

U.S. SMALL BUSINESS ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

SBA's Corrective Actions to Improve Controls Over 7(a) Loans Sold on the Secondary Market



Verification Inspection

Report #23-14

September 27, 2023

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NOTICE:

Pursuant to the James M. Inhofe National Defense Authorization Act for Fiscal Year 2023, Public Law 117-263, Section 5274, any nongovernmental organizations and business entities identified in this report have the opportunity to submit a written response for the purpose of clarifying or providing additional context as it relates to any specific reference contained herein. Comments must be submitted to AIGA@sba.gov within 30 days of the final report issuance date. We request that any comments be no longer than two pages, Section 508 compliant, and free from any proprietary or otherwise sensitive information. The comments will be appended to this report and posted on our public website.



**OFFICE OF INSPECTOR GENERAL
U.S. SMALL BUSINESS ADMINISTRATION**

MEMORANDUM

Date: September 27, 2023

To: Isabella Casillas Guzman
Administrator

From: Hannibal "Mike" Ware
Inspector General

A handwritten signature in black ink, appearing to be "H. Ware", written over the name of the sender.

Subject: Verification Inspection of SBA's Corrective Actions to Improve Controls Over 7(a) Loans Sold on the Secondary Market (Report Number 23-14)

This report represents the results of our verification inspection on *SBA's Corrective Actions to Improve Controls Over 7(a) Loans Sold on the Secondary Market*. A verification inspection is a short review that focuses on closed recommendations from prior OIG reports.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact me or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6586.

cc: Kathryn Frost, Acting Associate Administrator, Office of Capital Access
Dilawar Syed, Deputy Administrator
Arthur Plews, Deputy Chief of Staff
Therese Meers, General Counsel, Office of General Counsel
Michael A. Simmons, Attorney Advisor, Office of General Counsel
Cynthia Pitts, Acting Director, Office of Continuous Operations and Risk Management
Anna M. Calcagno, Director, Office of Program Performance, Analysis, and Evaluation
Katherine Aaby, Associate Administrator, Office of Performance, Planning, and Chief Financial Officer
Tonia Butler, Director, Internal Controls, Office of Chief Financial Officer

Background

The U.S. Small Business Administration (SBA) is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government guaranteed loans. SBA guarantees up to 90 percent for private lender loans of up to \$5 million to eligible small businesses. If a borrower defaults, SBA will honor its guaranty if it determines that the lender originated, closed, serviced, and liquidated the loan in accordance with SBA's loan program requirements.

The secondary market was established to provide greater liquidity to lenders, thereby, expanding the availability of commercial credit for small businesses. Lenders are allowed to sell the guaranteed portions of their loans in the secondary market. The lender receives cash equal to the amount of the guaranteed portion sold plus a market driven premium, while the investor gets an interest earning security that is backed by the full faith and credit of the U.S. government. Between October 2021 and July 2023, approximately 20,000 7(a) loans totaling \$16.2 billion were approved, disbursed, and sold on the secondary market.

If a lender chooses to sell a loan on the secondary market, they enter into an agreement with the fiscal and transfer agent (FTA), the investor, and SBA. Once the sale is finalized, the lender maintains responsibility for servicing the loan in accordance with SBA loan program requirements. The FTA is responsible for facilitating the sale of the loan to the investor, accounting for borrower payments, and assisting with guaranty purchase if the loan defaults.

Before a loan can be sold on the secondary market, the lender must submit it to the FTA for approval. SBA has established a risk-based review process to determine whether loans are eligible to be sold. FTA reviews loans submitted for sale approval via Secondary Participation Guarantee Agreement (SBA Form 1086). For lenders under regulatory, state, or federal orders, SBA maintains a watch list. Lenders on this list may request for a loan to be sold on the secondary market through the FTA. However, due to the risk associated with these lenders, SBA's Office of Credit Risk Management (OCRM) conducts a detailed review of each loan to determine whether it complies with SBA requirements and is eligible for sale.

We conducted an audit of *SBA's Controls Over 7(a) Loans Sold on the Secondary Market* (Report Number 19-07, March 14, 2019). The audit determined that internal controls related to selling loans into the secondary market and SBA's reviews for lender compliance on defaulted loans were generally effective. However, opportunities existed to strengthen controls to further mitigate the risk of loss for loans sold on the secondary market. Specifically, we found that the

OCRM did not communicate the results of their secondary market loan sale reviews to the National Guaranty Purchase Center and the Commercial Loan Servicing Centers. In addition, SBA did not always provide statutory reports to Congress timely and SBA's lender guidance for the secondary market was outdated. Lastly, SBA did not properly determine lender compliance with loan program requirements for one of the loans reviewed.

We made — and SBA management agreed to — five recommendations to strengthen SBA's internal controls, enhance external communication, and seek recovery of funds on ineligible charged off loans.

This inspection focuses on recommendation 2, which recommended that SBA establish a process to ensure that, going forward, OCRM communicates pertinent secondary market loan review results to the appropriate SBA loan centers.

Our objective was to determine the effectiveness of corrective actions SBA implemented to improve communication of identified secondary market loan deficiencies to the appropriate SBA loan centers.

Summary of Results

We found that OCRM's process for documenting secondary market loan sale denials in the Centralized Loan Chron System (CLCS) was generally effective at communicating loan deficiencies to the appropriate loan centers. The purpose of this entry is to ensure SBA loan guarantee processing centers are aware of identified deficiencies in the event the loan has a servicing request or receive a request to honor the guarantee.

Report 19-07: Audit of SBA’s Controls Over 7(a) Loans Sold on the Secondary Market

The following information details the original finding, recommendation, and SBA’s corrective action for recommendation 2.

OIG Finding	OIG Recommendation	SBA Corrective Action(s)
<p>OCRM officials did not communicate loan review results to the SBA loan centers responsible for guaranty purchases. Deficiencies found in loans for sale on the secondary market may warrant loan guaranty denial consideration.</p>	<p>We recommended that the Director of the Office of Credit Risk Management establish a process to ensure that pertinent review results from future OCRM secondary market loan reviews are communicated to the appropriate SBA loan centers.</p>	<p>We closed this recommendation on May 2, 2019, because OCRM established a process to ensure that pertinent results from future secondary market loan sale reviews are communicated via comments in the CLCS system to the appropriate loan centers.</p>

Inspection Result

We determined that the process OCRM established to document secondary market loan sale denials in CLCS was generally effective at communicating loan deficiencies to the appropriate loan centers.

OCRM reviewed a total of 37 secondary market loan sale applications from 10 watch list lenders, for a total of 30 loans, between October 1, 2020 and August 30, 2023, including resubmissions. As a result of their review, OCRM initially denied eight loan sale applications, preventing them from being sold on the secondary market. In some instances, the watch list lender resubmitted the request with additional documentation. As a result, OCRM subsequently approved four of the originally denied eight applications, after the lenders corrected the deficiencies.

OCRM completed its process to document secondary market loan sale denials in CLCS; however, we noted that the required CLCS notes on two of the eight denied applications were not made until after we announced this inspection and requested applicable information. An OCRM official stated they noted the error while compiling the requested information, and they made the corrections in the system prior to sending us the information.

To assess the impact of OCRM's delay in documenting the loan sale denials, we reviewed the two loans in the Capital Access Financial System and found that the loans were current. Additionally, since OCRM added the notes when they discovered the issue, they reduced the risk that loan centers could improperly purchase the guaranties on these loans. As a result, we will not reopen the recommendation.

Although we believe the recommendation has been fully implemented, during our verification review, we observed an opportunity for SBA to further strengthen controls in their manual CLCS entry process. As implemented, the manual process is subject to human error and SBA has the opportunity to consider and implement additional validation steps to ensure that CLCS notes are added as required.

Scope and Methodology

We selected one of the five recommendations from SBA OIG Report Number 19-07 to follow-up on the program office's corrective actions. We did not review the report's remaining four recommendations because the corrective actions did not result in a policy or procedural change.

For the recommendation selected, we reviewed management's justification and documentation of the corrective actions implemented to close the recommendation. This recommendation was closed because SBA provided evidence it had implemented corrective actions addressing the communication of future secondary market loan sale review results.

Our inspection scope covered the period from issuance of the March 2019 report to August 2023. We interviewed OCRM officials to understand the current process of maintaining a watch list of the 7(a) lenders that are under increased supervision, reviewing secondary market loan sale applications, and communicating the review results to loan guaranty purchase centers. We obtained and reviewed watch lists and a list of secondary market loan sale requests reviewed by OCRM. We reviewed OCRM's secondary market loan sale application denial notes in the CLCS.

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

Use of Computer-processed Data

We relied on OCRM's secondary market loan sale tracking list and data from SBA's Mainframe Loan Accounting System. Previous OIG engagements have verified that the information maintained in the Mainframe Loan Accounting System is reasonably reliable. To assess the reliability of the tracking list, we compared data from SBA's Mainframe Loan Accounting System and the lender watch list to determine if there were loans sold by lenders on the watch list that were not included on the tracking list. As a result, we believe that SBA's provided information is reliable for the purposes of this inspection.