EVALUATION REPORT

SBA's FY 2017 Progress in Reducing Improper Payments

MAY 15, 2018 **REPORT NUMBER 18-17**

EXECUTIVE SUMMARY

SBA'S FY 2017 PROGRESS IN REDUCING IMPROPER PAYMENTS

Report Number 18-17

May 15, 2018

What OIG Reviewed

This evaluation report represents the results of the Office of Inspector General's (OIG's) evaluation of the Small Business Administration's (SBA's) progress in reducing improper payments.

Our objectives were (1) to determine whether SBA complied with the Improper Payments Elimination and Recovery Act of 2010 (IPERA) using guidelines outlined in Office of Management and Budget (OMB) Memorandum M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments*, and (2) to assess progress SBA made in remediating improper payment–related recommendations.

What OIG Found

Our overall qualitative review of Agency efforts to prevent and reduce improper payments showed that SBA continued to maintain adequate controls to prevent and reduce improper payments, as summarized in the following table.

OIG IPERA Qualitative Assessment for FY 2017 by Program or Activity

SBA Program or Activity	Status
Disaster Direct Loan Program	Improvement Needed
7(a) Loan Guaranty Approvals	Substantial Progress
7(a) Loan Guaranty Purchases	Substantial Progress
504 CDC Loan Guaranty Approvals	Implemented
Disbursements for Goods and Services	Implemented

Further, SBA was generally compliant in meeting the minimum requirements in accordance with OMB guidance. In accordance with IPERA, SBA published and posted an agency financial report (AFR) on its website, conducted program-specific risk assessments, and published improper payment estimates for all programs and activities identified as susceptible to significant improper payments.

SBA also published extracts from the applicable programmatic corrective action plans in the AFR for three of five areas tested for fiscal year 2017 reporting, and it met and published the annual reduction target for three of the applicable five areas tested. However, SBA was not compliant with IPERA reporting requirements because disbursements for disaster direct loans had an improper payment rate that exceeded the 10 percent threshold. SBA's improper payment rate for disaster direct loan disbursements more than doubled, from 5.32 percent in FY 2016 to 13.65 percent in FY 2017. SBA management attributed the increase in the disaster improper payment rate to SBA loan officers not providing justifications when they approved loans exceeding SBA's guidelines for repayment ability, documenting insurance coverage, or properly determining eligible loan amounts as a result of insurance or other payments received by the borrower related to the disaster. Also, 7(a) loan guaranty purchases and disbursements for disaster direct loans did not meet their annual reduction target.

OIG Recommendations

We made two recommendations to improve the effectiveness of the Agency's improper payment controls for disbursements for disaster direct loans and 7(a) loan guaranty approvals.

Agency Response

SBA management partially agreed with finding and recommendation 1 and agreed with finding and recommendation 2 of this report. For recommendation 1, SBA agreed to establish corrective action plans that address the quality of justifications; however, SBA intends to require justifications only upon exceeding a maximum acceptable fixed debt ratio of 75 percent. For recommendation 2, SBA intends to request and review additional documentation from the lender to reassess the potential improper payment in the amount of $697,500. If an improper payment is determined, management will apply the necessary corrective action to recapture the improper payment. We encourage the Agency to continue improving its review processes to decrease the number of improper payments.

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

Final Report Transmittal
Report Number 18-17

DATE: May 15, 2018

TO: Linda E. McMahon
Administrator

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: *SBA's FY 2017 Progress in Reducing Improper Payments*

This report presents the results of our evaluation of the Small Business Administration's (SBA's) fiscal year (FY) 2017 progress in reducing improper payments. Our objectives were (1) to determine whether SBA complied with requirements of the Improper Payments Elimination and Recovery Act of 2010 (IPERA) using guidelines outlined in the Office of Management and Budget (OMB) Memorandum M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments,* and (2) to assess the progress SBA made in remediating improper payment–related recommendations.

We previously furnished copies of the draft report and requested written comments on the recommendations. SBA management's comments are appended and were considered in finalizing the report. The report contains two recommendations. SBA partially agreed to recommendation 1 and agreed to recommendation 2. Recommendations 1 and 2 will remain open until OIG receives documentation demonstrating that these recommendations have been addressed. Please provide us within 90 days your progress in addressing these recommendations. We encourage the Agency to continue improving its review processes to decrease the number of improper payments.

We appreciate the courtesies and cooperation of the Offices of the Chief Financial Officer, Capital Access, and Disaster Assistance during this evaluation. If you have any questions, please contact me or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6586.

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Introduction

The Improper Payments Information Act of 2002 (IPIA) requires agencies to review and identify programs susceptible to significant improper payments, report on the amount and causes of improper payments, and develop plans for reducing improper payments.[1] An improper payment is any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements. Incorrect amounts are overpayments or underpayments made to eligible recipients (including inappropriate denials of payment or service, any payment that does not account for credit for applicable discounts, payments that are for an incorrect amount, and duplicate payments). An improper payment also could be any payment made to an ineligible recipient or for an ineligible good or service, or payments for goods or services not received (except for such payments authorized by law). In addition, when an agency's review is unable to discern whether a payment was proper as a result of insufficient or lack of documentation, this payment also must be considered an improper payment.

Background

In accordance with the Office of Management and Budget (OMB) guidance, each Office of Inspector General (OIG) is required to annually review their agency's improper payment reporting, along with accompanying materials, within 180 days of the publication of their performance and accountability report (PAR) or agency financial report (AFR).[2] OMB requested OIGs to assess the following:

- the agency's efforts to prevent and reduce improper payments
- whether the agency's corrective action plans were robust and focused on the appropriate root causes of improper payments
- the agency's performance in reducing and recapturing improper payments

To perform our qualitative assessment of the areas listed above, OIG categorically developed the following ratings:

- implemented because no further improvements were noted for this reporting period
- substantial progress due to a change in the improper payments rate, implementation of improved controls, and closed recommendations
- progress because the Small Business Administration (SBA) either reduced the improper payments rate since last year, improved its controls, or closed recommendations
- improvement needed because controls were not fully implemented

OMB further requested OIGs to determine whether agencies were in compliance with the Improper Payments Elimination and Recovery Act of 2010 (IPERA). To be in compliance with IPERA, agencies must have, at a minimum, completed the following:

- published a PAR or AFR for the most recent fiscal year and posted that report and any accompanying materials required by OMB on the agency website

[1] IPIA was amended by IPERA and the Improper Payments Elimination and Recovery Improvement Act of 2012 (IPERIA). IPERIA directed OMB to issue implementation guidance to agencies. OMB issued Memorandum M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments*, as implementation guidance to Federal agencies for IPERIA.
[2] OMB Memorandum M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments* (October 14, 2014).

- conducted a program-specific risk assessment for each applicable program or activity that conforms with Section 3321 of Title 31 U.S.C. (if required)
- published improper payments estimates for all programs and activities identified as susceptible to significant improper payments under its risk assessment (if required)
- published programmatic corrective action plans in the PAR or AFR (if required)
- published and met annual reduction targets for each program assessed to be at risk and measured for improper payments (if required and applicable)[3]
- reported a gross improper payment rate of less than 10 percent for each program and activity for which an improper payments estimate was obtained and published in the PAR or AFR

Prior Work

OIG audits have determined that the improper payment rate reported for SBA's 7(a) and Disaster Direct Loan Programs were understated.[4] Prior OIG audits have also identified high percentages of disaster and business loans that were made to borrowers who were ineligible, lacked repayment ability, or did not provide sufficient documentation to justify the approval or disbursement.

OIG's fiscal year (FY) 2016 IPERA review found that SBA continued to make progress in its efforts to prevent and reduce improper payments. More specifically, we found that SBA published and posted an AFR on its website, conducted program-specific risk assessments, and published improper payment estimates for all programs and activities identified as susceptible to significant improper payments. SBA also published extracts from the applicable programmatic corrective action plans in the AFR, reported a gross improper payment rate of less than 10 percent for six of seven areas tested for FY 2016 reporting, and published and met the annual reduction target for six of the applicable seven areas tested. However, SBA was not compliant with IPERA reporting requirements because disbursements for goods and services had an improper payment rate that exceeded the 10 percent threshold, and the 7(a) loan guaranty purchases did not meet their annual reduction target.

Objectives

Our objectives were (1) to determine whether SBA complied with IPERA using guidelines outlined in OMB Memorandum M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments*, and (2) to assess progress SBA made in remediating improper payment–related recommendations. More specifically, we assessed the status of OIG's open prior year audit recommendations, which focused on the accuracy and completeness of Agency reporting, and SBA's performance in reducing and recapturing improper payments.

[3] A program will have met a reduction target if its improper payment rate falls within +/- 0.1 percent of the reduction target set in the previous year's PAR or AFR.
[4] OIG Report 18-07, *Accuracy of the FY 2015 7(a) Loan Guaranty Purchase Improper Payment Rate* (December 11, 2017) and OIG Report 18-12, *Accuracy of the FY 2015 Disaster Loan Program Improper Payments Rate* (February 13, 2018).

Results

We have divided our review into five sections: one for each program or activity that has been identified as susceptible to improper payments. While SBA continued to make progress in preventing and reducing improper payments, for FY 2017, we determined that two of five areas did not meet the minimum reporting requirements for IPERA compliance. Specifically, the Disaster Direct Loan Program was not compliant with IPERA because the reported improper payment rate exceeded 10 percent. Also, 7(a) loan guaranty purchases and the Disaster Direct Loan Program were not compliant because they did not meet their annual reduction targets (see Table 1).

Table 1. Summary of SBA's IPERA Compliance

Program or activity	Posted materials	Assessed risk[5]	Published estimates for susceptible programs	Published programmatic corrective action plans	Published and met annual reduction target	Reported rate of less than 10 percent	Overall FY 2017 results
Disaster Direct Loan Program	■	■	■	■	□	□	□
Section 7(a) Loan Guaranty Approvals	■	■	■	■	■	■	■
Section 7(a) Loan Guaranty Purchases	■	■	■	■	□	■	□
Section 504 CDC Loan Guaranty Approvals	■	■	■	■	■	■	■
Disbursements for Goods and Services	■	■	■	■	■	■	■

Legend: ■ Compliant with IPERA reporting requirements
□ Not compliant with IPERA reporting requirements

[5] All reporting segments have been deemed as susceptible to significant improper payments and are already reporting an estimate. Therefore, no risk assessment is required in accordance with OMB Memorandum M-15-02.

Section 1: Disaster Direct Loan Program

The Disaster Direct Loan Program plays a vital role in the aftermath of disasters by providing long-term, low-interest loans to affected homeowners, renters, businesses, and nonprofit organizations. SBA offers home and business loans to compensate for physical damages and also offers loans to businesses to compensate for economic damages. This program is particularly vulnerable to fraud and unnecessary losses because loan transactions are expedited in order to provide quick relief to disaster survivors. In FY 2017, SBA disbursed $904 million in disaster assistance loans.

OIG's Qualitative Assessment of Agency Efforts

SBA's improper payment rate for the Disaster Direct Loan Program disbursements increased from 5.32 percent ($18.4 million) in FY 2016 to 13.65 percent ($123.38 million) in FY 2017. The Agency asserted the rate increase was anticipated due to larger disaster volume and less experienced staff. In FY 2017, SBA disbursed $904 million as compared to $345 million in FY 2016.

In its FY 2017 AFR, SBA identified the following as primary root causes for the current year's improper payments:

- lack of appropriate justifications for assistance made to borrowers who may not have had a repayment ability based on their maximum acceptable fixed debt (MAFD) ratio
- failure to validate personal property insurance coverages on disaster survivor's temporary housing locations
- disbursements made in excess of eligible loan amounts due to duplication of benefits

SBA's corrective action plan to remediate the root causes and reduce the improper payment rate includes increasing the borrower's MAFD percentage limits. Standard Operating Procedure (SOP) 50 30 8, *Disaster Assistance Program* requires loan officers to provide a justification for approving a loan when the MAFD exceeds the standard (which ranges from 36 to 50 percent depending on income levels). SBA management intends to raise the percentage limit to 75 percent. In discussions with management, they stated the increase was to accomplish a reasonable private sector lending approach. However, they stated in the AFR that this change would lessen the need to provide justifications outside the SBA's limits. Changing the MAFD doesn't address the root cause for the improper payment; instead, it weakens a control that was implemented to reduce the risk of defaults in the program. This is especially concerning considering SBA's assertion that the rate increased due to higher loan volume and inexperienced staff. Given the recent hurricane activity, it doesn't seem prudent to give inexperienced loan officers the latitude to independently increase the MAFD without justification.

OMB Memorandum M-15-02 requires agencies to identify the reasons their programs or activities are at risk in developing their corrective action plan. Furthermore, this guidance states that, for programs susceptible to significant improper payments, agencies should identify the root causes of the improper payments, and implement appropriate, robust corrective actions to prevent and reduce the related improper payments.

According to SBA management, the Agency's corrective action plan is based on data analysis provided by an independent firm, which indicated that increasing the MAFD percentage would have an insignificant impact on the loan portfolio's loss rate. SBA implemented the increase as part of a new credit model pilot dated September 6, 2017. The pilot program allowed loan officers to increase the MAFD percentage to 75 percent without justification for exceeding the standard. The evidence that SBA presented to OIG regarding this change did not address a correlation between MAFD and the portfolio's loss rate, and as a result, it did not adequately support its assertion that it would minimally increase risk in the program.

In a recently released OIG audit report, we determined that the 2015 improper payments rate was understated, and we made four recommendations related to the FY 2015 Disaster Direct Loan Program IPERA process: (1) incorporate 13 CFR Section 123 requirements into the Disaster Direct Loan Program improper payments rate test criteria and incorporate these into the quality control review checklist to ensure consistent application; (2) ensure that management does not override designated improper payments that have not been appealed as part of the process specified in Office of Disaster Assistance Memorandum 11-08, *Quality Control Department Processes*; (3) issue supplemental guidance to emphasize to quality control staff the importance of considering all documents in the loan file, and the SOP requirements related to repayment ability; and (4) ensure that future improper payment rate estimates are correctly computed using all improper payments identified in sampling. SBA fully agreed with three recommendations and partially agreed with the other. Three recommendations remain open. OIG will continue to monitor the status of corrective actions associated with these recommendations.

Based on our recent audit work and the related open recommendations, OIG is downgrading the status of accuracy and completeness of Agency reporting to "Progress." OIG also is downgrading the status of the quality of corrective action plans from "Implemented" in FY 2016, to "Improvement Needed" in FY 2017. Additionally, due to the increased rate, open recommendations, and the uncertainty of the impact of the new credit model pilot, we have downgraded the Disaster Direct Loan Program overall rating to "Improvement Needed" for FY 2017. Table 2 summarizes OIG's evaluation of Agency efforts.

Table 2. OIG's Evaluation of Agency Efforts

OMB Criteria	Status at End of 2017
Overall assessment of Agency efforts	Improvement Needed
Accuracy & completeness of Agency reporting	Progress
Performance in reducing/recapturing improper payments	N/A[6]
Quality of corrective action plans	Improvement Needed

AFR Review

Our review of the AFR found that SBA was compliant with four of the six IPERA reporting requirements. SBA did not meet the target rate of 4.78 percent for FY 2017. Also, the estimated 13.65 percent for the improper payment rate exceeded the 10 percent rate necessary to be in compliance with IPERA requirements. Table 3 summarizes OIG's review of the AFR.

[6] SBA has determined that payment recapture audits for this program would not be cost effective.

Table 3. OIG's Review of the AFR

OMB Reporting Requirement	Status at End of 2017
Posted materials	Compliant
Assessed risk	Compliant
Published estimates for susceptible programs	Compliant
Published programmatic corrective action plans	Compliant
Met annual reduction target	Not Compliant
Reported rate of less than 10 percent	Not Compliant

Recommendation

We recommend that the Associate Administrator for Disaster Assistance

1. Establish and implement corrective action plans that address the quality of justifications for exceeding the standard MAFD.

Agency Comments

SBA management provided formal comments that are included in their entirety in Appendix III. SBA management partially agreed with our recommendation; however, its planned action does not adequately resolve the recommendation.

Summary of Management's Response

The Office of Disaster Assistance (ODA) stated that it disagreed with the OIG's contention that its reason for implementing the change in the MAFD percentage was solely for the purpose of reducing the improper payment rate in the disaster program. In addition, ODA disagreed that increasing the MAFD weakens a control that was implemented to reduce risk. ODA believes that raising the MAFD to 75 percent with no justification is still an acceptable risk based on the information provided by its third-party contractor, which predicted a 2.13 percent charge-off rate for loans approved under the new credit model.

OIG Analysis of Management's Response

Our report accurately depicts ODA's statement in the AFR, which stated that SBA's corrective action plan to remediate the root causes and reduce the improper payment rate includes increasing the borrower's MAFD percentage limits. ODA did not substantiate its claim that the increase would result in insignificant risk to the portfolio loss rate. Rather, it based its assertion on a projected loss rate rather than on historical data.

OIG believes that this change does not address the root cause for the improper payment; instead, it increases the risk of defaults in the program. Additionally, SBA's own guidance, SOP 50 30 8, states that once the maximum debt level is exceeded, the risk of default increases. According to the SOP, the standard MAFD is still 40 percent when gross annual income exceeds $25,000, and we maintain our position that loan officers should be required to provide adequate justification for exceeding that standard.

Summary of Action Necessary to Close the Recommendation

This section provides the status of the recommendation and actions necessary to resolve or close it.

1. **Unresolved**. ODA agreed to establish corrective action plans that address the quality of justifications; however, it would require justifications only upon exceeding a MAFD of 75 percent. Because the standard MAFD is still 40 percent when gross annual income exceeds $25,000, only requiring justifications for MAFD percentages above 75 percent does not satisfy the intent of the recommendation. ODA acknowledged that they had inexperienced loan officers, and we believe that allowing these individuals to increase the MAFD to 75 percent without justification is not prudent. As a result, to close this recommendation, ODA should provide proof that it requires quality justifications for increasing the MAFD above the standard MAFD included in its SOP.

Section 2: Section 7(a) Loan Guaranty Approvals

The Agency's largest lending program, the 7(a) Loan Program, is SBA's principal vehicle for providing small businesses with access to credit that cannot be obtained elsewhere. This program relies on numerous outside parties (e.g., borrowers, loan agents, and lenders) to complete loan transactions, with at least 87 percent of the loans being made by lenders to whom SBA has delegated loan-making authority. Additionally, SBA has centralized many loan functions and reduced the number of staff performing these functions, placing more responsibility on and giving greater independence to its lenders. In FY 2017, SBA guaranteed approximately $25.4 billion in 7(a) loan approvals.

OIG's Qualitative Assessment of Agency Efforts

SBA's improper payment rate for 7(a) loan guaranty approvals increased from 0.96 percent ($166.8 million) in FY 2016 to 1.29 percent ($233.9 million) in FY 2017. SBA determined that the most prevalent root cause for 7(a) loan approval improper payments stemmed from delegated lenders' failure to authenticate borrowers' eligibility at origination.

OIG's assessment included reviewing a 7(a) loan approval from SBA's sample, analyzing SBA's internal process, and interviewing SBA officials involved in the 7(a) loan guaranty approval IPERA process. Based on our assessment, we determined that SBA did not accurately identify an improper payment, in the amount of $697,500, during their improper payment review process; as a result, the improper payment rate for 7(a) loan guaranty approvals was understated. One SBA official initially determined that the loan we reviewed did not have adequate support for the borrower's income and expense projections. However, the IPERA approving official stated that while there was an issue, it did not represent a critical error. SBA's improper payment guidance indicates that in the event one or more deficiencies are noted during its review, additional documents would be reviewed and/or requested from the appropriate party. OIG believes that SBA officials considering whether an issue is critical without requesting the appropriate documentation could have a significant impact on the accuracy of SBA's reported improper payment rate, because it would result in increased subjectivity when determining what should be reported as improper.

In FY 2016, we rated the Agency as "Substantial Progress" for accuracy and completeness of Agency reporting, and although the Agency did not accurately identify an improper payment during their FY 2017 testing, we maintained the rating of "Substantial Progress" for FY 2017. Also, we maintained the overall rating of "Substantial Progress" for 7(a) loan guaranty approvals for FY 2017. Table 4 summarizes OIG's evaluation of Agency efforts.

Table 4. OIG's Evaluation of Agency Efforts

OMB Criteria	Status at End of 2017
Overall assessment of Agency efforts	Substantial Progress
Accuracy & completeness of Agency reporting	Substantial Progress
Performance in reducing/recapturing improper payments	N/A[7]
Quality of corrective action plans	Implemented

[7] SBA has determined that the 7(a) loan approval program is not subject to recapture audits because no payment is made at the time of approval.

AFR Review

Our review of the AFR found that SBA was fully compliant with IPERA reporting requirements. Table 5 summarizes OIG's review of the AFR.

Table 5. OIG's Review of the AFR

OMB Reporting Requirement	Status at End of 2017
Posted materials	Compliant
Assessed risk	Compliant
Published estimates for susceptible programs	Compliant
Published programmatic corrective action plans	Compliant
Met annual reduction target	Compliant
Reported rate of less than 10 percent	Compliant

Recommendation

We recommend that the Director for the Office of Financial Program Operations

2. Conduct an additional review of the potential improper payment in the amount of $697,500, and take the appropriate corrective action, if necessary.

Summary of Action Necessary to Close the Recommendation

The following provides the status of recommendation 2 and the necessary action to either resolve or close the recommendation.

2. **Resolved**. SBA management concurred with our recommendation and plans to request and review additional documentation from the lender to reassess the potential improper payment in the amount of $697,500 by November 9, 2018. If an improper payment is determined, the Office of Financial Program Operations will apply the necessary corrective action to recapture the improper payment.

Section 3: Section 7(a) Loan Guaranty Purchases

Under the 7(a) Loan Program, SBA guarantees up to 90 percent of the principal amount of loans made by banks and other lending institutions to small businesses not able to obtain credit elsewhere. When a loan goes into default, SBA reviews the lender's actions on the loan to determine whether it is appropriate to pay the lender the guaranty, which SBA refers to as a "guaranty purchase." Under its regulations, SBA is released from liability on the guaranty, in whole or in part, within SBA's exclusive discretion, if the lender fails to comply materially with any SBA loan program requirement or does not prudently make, close, service, or liquidate the loan. The guaranty purchase review is SBA's primary control for ensuring lender compliance and preventing improper payments. In FY 2017, SBA purchased approximately $661 million in 7(a) loan guaranties.

OIG's Qualitative Assessment of Agency Efforts

SBA's improper payment rate for 7(a) loan guaranty purchases increased from 2.32 percent ($13.4 million) in FY 2016 to 4.32 percent ($28.4 million) in FY 2017. Since FY 2015, SBA has increased its reported improper payment rate from 0.9 percent to 4.32 percent, as reported in the current AFR. A recently released audit report by our office estimated that the FY 2015 rate was higher than the rate identified by the Agency at 3.61 percent.[8] OIG determined that although the rate increased, SBA is more accurately identifying a higher percentage of improper payments in its 7(a) loan guaranty purchase program, which is consistent with our recent audit findings. We believe that the increased identification of improper payments demonstrated that the improper payment review process improved. In its FY 2017 AFR, SBA stated that the root cause for the identified improper payments was new center staff making administrative and process errors. As a means to reduce and/or eliminate the occurrence of future improper payments, SBA formalized a corrective action plan that included internal training and recovering unjustified expenses.

While we determined that SBA increased its identification of improper payments in the 7(a) loan guaranty purchase program, opportunities exist for SBA to improve its improper payment review process to ensure accurate identification of improper payments. Our recently released audit report made three recommendations related to the 7(a) loan guaranty purchase IPERA process: (1) conduct an assessment of the improper payment process to improve improper payment identification, (2) revise internal center guidance to ensure that critical lender calculations were verified and/or recalculated, and (3) revise internal center guidance to ensure the guides were consistent with the appropriate SOPs. SBA agreed with the three recommendations, which remain open. OIG will continue to monitor the status of corrective actions associated with these recommendations.

In FY 2016, we rated the Agency as "Progress" for accuracy and completeness of Agency reporting. Although SBA is identifying improper payments and has implemented its corrective action plan, it has three open recommendations related to improving its 7(a) loan guaranty purchase improper payment review process. As a result, we have maintained the rating of "Progress" for FY 2017. Due to the Agency appropriately disclosing that it no longer performs payment recapture audits, and our assessment of Agency efforts, we have upgraded the 7(a) loan guaranty purchase program overall rating to "Substantial Progress" for FY 2017. Table 6 summarizes OIG's evaluation of Agency efforts.

[8] OIG Report 18-07, *Accuracy of the FY 2015 7(a) Guaranty Purchases Improper Payments Rate* (December 11. 2017).

Table 6. OIG's Evaluation of Agency Efforts

OMB Criteria	Status at End of 2017
Overall assessment of Agency efforts	Substantial Progress
Accuracy & completeness of Agency reporting	Progress
Performance in reducing/recapturing improper payments	N/A[9]
Quality of corrective action plans	Implemented

AFR Review

Our review of the AFR found that SBA was compliant with most IPERA reporting requirements. However, SBA did not meet its planned reduction target of 1.66 percent for the program. This is the second consecutive year of non-compliance for the 7(a) loan guaranty purchase program. In accordance with OMB criteria, the OMB director will review SBA's 7(a) loan guaranty purchases to determine whether additional funding would help the Agency come into compliance with IPERA requirements. Table 7 summarizes OIG's review of the AFR.

Table 7. OIG's Review of the AFR

OMB Reporting Requirement	Status at End of 2017
Posted materials	Compliant
Assessed risk	Compliant
Published estimates for susceptible programs	Compliant
Published programmatic corrective action plans	Compliant
Met annual reduction target	Not Compliant
Reported rate of less than 10 percent	Compliant

[9] SBA has determined that payment recapture audits for 7(a) loan guaranty purchases would not be cost effective.

Section 4: Section 504 CDC Loan Guaranty Approvals

SBA's 504 Loan Program provides small businesses with long-term, fixed-rate financing to purchase land, buildings, machinery, and other fixed assets. Economic development organizations, approved by SBA, are known as certified development companies (CDCs). CDCs package, close, and service these loans, which are funded through a variety of private sector lenders, proceeds from selling SBA-guaranteed debentures, and borrower equity investment. Of the total project costs, a third-party lender provides at least 50 percent of the financing, the CDC provides up to 40 percent of the financing through a 100 percent SBA-guaranteed debenture, and the applicant provides at least 10 percent of the financing. In FY 2017, SBA guaranteed approximately $5.0 billion in 504 loan approvals.

OIG's Qualitative Assessment of Agency Efforts

SBA's improper payment rate for 504 CDC loan guaranty approvals decreased from 2.60 percent ($119.6 million) in FY 2016 to 1.20 percent ($59 million) in FY 2017. SBA determined that the most prevalent root cause for improper payments in FY 2017 was due to lack of documentation to support the repayment analysis and eligibility. SBA was not required to implement a corrective action plan because the improper payments did not meet the reporting thresholds. Following significant increases from FY 2013 to FY 2015, the improper payment rate decreased from FY 2015 to FY 2017. OIG believes the 504 CDC loan guaranty approvals program has seen sufficient sustained progress to upgrade SBA's rating from "Substantial Progress" in FY 2016 to "Implemented" in 2017. OIG will continue to monitor this program as part of its annual IPERA reviews and will make subsequent determinations to ensure the program remains in compliance with IPERA. Table 8 summarizes OIG's evaluation of Agency efforts.

Table 8. OIG's Evaluation of Agency Efforts

OMB Criteria	Status at End of 2017
Overall assessment of Agency efforts	Implemented
Accuracy & completeness of Agency reporting	Implemented
Performance in reducing/recapturing improper payments	N/A[10]
Quality of corrective action plans	N/A[11]

AFR Review

Our review of the AFR found that SBA was fully compliant with IPERA reporting requirements. Table 9 summarizes OIG's review of the AFR.

Table 9. OIG's Review of the AFR

OMB Reporting Requirement	Status at End of 2017
Posted materials	Compliant
Assessed risk	Compliant
Published estimates for susceptible programs	Compliant
Published programmatic corrective action plans	Compliant
Met annual reduction target	Compliant
Reported rate of less than 10 percent	Compliant

[10] SBA has determined that the 504 Loan Program is not subject to recapture audits because no payment is made at the time of approval.

[11] Improper payments did not exceed the 1.5 percent and $10 million threshold for reporting a corrective action plan.

Section 5: Disbursements for Goods and Services

SBA awards contracts for goods and services to assist in carrying out its mission. For FY 2017, SBA made 3,118 disbursements for goods and services totaling approximately $110.2 million.

OIG's Qualitative Assessment of Agency Efforts

SBA's improper payment rate for disbursements for goods and services decreased from 10.35 percent ($11.6 million) in FY 2016 to 4.99 percent ($5.4 million) in FY 2017. SBA attributed the significant reduction of improper payments to implementation of an automated interface between SBA's financial system and the System for Award Management in January 2016, which ensured that SBA used only the most current vendor information when making payments. Since the amount of improper payments totaled less than $10 million, SBA was not required to implement a corrective action plan.

Because SBA's improper payment rate has continued to decrease, we maintained the rating of "Implemented" for FY 2017. Table 10 summarizes OIG's evaluation of Agency efforts.

Table 10. OIG's Evaluation of Agency Efforts

OMB Criteria	Status at End of 2017
Overall assessment of agency efforts	Implemented
Accuracy & completeness of agency reporting	Implemented
Performance in reducing/recapturing improper payments	N/A[12]
Quality of corrective action plans	N/A[13]

AFR Review

Our review of the AFR found that SBA was compliant with IPERA reporting requirements. Table 11 summarizes OIG's review of the AFR.

Table 11. OIG's Review of the AFR

OMB Reporting Requirement	Status at End of 2017
Posted materials	Compliant
Assessed risk	Compliant
Published estimates for susceptible programs	Compliant
Published programmatic corrective action plans	Compliant
Met annual reduction target	Compliant
Reported rate of less than 10 percent	Compliant

[12] SBA has determined that payment recapture audits for this program would not be cost effective.
[13] Improper payments did not exceed the 1.5 percent and $10 million threshold for reporting a corrective action plan.

Appendix I: Objectives, Scope, and Methodology

This report presents the results of our evaluation of SBA's FY 2017 progress in reducing improper payments. Our objectives were (1) to determine whether SBA complied with IPERA using guidelines outlined in OMB Memorandum M-15-02, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments*, and (2) to assess SBA's progress in remediating improper payment–related recommendations. To perform the evaluation, our scope included an assessment of improper payments that SBA reported for 7(a) loan guaranty purchases, 7(a) loan guaranty approvals, 504 CDC loan guaranty approvals, disbursements for disaster direct loans, and disbursements for goods and services.

To answer our objectives, we assessed the controls SBA implemented to address prior-year OIG recommendations, evaluated whether SBA addressed IPERA reporting requirements, and reviewed documentation and plans regarding the Agency's specific guidelines for determining improper payments. We also assessed the Agency's efforts to prevent and reduce improper payments and reviewed the accuracy and completeness of improper payment disclosures in the AFR, as specified in OMB guidance. Our review did not assess whether the current year program-reported rates were accurate. However, in FY 2018, OIG issued two reports on the accuracy of the 2015 improper payment rates for 7(a) loan guaranty purchases and disaster direct loan disbursements.[14]

We conducted this evaluation in accordance with the Council of Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*. These standards require that we plan and perform the evaluation to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our conclusions based on our objectives.

Use of Computer-Processed Data

We relied on information provided by SBA officials that was extracted from SBA's Electronic Loan Information Processing System, Disaster Credit Management System, Oracle Federal Financial System, Guaranty Purchase Tracking System, and E-Tran. Previous independent public accountant and OIG audits have verified that the financial information maintained in those systems is reliable. Further, certain data elements associated with loan disbursements, procurements, and grants were verified against source documentation maintained in SBA files. We believe this information is reliable for the purposes of this evaluation.

[14] OIG Report 18-07, *Accuracy of the FY 2015 7(a) Loan Guaranty Purchase Improper Payment Rate* (December 11, 2017) and OIG Report 18-12, *Accuracy of the FY 2015 Disaster Loan Program Improper Payments Rate* (February 13, 2018).

Prior Coverage

Between March 2012 and February 2018, OIG issued the following reports related to the Agency's controls over improper payments:

Accuracy of the FY 2015 Disaster Loan Program Improper Payments Rate (Report 18-12, February 13, 2018)

Accuracy of the FY 2015 7(a) Loan Guaranty Purchase Improper Payment Rate (Report 18-07, December 11, 2017)

The OIG High Risk 7(a) Loan Review Program (Report 17-18, September 28, 2017)

The OIG High Risk 7(a) Loan Review Program Recommends $3.2 Million in Recoveries (Report 16-22, September 30, 2016)

SBA Loan Number 6439845000 (Report 16-19, August 16, 2016)

SBA's FY 2015 Progress in Reducing Improper Payments (Report 16-15, May 13, 2016)

SBA Loan Number 4949845001 (Report 16-11, March 17, 2016)

SBA's FY 2014 Compliance with the Improper Payments Elimination and Recovery Act (Report 15-11, May 15, 2015)

The OIG High Risk 7(a) Loan Review Program Recommends $1.8 Million in Recoveries (Report 15-09, March 20, 2015)

SBA's Progress in Complying with the Improper Payments Elimination and Recovery Act (Report 14-11, April 10, 2014)

Purchase Reviews Allowed $3.1 Million in Improper Payments on 7(a) Recovery Act Loans (Report 14-09, January 29, 2014)

Purchase Reviews Allowed $4.6 Million in Improper Payments on 7(a) Recovery Act Loans (Report 13-16R, June 14, 2013)

Evaluation of SBA's Progress in Reducing Improper Payments in FY 2012 (Report 13-13, March 14, 2013)

The Small Business Administration's Improper Payment Rate for 7(a) Guaranty Purchases Remains Significantly Understated (Report 13-07, November 15, 2012)

A Detailed Repayment Ability Analysis is Needed on High-Dollar Early-Defaulted Loans to Prevent Future Improper Payments (Report 12-18, August 16, 2012)

High-Dollar Early-Defaulted Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the National Guaranty Purchase Center (Report 12-11R, March 23, 2012)

SBA Generally Meets IPERA Reporting Guidance but Immediate Attention Is Needed to Prevent and Reduce Improper Payments (Report 12-10, March 15, 2012)

Appendix II: Status of Open Recommendations

In FY 2017, the 7(a) loan guaranty purchases program closed two improper payment–related recommendations. The following improper payment–related recommendations remain open.

OIG Report	Recommendation	Management Decision Date	Final Action Date
17-18, *The OIG High Risk 7(a) Loan Review Program* (September 28, 2017)	1. Bring the loan into compliance and, if not possible, seek recovery of $917,107 plus interest, on the guaranty paid by SBA for the loan to (see report for bank and borrower names).	09/21/2017	09/21/2018
18-07, *Accuracy of the FY 2015 7(a) Loan Guaranty Purchase Improper Payment Rate (*December 11, 2017)	1. Conduct an assessment of the 7(a) loan guaranty purchase improper payments review process to improve improper payment identification. Based on the results of the assessment, implement additional controls to ensure improper payment identification and accurate reporting of the rate.	11/15/2017	11/15/2018
	2. Revise internal center guidance to ensure that critical lender calculations are verified and/or recalculated.	11/15/2017	05/15/2018
	3. Revise internal center guidance to ensure the guides are consistent with the appropriate SOPs.	11/15/2017	05/15/2018
	4. Require bank to bring the loan into compliance and, if not possible, seek recovery of $12,266, plus interest, on the guaranty paid by SBA for the loan to (see report for bank and borrower names).	11/15/2017	11/15/2018
	5. Require bank to bring the loan into compliance and, if not possible, seek recovery of $72,123, plus interest, on the guaranty paid by SBA for the loan to (see report for bank and borrower names).	11/15/2017	11/15/2018

OIG Report	Recommendation	Management Decision Date	Final Action Date
	6. Require bank to bring the loan into compliance and, if not possible, seek recovery of $124,500, plus interest, on the guaranty paid by SBA for the loan to (see report for bank and borrower names).	11/15/2017	11/15/2018
	7. Require bank to bring the loan into compliance and, if not possible, seek recovery of $69,730, plus interest, on the guaranty paid by SBA for the loan to (see report for bank and borrower names).	11/15/2017	11/15/2018
	8. Require lender to bring the loan into compliance and, if not possible, seek recovery of $64,747, plus interest, on the guaranty paid by SBA for the loan to (see report for lender and borrower names).	11/15/2017	11/15/2018
	9. Require bank to bring the loan into compliance and, if not possible, seek recovery of $1,903,213, plus interest, on the guaranty paid by SBA for the loan to (see report for bank and borrower names).	11/15/2017	11/15/2018
18-12, *Accuracy of the FY 2015 Disaster Loan Program Improper Payments Rate* (February 13, 2018)	1. Incorporate 13 CFR Section 123 requirements into the Disaster Loan Program improper payments rate test criteria and incorporate these into the quality control review checklist to ensure consistent application.	02/16/2018	07/02/2018
	3. Issue supplemental guidance to emphasize to QC staff the importance of considering all documents in the loan file, and the SOP requirements related to repayment ability.	02/16/2018	07/02/2018
	4. Ensure that future improper payment rate estimates are correctly computed using all improper payments identified in sampling.	02/16/2018	07/02/2018

SBA’s Response to Evaluation Report

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

To: Hannibal "Mike" Ware
Inspector General

From: Timothy Gribben
Chief Financial Officer and Associate Administrator for Performance Management

William Manger
Associate Administrator for Capital Access

James Rivera
Associate Administrator for Disaster Assistance

Date: May 10, 2018

Subject: Comments on OIG Draft Audit Report "SBA's FY 2017 Compliance with the Improper Payment Elimination and Recovery Act"

The Small Business Administration (SBA) appreciates the opportunity to review and respond to the draft report "SBA's FY2017 Progress in Reducing Improper Payments".

Improved financial performance through the reduction of improper payments continues to be a key financial management focus of the Federal government. SBA management continually develops strategies to reduce improper payments for responsible stewardship of public assets.

SBA offers the following comments in response to your audit recommendations:

Recommendation #1: We recommend that the Office of Financial Program Operations (OFPO) conduct an additional review of the potential improper payment in the amount of $697,500 and take the appropriate corrective action, if necessary.

Agency Response: OFPO will request and review additional documentation from the lender to reassess the potential improper payment in the amount of $697,500. If an improper payment is determined, OFPO will apply the necessary corrective action to recapture the improper payment.

Recommendation #2: We recommend that the Associate Administrator for Disaster Assistance establish and implement corrective action plans that address the quality of justifications for exceeding the standard MAFD.

Agency Response: The Office of Disaster Assistance (ODA) has long established risk scoring based on credit scores, income, and Monthly Allowable Fixed Debt (MAFD) percentage. Since 2014, working with a third party credit risk scorer, ODA has refined risk scoring and implemented new policies associated with this process. As such, after four years of analyzing data associated with risk scoring, we believed that we had gathered sufficient information to evaluate the portfolio risk and determined that the outcome of the default rate can be predicted.

ODA has years of historical information which shows minimal changes in the charge-off rate, including the previous change, made in SOP 50 30 8, which generally increased the MAFD from 40 percent to 50 percent. As such, ODA is continuously monitoring and evaluation our portfolio and criteria, to determine an acceptable level of risk. In making the decision to raise the MAFD, ODA validated the portfolio with our risk scorer and their conclusions supports ODA's decision to increase MAFD from 51 percent to 75 percent (as outlined in Numbered Memo 2017-22) as an acceptable risk. This has culminated in the most recent data model outlined Numbered Memo 2017-22, which resulted in a charge off rate in the last 12 months of approximately 1.4%. Based on the success of the pilot, the data model has now been incorporated into SOP 50 30 9 as policy. We believe that raising the MAFD to 75% with no justification is still an acceptable risk based on the information provided by the contractor which predicts a 2.13% charge off rate which is less than 2% increase.

Based on the information above, we disagree with the IG's contention that our reason for implementing the change in the MAFD percentage was solely for the purpose of reducing the improper payment rate in the Disaster Program. In addition, we disagree that increasing the MAFD "weakens a control that was implemented to reduce risk." As our analysis shows, there is no difference between an individual's acceptable justification at the time of file review versus a portfolio-wide review to determine likelihood of charge-off to a particular credit score, MAFD percentage, or income set. In fact, we believe that ODA is better able to control portfolio health when we risk score versus an individual's subjective decisioning. It should also be noted that of the 24 loans that were reported as improper, only 3 would not have sufficient enough cash flow to service the SBA loan. Additionally, as of April 30, 2018, none of these referenced loans are in charge-off status.

ODA recognizes the credit risk of exceeding a 75% MAFD and plans to incorporate the following policy into SOP 50-3-9:

> All loan recommendation requiring the applicant to carry more than 75 percent of MAFD must be adequately justified prior as a part of the approval process and only the Assistance Center Director for Application Processing having final loan approval authority.
>
> Further, the applicant must have satisfactory credit history for any consideration of increased MAFD percent. Examples of justifications to exceed the 75% MAFD percentage based on the following:
>
> a. <u>High Income and Relatively Low Living Expenses</u>: The applicant must justify high income and low living expenses. This justification may only be used if both of these factors are present.
>
> b. <u>Future Income Prospects</u>: This applies only to:
>
> (1) Applicants whose earnings in their occupational field or industry are rapidly increasing (e.g., a doctor who at the time of the disaster was in the first few years of a medical practice); or
>
> (2) Applicants with excellent prospects for substantial future income increases (e.g., a skilled tradesperson such as apprentice plumber who can reasonably expect to get a journeyman's license shortly).

c. Demonstrated Ability to Handle Debt: The 75% MAFD percentage may be exceeded if the applicant has demonstrated the ability to devote a greater part of income to monthly fixed debts. The historically demonstrated debt level may not be exceeded using this justification. For example, an applicant has demonstrated the ability to handle 80 percent MAFD. If the MAFD percentage after the SBA loan (with or without refinancing) exceeds 80 percent, this justification may not be utilized.

d. Accumulation of Sizeable Net Worth: The 75% MAFD percentage may be exceeded if the applicant has accumulated sizeable net worth and maintained a good credit history. For this purpose, "sizeable net worth" means tangible net worth equal to or greater than one year current salary.