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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, DC 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 9:00 A.M. EDT.
MONDAY, JUNE 30, 1980

STATEMENT OF
HENRY ESCHWEGE, DIRECTOR
COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE
SELECT COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

ON

THE SMALL BUSINESS ADMINISTRATION'S
SURETY BOND GUARANTEE PROGRAM

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

WE WELCOME YOUR INVITATION TO DISCUSS THE RESULTS OF OUR RECENT REVIEW, MADE AT YOUR REQUEST, OF THE SMALL BUSINESS ADMINISTRATION'S (SBA) SURETY BOND GUARANTEE PROGRAM. THE COMPTROLLER GENERAL'S REPORT WAS RELEASED TO THIS COMMITTEE ON DECEMBER 27, 1979, (CED-80-34).

OUR REVIEW SHOWED THAT THE SBA IS NOT MANAGING THE SURETY BOND GUARANTEE PROGRAM SATISFACTORILY. FOR EXAMPLE:

- BOND GUARANTEES OFTEN ARE BASED ON UNRELIABLE UNDERWRITING DATA AND SUPERFICIAL REVIEWS.
- SBA AND THE SURETY COMPANIES ARE MAKING LITTLE EFFORT TO MINIMIZE LOSSES.

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--THE PROGRAM IS NOT "GRADUATING" SIGNIFICANT
NUMBERS OF CONTRACTORS INTO THE PRIVATE
SURETY BONDING MARKET.

--SBA IS NOT PROVIDING MANAGEMENT ASSISTANCE
TO SURETY BOND GUARANTEE PROGRAM CONTRACTORS.

WE MADE A NUMBER OF RECOMMENDATIONS TO IMPROVE THE
PROGRAM.

BACKGROUND

SINCE 1971, SBA HAS PROVIDED BOND GUARANTEES ON MORE THAN
110,000 CONTRACTS TOTALING ABOUT \$8 BILLION. MANY OF THE
CONTRACTORS INVOLVED COULD NOT HAVE OBTAINED BONDING WITHOUT
THE SBA GUARANTEE. SBA REPORTED A NET COST OF \$129.3 MILLION
FOR THE SURETY BOND GUARANTEE PROGRAM THROUGH APRIL 1980, BUT
SBA ALSO REPORTED SIGNIFICANT SAVINGS TO THE FEDERAL, STATE,
AND LOCAL GOVERNMENTS BECAUSE THE LOW BIDDER ON MANY CONTRACTS
HAD SURETY BOND GUARANTEES.

THE SURETY BOND GUARANTEE PROGRAM IS INTENDED TO ASSIST
SMALL BUSINESSES DEVELOP SUFFICIENTLY TO SECURE BONDS WITHOUT
THE GUARANTEE. THE SBA GUARANTEES 80 TO 90 PERCENT OF A
SURETY COMPANY'S LOSSES ON BONDS EXECUTED FOR SMALL BUSINESSES
WHICH CAN BE REASONABLY EXPECTED TO PERFORM AS REQUIRED BY A
CONTRACT AND WHICH CANNOT OBTAIN BONDING WITHOUT THE GUARANTEE.
SURETY COMPANIES PAY SBA 20 PERCENT OF THE BOND PREMIUM IN
RETURN FOR THE GUARANTEE.

SBA IS RESPONSIBLE FOR DECIDING WHETHER TO APPROVE OR
DENY A BOND GUARANTEE REQUEST. THE AGENT, OR IN SOME CASES

THE SURETY, IS EXPECTED TO UNDERWRITE A CONTRACTOR'S BOND REQUEST BY ANALYZING A NUMBER OF FACTORS, INCLUDING THE CONTRACTOR'S FINANCIAL CAPACITY, TECHNICAL CAPABILITY, AND CHARACTER. SBA REQUIRES THE AGENTS TO FURNISH THIS AND OTHER TYPES OF FINANCIAL, MANAGEMENT, AND PERSONAL HISTORY INFORMATION TO SUPPORT THE CONTRACTOR'S BOND GUARANTEE APPLICATION.

SCOPE OF REVIEW

TO ENSURE SUFFICIENT PROGRAM COVERAGE, WE CARRIED OUT OUR REVIEW AT SBA'S CENTRAL OFFICE AND AT 3 OF ITS 10 REGIONS WHICH HAD MORE THAN 60 PERCENT OF THE SURETY BOND GUARANTEE PROGRAM ACTIVITY DURING FISCAL YEAR 1978. WE ALSO VISITED SELECTED SURETY COMPANIES, AGENTS, AND CONTRACTORS; AND WE MET WITH THE SURETY ASSOCIATION OF AMERICA. AN EXPERIENCED SURETY CONSULTANT ASSISTED US IN THE SPECIALIZED REVIEW OF UNDERWRITING AND CLAIMS.

OUR FINDINGS RELATE TO THE FILES REVIEWED AND ARE NOT BASED ON A STATISTICAL PROJECTION OF SAMPLE RESULTS TO A NATIONAL SCALE. HOWEVER, IN VIEW OF THE OVERWHELMING NATURE OF OUR SAMPLE FINDINGS AND THE FACT THAT THE SAMPLE WAS RANDOMLY SELECTED, WE BELIEVE OUR FINDINGS INDICATE TRENDS ON A BROAD-SCALE BASIS.

LET ME BRIEFLY DISCUSS OUR FINDINGS AND RECOMMENDATIONS.

UNDERWRITING

SBA APPROVES MOST SURETY BOND GUARANTEE APPLICATIONS BASED ON LIMITED REVIEWS OF INCOMPLETE OR ERRONEOUS UNDERWRITING DATA. SURETY AGENTS WHO UNDERWRITE A CONTRACTOR'S BOND REQUEST FREQUENTLY PROVIDE SBA OUTDATED, INACCURATE, INCOMPLETE, OR INCONSISTENT DATA IN SUPPORT OF THE GUARANTEE SUBMISSION.

OUR REVIEW OF 639 APPLICATIONS SHOWED THAT 87 PERCENT CONTAINED UNRELIABLE DATA. FOR EXAMPLE, WORKING CAPITAL, WHICH INDICATES A CONTRACTOR'S ABILITY TO MEET HIS SHORT-TERM OBLIGATIONS, WAS MISSTATED ON 31 PERCENT OF THE APPLICATIONS WHICH WE REVIEWED. IN ADDITION, INCOME STATEMENTS WERE OUTDATED OR WERE NOT SUBMITTED AT ALL WITH 33 PERCENT OF THE APPLICATIONS. THE DEFICIENCY RATE FOR SEVEN OTHER IMPORTANT UNDERWRITING ELEMENTS RANGED FROM 18 TO 53 PERCENT.

ALTHOUGH SOME OF THESE UNDERWRITING DEFICIENCIES WOULD NOT HAVE ALTERED SBA'S DECISION ON THE APPLICATION, MANY WERE QUITE SIGNIFICANT. ONE SURETY AGENT, FOR EXAMPLE, REPORTED THAT A CONTRACTOR HAD WORKING CAPITAL OF \$164,000, BUT OUR EXAMINATION OF FINANCIAL STATEMENTS SHOWED A NEGATIVE WORKING CAPITAL OF \$43,000. IN ANOTHER INSTANCE AN AGENT REPORTED WORKING CAPITAL OF \$105,000, BUT OUR UNDERWRITING CONSULTANT COMPUTED A WORKING CAPITAL OF ONLY ABOUT \$3,000. IN THIS CASE THE AGENT REPORTED THE INACCURATE INFORMATION TO SBA ON SEVEN BOND APPLICATIONS, AND SBA APPROVED BOND REQUESTS TOTALING

ALMOST \$1.4 MILLION. THE CONTRACTOR ULTIMATELY DEFAULTED ON 13 CONTRACTS WITH SBA BOND GUARANTEES, AND AT THE TIME OF OUR REVIEW SBA HAD PAID CLAIMS OF MORE THAN \$770,000.

PROGRAM OFFICIALS GENERALLY PERFORM ONLY A CURSORY REVIEW OF THE DATA, DEPENDING HEAVILY ON THE AGENT'S DECISION REGARDING GUARANTEE APPROVAL. ALTHOUGH SERIOUS UNDERWRITING DEFICIENCIES ARE COMMON, SBA HAD APPROVED 96 PERCENT OF THE BOND GUARANTEE APPLICATIONS SINCE THE PROGRAM BEGAN. EVEN WHEN DISCREPANCIES ARE FOUND, SBA OFTEN DOES NOT TAKE APPROPRIATE CORRECTIVE ACTION. SBA APPROVES GUARANTEE APPLICATIONS AS SUBMITTED OR MERELY RETURNS THEM TO THE AGENT, POINTING OUT THE UNDERWRITING SHORTCOMINGS AND SUGGESTING THAT THEY NOT BE REPEATED. FOR EXAMPLE, TOWARD THE END OF OUR REVIEW ONE DISTRICT OFFICE WROTE 190 LETTERS TO SURETY AGENTS DURING A 4-MONTH PERIOD DELINEATING THE AGENTS' UNDERWRITING DEFICIENCIES. ALTHOUGH ONE AGENT RECEIVED 79 OF THESE LETTERS REPEATEDLY ADMONISHING HIM FOR SUBMITTING OUTDATED FINANCIAL DATA AND INACCURATE CONTRACT START DATES, HE CONTINUED TO SUBMIT BOND GUARANTEE APPLICATIONS WITH UNRELIABLE DATA. SBA CONTINUED TO APPROVE THE APPLICATIONS AND GUARANTEE THE BONDS.

NEITHER SBA NOR PARTICIPATING SURETIES HAVE ESTABLISHED ADEQUATE UNDERWRITING CRITERIA OR GUIDELINES TO ASSIST PROGRAM PERSONNEL OR SURETY AGENTS IN ANALYZING CONTRACTORS' BOND REQUESTS. WE RECOGNIZE THAT EXPLICIT UNDERWRITING CRITERIA MIGHT BE TOO RESTRICTIVE, BUT WE BELIEVE THAT AN OPERATING MANUAL ESTABLISHING BASIC PARAMETERS FOR THE PROGRAM WOULD BE USEFUL AND PRACTICAL.

WE CONCLUDED THAT FUTURE LOSSES COULD BE REDUCED IF SBA RECEIVED RELIABLE UNDERWRITING DATA, ADEQUATELY REVIEWED IT, AND TOOK APPROPRIATE ACTIONS.

LOSS MINIMIZATION

SBA AND THE SURETY COMPANIES EXECUTING MOST OF THE SBA GUARANTEED BONDS ARE NOT PLACING SUFFICIENT EMPHASIS ON PREVENTING CONTRACTOR DEFAULTS. SBA GUARANTEES MANY BONDS WITHOUT SUFFICIENT INFORMATION TO DETERMINE WHETHER THE CONTRACTOR CAN ADEQUATELY HANDLE THE PROJECTED WORKLOAD. IN ADDITION, NEITHER SBA NOR MANY OF THE SURETY COMPANIES MONITOR CONTRACTOR PROGRESS SUFFICIENTLY TO DETECT POTENTIAL DEFAULTS BEFORE THEY OCCUR. SOME SURETIES PERIODICALLY VISIT CONTRACTORS AND REQUIRE QUARTERLY WORK-IN-PROCESS REPORTS AS A MEANS OF IDENTIFYING PROBLEMS AND ALLEVIATING THEM BEFORE THEY RESULT IN DEFAULTS.

IN ADDITION, SPECIALTY SURETIES--COMPANIES WHICH SPECIALIZE IN WRITING SBA-GUARANTEED BONDS--ARE MORE COSTLY TO SBA THAN STANDARD SURETIES. THIS IS PARTICULARLY SIGNIFICANT SINCE THE SPECIALTY COMPANIES WRITE 93 PERCENT OF THE BONDS FOR THE SURETY BOND GUARANTEE PROGRAM.

THE HIGHER COSTS RESULT IN PART BECAUSE MOST SPECIALTY SURETIES DO NOT HAVE THE CAPABILITY TO HANDLE CLAIMS INTERNALLY. THE SPECIALTY SURETIES CHARGE SBA FOR CLAIMS HANDLED BY OUTSIDE ATTORNEYS. CONVERSELY, THE LARGE STANDARD SURETY COMPANIES, WHICH PREDOMINANTLY WRITE BONDS IN THE PRIVATE MARKET, USUALLY HANDLE CLAIMS INTERNALLY AT

MINIMAL COST TO SBA. WE RECOGNIZE THAT SINCE THE STANDARD COMPANIES HAVE ESTABLISHED BRANCH OFFICES WHICH HANDLE CLAIMS, THEY MAY BE ABLE TO PERFORM THE CLAIMS-HANDLING FUNCTION AT A SOMEWHAT LESSER COST THAN SPECIALTY SURETIES; BUT IT COSTS THEM SOMETHING. SBA DOES NOT KNOW, HOWEVER, WHETHER THE REIMBURSEMENT RATES FOR CLAIMS HANDLING ARE REASONABLE AND REALISTIC FOR THE STANDARD SURETIES AND THE SPECIALTY SURETIES.

CONTRACTOR GRADUATION

THE SURETY BOND GUARANTEE PROGRAM IS NOT SIGNIFICANTLY CONTRIBUTING TOWARD GRADUATING CONTRACTORS INTO THE PRIVATE BONDING MARKET. OUR REVIEW OF 123 RANDOMLY SELECTED CONTRACTORS NOT CURRENTLY PARTICIPATING IN THE PROGRAM SHOWED THAT ONLY ABOUT 6 PERCENT HAD ACTUALLY GRADUATED. SINCE THESE CONTRACTORS ARE NOT CURRENTLY REQUESTING BOND GUARANTEES, THEY WOULD BE THE MOST LIKELY GROUP TO HAVE GRADUATED.

ALSO MANY CONTRACTORS CURRENTLY PARTICIPATING IN THE PROGRAM MAY QUALIFY FOR THE PRIVATE BONDING MARKET. SOME CONTRACTORS WITH GOOD FINANCIAL POSITIONS HAVE PARTICIPATED IN THE PROGRAM FOR SEVERAL YEARS. FOR EXAMPLE, ONE CONTRACTOR APPLIED FOR 160 SBA-GUARANTEED BONDS DURING A 4-YEAR PERIOD. HE RECEIVED 36 CONTRACT AWARDS AND PERFORMED SUCCESSFULLY ON EVERY ONE OF THEM.

THE LACK OF PROGRAM GRADUATES MAY RESULT IN PART BECAUSE NEITHER SBA NOR THE SURETY COMPANIES ENCOURAGE GRADUATION. OUR REVIEW OF 273 RANDOMLY SELECTED CONTRACTOR FILES FROM

THREE HIGH VOLUME SBA REGIONS SHOWED ONLY ONE INSTANCE WHERE SBA FORMALLY QUESTIONED WHETHER A CONTRACTOR SHOULD REMAIN IN THE PROGRAM AND ENCOURAGED HIM TO OBTAIN BONDING WITHOUT THE SBA GUARANTEE. IN ADDITION, THE SURETY COMPANIES WRITING MOST OF THE PROGRAM'S BONDS WRITE FEW, IF ANY, BONDS WITHOUT SBA'S GUARANTEE; SO THESE COMPANIES HAVE NO INCENTIVE TO GRADUATE CONTRACTORS. FURTHERMORE, THE ABSENCE OF SBA PROCEDURES AND GUIDELINES REGARDING CONTRACTOR GRADUATION PROBABLY CONTRIBUTES TO THIS INADEQUATE EMPHASIS ON GRADUATION.

MANAGEMENT ASSISTANCE

SBA DOES NOT IDENTIFY THE NEED FOR MANAGEMENT ASSISTANCE OR PROVIDE IT TO SURETY BOND GUARANTEE PROGRAM CONTRACTORS. SBA RELIES ON THE CONTRACTORS OR SURETY COMPANIES TO RECOGNIZE THE NEED FOR MANAGEMENT ASSISTANCE AND REQUEST IT WHEN APPLYING FOR A BOND GUARANTEE. OUR REVIEW OF 273 RANDOMLY SELECTED CONTRACTORS SHOWED ONLY FIVE INSTANCES IN WHICH MANAGEMENT ASSISTANCE WAS REQUESTED.

ADEQUATE AND TIMELY MANAGEMENT ASSISTANCE COULD MINIMIZE DEFAULTS OR SIGNIFICANTLY ENHANCE A CONTRACTOR'S ABILITY TO OBTAIN SUBSEQUENT BONDING IN THE PRIVATE MARKET.

RECOMMENDATIONS TO THE ADMINISTRATOR

OUR OVERALL CONCLUSION IS THAT SBA NEEDS TO STRENGTHEN ITS MANAGEMENT OF THE SURETY BOND GUARANTEE PROGRAM. SPECIFICALLY, WE RECOMMENDED IN OUR REPORT THAT THE SBA ADMINISTRATOR:

--DEVELOP UNDERWRITING GUIDELINES TO ASSIST PROGRAM PERSONNEL AND SURETY COMPANIES IN EVALUATING CONTRACTORS' SURETY BOND GUARANTEE APPLICATIONS AND REQUIRE PROGRAM OFFICERS TO VERIFY THE DATA CONTAINED IN SELECTED CONTRACTOR APPLICATIONS.

--DIRECT PROGRAM OFFICERS TO DECLINE APPLICATIONS WITH OUTDATED, INACCURATE, INCONSISTENT, OR INCOMPLETE UNDERWRITING DATA AND TO REFUSE TO DO BUSINESS WITH AGENTS WHO REPEATEDLY SUBMIT UNRELIABLE DATA.

--ESTABLISH AND ENFORCE GUIDELINES REGARDING SURETY RESPONSIBILITIES FOR MONITORING CONTRACTOR PROGRESS AND PREVENTING DEFAULTS.

WE RECOMMENDED FURTHER THAT HE:

--ESTABLISH A CLAIMS-HANDLING REIMBURSEMENT RATE(S) WHICH WILL RESULT IN A REASONABLE AND EQUIVALENT NET CLAIMS-HANDLING COST FOR THE TWO TYPES OF SURETIES IN THE PROGRAM--THOSE WHICH HAVE AN IN-HOUSE CLAIMS-HANDLING CAPABILITY AND THOSE WHICH DO NOT.

--ESTABLISH A SYSTEMATIC PROCEDURE FOR INDEPTH VERIFICATION OF SELECTED SURETY COMPANY CLAIMS.

--ESTABLISH GRADUATION CRITERIA AND PROCEDURES FOR FORMALLY ENCOURAGING AND ASSISTING CONTRACTORS TO OBTAIN PRIVATE BONDING AND PLACE INCENTIVES ON THE SURETY COMPANIES TO GRADUATE CONTRACTORS.

--IDENTIFY THE MANAGEMENT ASSISTANCE NEEDS OF SURETY
BOND GUARANTEE PROGRAM CONTRACTORS AND PROVIDE
TIMELY AND ADEQUATE MANAGEMENT ASSISTANCE TO THEM.

SBA AND SURETY COMPANY
RESPONSES TO OUR REPORT

SBA, FIVE SURETY COMPANIES, AND ONE SURETY AGENT FORMALLY COMMENTED ON OUR REPORT. WE CONSIDERED THESE RESPONSES IN FINALIZING OUR REPORT, BUT THEY DID NOT FURNISH ANY ADDITIONAL FACTS OR OPINIONS WHICH CAUSED US TO MODIFY OUR BASIC POSITIONS.

AFTER RECEIVING OUR REPORT, THE SBA PLACED A NEW MANAGEMENT TEAM IN THE SURETY BOND GUARANTEE PROGRAM'S CENTRAL OFFICE FOR A 120-DAY PERIOD. THIS TEAM--SCHEDULED TO COMPLETE ITS WORK BY JULY 6, 1980--HAS, AMONG OTHER THINGS, DRAFTED MANUALS ON UNDERWRITING AND CLAIMS. IN ADDITION, THE SBA HAS BEGUN AN AUDIT OF SURETY BOND CLAIMS ACTIVITIES AT COMPANIES WRITING A MAJOR PART OF THE PROGRAM'S BONDS.

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MR. CHAIRMAN, THIS CONCLUDES MY PREPARED STATEMENT. WE WILL BE PLEASED TO RESPOND TO ANY QUESTIONS.