defaulted. SBA purchased these defaulted loans for about $2.1 million.

For CA pilot program loans approved between FYs 2014 and 2016, loans with SBSS scores of 140 and above had a cumulative default rate of 11.7 percent, compared to a cumulative default rate of 23.7 percent on loans with SBSS scores under 140. SBA officials stated that they did not have enough data in 2015 to make programmatic changes. We found that not only did SBA not make changes, but it also did not continue to monitor this risk. Specifically, SBA did not perform a CA analysis in FY 2016. In FY 2017, SBA performed an analysis, but it did not evaluate the performance of loans relative to SBSS scores.

This contributed to higher risk loans being approved until SBA made changes in October 2018. From December 2015 to the end of FY 2016, 83 loans were approved to borrowers with SBSS scores under 140. Of the 83 loans, 18 loans defaulted, which represented a default rate of 22 percent. From FY 2017 to June 2018, an additional 178 loans to borrowers with SBSS scores under 140 were approved. Of the 178 loans, 17 loans defaulted, which represented a default rate of 9.6 percent. We question SBA's guaranty purchases of these 35 defaulted loans totaling $2,078,586. See Appendix II for questioned cost details.

Effective October 1, 2018, SBA changed the minimum credit score for CA loans from 120 to 140. No CA loan scoring less than the minimum credit score can be processed using delegated authority. If a lender believed there were mitigating issues to justify the loan despite an unacceptable score, the lender may contact the LGPC with a full credit write-up for consideration.[10]

However, based on historical data, we found that approvals made by LGPC did not mitigate risk and defaults. The default rate of loans approved by the LGPC was higher than of those approved by CA lenders.[11] Specifically, between FYs 2011 and 2016, SBA-approved CA loans cumulative default rate was 15 percent. The cumulative default rate for loans approved by lenders with delegated authority was 12 percent.

Based on discussions with SBA officials, we believe that SBA did not conduct an analysis in 2016 because they performed an extensive performance analysis in FY 2015 and the CA program was a new pilot with limited volume. We were unable to determine why SBA's FY 2017 analysis did not evaluate the performance of loans relative to SBSS scores.

[10] Community Advantage Participant Guide, October 2018.

[11] Based on the scope of this audit, we did not conduct a review of the LGPC to determine why the loans approved at the LGPC defaulted at higher rate. However, we plan to monitor this matter and conduct additional audits as necessary.

Recommendation

We recommend the Administrator to direct the Associate Administrator of Office of Capital Access to:

6. Establish a process to periodically assess the performance of CA loans approved with SBSS scores under 140, to determine whether the recently implemented SBA approval requirement is adequately mitigating the risk of loss.

Analysis of Agency Response

Management provided formal comments that are included in their entirety in appendix III. Management agreed with recommendations 1, 2, and 6; partially agreed with recommendations 4 and 5 and disagreed with recommendation 3. Management's planned actions resolve three of the recommendations. In accordance with our audit follow-up policy, we will attempt to reach agreement with management on the three unresolved recommendations within 60 days after the date of this final report. If not, OIG will notify the audit follow-up official of the disputed issues.

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 and stated it will continue to evaluate options that facilitate the CA pilot program's ability to effectively expand access to capital to businesses located in underserved areas. The CA pilot program is addressing the goals, although SBA recognizes the pilot program portfolio risk remains a challenge. Management reiterated the report findings, stating CA loans significantly outpaced 7(a) loans for veterans and start-ups. They further stated historical data shows that the pilot program exceeded the program's requirement that 60 percent of the loans be in underserved areas. Between October 1, 2014 and December 31, 2019, 68 percent of the loans met this requirement. Further, management stated that effective October 1, 2018, SBA designated Opportunity Zones and Rural Areas as underserved areas for the program. This recommendation can be closed when management provides evidence that they conducted an analysis of the program, evaluated options to effectively expand access to capital in underserved areas, and provides the analysis with their conclusions and applicable action plan(s).

2. **Resolved.** Management agreed with our recommendation, stating they were evaluating the feasibility of aligning the maximum interest rates available to CA and non-CA 7(a) lenders on loans up to $250,000. This recommendation can be closed when management provides evidence that it evaluated the feasibility of aligning the interest rates and provides the justification to support its final decision.

3. **Unresolved.** Management disagreed with our recommendation, stating that it will continue to encourage CA lenders to provide M&TA when necessary, but M&TA is not a mandatory requirement. Management also stated each lender is responsible for determining the borrowers they will service and the level of risk they will take. Additionally, management stated that there is no single set of criteria that can be given to the lenders to assist them with assessing a borrower's M&TA needs. Further, management stated SBA reviewed the lender's capacity to provide M&TA and all CA lenders should have the ability to assess borrowers M&TA needs. However, our survey results for participating lenders showed that some lenders felt they did not receive adequate training regarding M&TA from SBA. Additionally, because these lenders were prohibited from participating in other SBA loan programs, they had limited experience in SBA lending. We identified these issues as contributing factors to CA loans where borrowers received M&TA defaulting at a rate higher than those that did not receive M&TA. To realize the perceived benefits of the M&TA, SBA should provide additional guidance to lenders to clarify how to effectively assess the borrowers M&TA needs. This recommendation can be closed when management provides evidence that they provided criteria to lenders to assist them with assessing the borrower's M&TA needs or an alternative solution to satisfy the intent of this recommendation.

4. **Unresolved.** Management partially agreed with our recommendation, stating OCRM feels that its review process is appropriate for determining whether the lender applicant has the requisite M&TA acumen to participate in the CA pilot. Management stated it does not agree to address any lender deficiencies as M&TA is not a mandatory requirement. Additionally, management stated contrary to the assertion in the report, it does not believe that M&TA is a primary benefit of the CA pilot program. However, in the CA pilot origination documentation, SBA indicated that M&TA is an important component of a successful underserved market lending program and established it as a goal in its CA Participant Guide. Thus, we believe that SBA intended M&TA to be a benefit for the borrowers. Also, without addressing lender deficiencies regarding M&TA, SBA may not be able to meet the intent of the pilot program and ensure the borrowers M&TA needs are being met to effectively mitigate the risk of default.

   This recommendation can be closed when management provides evidence that they conducted an analysis to assess whether active CA lenders have the experience needed to assess borrowers M&TA needs and provide a solution to address any lender deficiencies to ensure M&TA is effectively provided.

5. **Unresolved.** Management partially agreed with our recommendation, stating it would reiterate through training that lenders are required to complete the data fields related to M&TA on SBA Form 2449. Management also stated it would make completion of the data fields mandatory in the electronic system. Additionally, management stated it would include an evaluation of the performance associated with various M&TA types when it analyzes the performance of the CA pilot program. Further, management stated it did not believe meaningful conclusions could be drawn from comparing the performance of loans that received M&TA to those that did not receive M&TA because many other variables affect the loan.

   We agree that other factors could contribute to overall loan performance. However, we also believe that an assessment of the various types of M&TA provided could offer SBA vital information regarding the CA borrowers needs and the related impact on loan performance. SBA partnered with mission-oriented lenders that were focused on economic development in underserved markets as the primary participants of the program. They stated data showed these lenders had figured out how to blend higher touch underwriting with appropriate M&TA. Additionally, when requesting approval for the CA pilot, SBA requested a program with a strong M&TA component that would provide ease of access to the borrower, minimal tracking demands on the lender, yet be able to provide sufficient data to allow analysis of its impact.

   This recommendation can be closed when SBA provides evidence that it: (1) required CA lenders to complete data fields related to M&TA, (2) Required lenders to complete the data fields in the electronic system, and (3) evaluated the performance associated with the various types of M&TA.

6. **Resolved.** Management agreed with our recommendation, stating that OCRM would establish a process to periodically assess the performance of loans with SBSS scores below 140 to determine if the increase in the minimum acceptable credit score implemented October 1, 2018 is adequately reducing risk in this area. This recommendation can be closed when management provides evidence that it conducted periodic assessments of the performance of loans with SBSS scores below 140.

Appendix I: Objective, Scope, and Methodology

This report presents the results of our audit of SBA's Community Advantage pilot program. Our objectives were to determine if SBA's Community Advantage pilot program expanded capital to benefit small businesses in underserved markets and if SBA established internal controls to mitigate the risk of loss.

To accomplish our objectives, we reviewed Section 7(a) of the Small Business Act and Title 13, Part 120 of the Code of Federal Regulations. In addition, we reviewed various versions of SBA's standard operating procedures, informational notices, and procedural notices for policies and procedures related to the CA pilot program. We also reviewed CA pilot program guidance and documentation to gain an understanding of the internal controls. Further, we met with SBA officials to gain an understanding of SBA's role and responsibilities in the CA pilot program. Our scope of work covered FYs 2011 through 2018. For purposes of analysis, we used SBA disbursement and performance data as of March 31, 2019.

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 and data from the Office of Performance and Systems Management to conduct our analyses. Previous OIG engagements have verified that the information maintained in Mainframe Loan Accounting System is reasonably reliable. In addition, we conducted reliability tests by comparing the supplemental loan level data provided by the Office of Performance and Systems Management to source documentation and determined it was reliable for the purposes of this audit.

Review of Internal Controls

SBA's internal control systems standard operating procedure provides guidance on implementing and maintaining effective internal control systems, as required by OMB Circular A-123.[12] 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.[13] To assess internal controls during the audit, we assessed the control environment in which SBA reviewed and evaluated loans for the CA pilot program. We interviewed SBA officials with the responsibility over the CA pilot program and SBA officials involved with various aspects such as oversight and the purchase of defaulted loans from the CA pilot program. We made recommendations in this report to address the identified deficiencies.

[12] SOP 00 02, Internal Control Systems (January 1986).
[13] OMB Circular A-123, Management's Responsibility for Enterprise Risk Management and Internal Control (July 15, 2016).

Appendix II: Questioned Costs

Table 5: OIG Schedule of Questioned Costs†

Description	Number of Loans	Questioned Cost	Explanation
1. Additional Projected Interest Cost to Borrowers	4,119	$49,394,358	CA borrowers' monthly payments were significantly higher than the monthly payments for similarly sized non-CA 7(a) loans and the projected cost was $49,394,358 million based on the maximum 7(a) rates.
2. Loan Guarantees Paid on Low Scoring Loans	35	$2,078,586	(1) There were 261 loans that were initially approved with SBSS under 140 during the timeframe between the 2015 analysis to the 2018 analysis. (2) We found a total of 35 of these loans defaulted and were purchased by SBA for $2,078,586.
Total Questioned Cost		**$51,472,944**	

Source: OIG Generated from audit results.

† Questioned costs are expenditures that (1) do not comply with legal, regulatory, or contractual requirement; (2) are not supported by adequate documentation; or (3) are not generally recognized as ordinary, prudent, relevant, and/or necessary.

SBA RESPONSE TO AUDIT REPORT

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

TO: Hannibal M. Ware, Inspector General
Office of Inspector General (OIG)

THRU: William M. Manger, Jr.
Associate Administrator, Office of Capital Access

FROM: Dianna Seaborn
Director, Office of Financial Assistance

SUBJECT: Response to OIG's Draft Report entitled "Audit of SBA's Community Advantage Pilot Program"

DATE: March 6, 2020

Thank you for providing the Office of Capital Access (OCA) the opportunity to respond to OIG's Draft Report entitled, "Audit of SBA's Community Advantage Pilot Program" (Project Number 19008), dated February 7, 2020. OIG's audit objective for this report was to determine if SBA's Community Advantage (CA) pilot program expanded capital to benefit small businesses in underserved markets and if SBA established internal controls to mitigate the risk of loss.

We have the following comments with respect to the recommendations:

Recommendation 1 – SBA Agrees

Evaluate options that facilitate the Community Advantage pilot program's ability to effectively expand access to capital in underserved markets.

OCA will continue to evaluate options that facilitate the CA pilot program's ability to effectively expand access to capital to businesses located in underserved areas. The goals of the CA pilot program are to increase access to credit for small businesses located in underserved areas; expand points of access to the SBA 7(a) loan program by allowing nontraditional, mission-oriented lenders to participate; provide management training and technical assistance (M&TA) to small businesses as needed; and manage portfolio risk. The CA pilot program is addressing these goals, although SBA recognizes that pilot program portfolio risk remains a challenge.

In two of the three underserved areas the OIG measured, the CA pilot program significantly outpaced the comparable non-CA 7(a) program results. Specifically, 54% of CA loans were made to start-ups, compared to 34% of non-CA 7(a) loans under $250,000, and 7% of CA loans were made to veteran-owned small businesses, compared to 5.3% of non-CA 7(a) loans under $250,000. Furthermore, historical data shows that the pilot program is exceeding the program's requirement that 60% of the loans be in underserved areas; between October 1, 2014 and December 31, 2019, 68% of the loans in the program meet that requirement. In addition, SBA has expanded the definition of underserved areas over the past several years, when appropriate.

For example, SBA determined that additional need for capital existed in rural areas and Opportunity Zones and, effective October 1, 2018, SBA added these areas to the designated underserved markets for the CA pilot program.

Recommendation 2 – SBA Agrees

Evaluate whether it is feasible to align the maximum interest rates charged under the CA pilot program with comparable 7(a) program rates, excluding SBA Express.

OFA agrees with this recommendation and is evaluating the feasibility of aligning the maximum interest rates available to CA and non-CA 7(a) lenders on loans up to $250,000.

Recommendation 3 – SBA Disagrees

Provide criteria to lenders to assist them with assessing the borrower's M&TA needs.

OFA disagrees with this recommendation. SBA will continue to encourage CA lenders to provide M&TA when necessary, but M&TA is not a mandatory requirement for loans made under the CA pilot program. Further, each lender that participates in the CA pilot program is responsible for determining the borrowers they will service and the level of risk they will take. This is determined at a very local level based on the needs of the community being served. There is no single set of criteria that can be given to CA lenders to assist them with assessing a borrower's M&TA needs; it is up to each CA lender to determine how it will assess the M&TA needs of the prospective borrowers in the community. Finally, when evaluating applications to participate in the CA pilot program, SBA reviewed the lender's capacity to provide M&TA, either within the lender's organization or through outside resources. All CA lenders should have the ability to assess borrower M&TA needs.

Recommendation 4 – SBA Partially Agrees

Establish methods to assess whether lenders have experience needed to provide M&TA to underserved borrowers and to address any lender deficiencies regarding M&TA.

OFA partially agrees with this recommendation. As stated above in the response to Recommendation 3, when evaluating applications to participate in the CA pilot program, the Office of Credit Risk Management (OCRM) reviews the CA Lender's ability to provide M&TA either through its own personnel or through outside resources, as well as the M&TA history, and performance of the organization. OCRM feels that its review process is appropriate for determining whether the lender applicant has the requisite M&TA acumen to participate in the CA pilot. SBA does not agree, however, to address any lender deficiencies as M&TA is not a mandatory requirement of the CA pilot program. (Contrary to the assertion in the audit report, SBA does not believe that M&TA is a "primary benefit" of the CA pilot program.)

Recommendation 5 – SBA Partially Agrees

Require lenders to complete the data fields related to the M&TA provided and enhance the annual CA performance analysis by including the evaluation of the performance associated with the various types of M&TA.

OFA partially agrees with this recommendation. While M&TA is not a mandatory requirement of the CA Program, CA lenders are already required to complete the data fields related to any M&TA provided by completing the SBA Form 2449 CA Addendum. To the extent CA lenders are not fulfilling this requirement, SBA will reinforce the requirement through additional training of CA lenders. SBA will also make completion of the data fields mandatory in the electronic system. Finally, OFA agrees to include an evaluation of the performance associated with various M&TA types when it analyzes the performance of the CA pilot program. However, SBA does not believe that meaningful conclusions can be drawn from comparing the performance of loans that received M&TA to those that did not receive such assistance because many other variables affect loan performance.

Recommendation 6 – SBA Agrees

Establish a process to periodically assess the performance of CA loans approved with SBSS scores under 140, to determine whether the recently implemented SBA approval requirement is adequately mitigating the risk of loss.

OFA agrees with this recommendation. SBA's Office of Credit Risk Management will establish a process to periodically assess the performance of loans with SBSS scores below 140 to determine if the increase in the minimum acceptable credit score implemented October 1, 2018 is adequately reducing risk in this area.