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Report to the Chairman, Committee on Small Business, U.S. Senate

June 1998

SMALL BUSINESS ADMINISTRATION

Few Reviews of Guaranteed Lenders Have Been Conducted

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June 11, 1998

The Honorable Christopher S. Bond
Chairman, Committee on Small Business
United States Senate

Dear Mr. Chairman:

This report contains the results of our review of the Small Business Administration's (SBA) oversight of lenders participating in its 7(a) loan program[1] and its efforts to comply with the preferred lender review requirements of the Small Business Programs Improvement Act of 1996 (SBPIA).[2] The 7(a) loan program is intended to serve small business borrowers who cannot otherwise obtain financing under reasonable terms and conditions from the private sector. In fiscal year 1997, 7(a) loan approvals totaled nearly $9.5 billion.

In discussions with your office, we agreed to determine (1) how SBA conducts on-site reviews to monitor participating lenders' compliance with its 7(a) loan program policies and procedures and (2) what actions SBA is taking to comply with the preferred lender oversight provisions of SBPIA. To address these objectives, we conducted work at SBA's headquarters in Washington, D.C.; 5 of the 69 SBA district offices—3 of the largest, a medium, and a smaller sized office in terms of the number of loans outstanding; SBA's Preferred Lender Review Branch in Kansas City, Missouri; and its Sacramento Loan Processing Center in Sacramento, California.

Background

The 7(a) program is SBA's largest lending program and its primary vehicle for providing small businesses with access to credit. The program is intended to serve small business borrowers who could not otherwise obtain credit under suitable terms and conditions from the private sector. Under the program, SBA provides guarantees of up to 80 percent on loans made by participating lenders. During fiscal year 1997, 7(a) loan approvals totaled nearly $9.5 billion—the highest level of loan approvals in the program's history. This was an increase of 23 percent over the $7.7 billion in loan approvals in fiscal year 1996. The total for 7(a) loans outstanding, as of December 31, 1997, was $21.5 billion.

[1]Section 7(a) of the Small Business Act (15 U.S.C.§636(a)) authorized this loan guarantee program.

[2]12 U.S.C.§1452(d).

SBA's 7(a) lenders have been given additional authority and responsibility over their 7(a) portfolios. According to SBA, it is in transition from its direct involvement in loan guarantees to increased reliance on private sector lenders to fulfill its mission. Within the 7(a) program, there are three classifications of lenders—regular, certified, and preferred. Although SBA completely analyzes regular lenders' loans and decides on their guarantee, certified lenders are expected to perform a complete credit analysis. Preferred lenders are given full authority to determine eligibility and creditworthiness and to approve loans without prior review by SBA. Certified and preferred lenders are to have their status renewed at least every 2 years by SBA. At the end of 1997, according to SBA, there were approximately 6,000 lenders participating in the 7(a) program—about 4,750 regular, 800 certified, and 450 preferred lenders. In 1997, the percentage of loans accounted for by preferred lenders represented about 30 percent of 7(a) loan approvals and 50 percent of loan dollar volume.

Participating lenders charge borrowers fees to obtain SBA loan guarantees, and the borrowers repay the loans through payments to the lenders. To be eligible for a 7(a) loan guarantee, lenders are required to document that borrowers are unable to obtain financing under reasonable terms and conditions through normal business channels. In the event of a default, SBA purchases an agreed-upon share of the unpaid balance of the loan. The maximum exposure allowable for SBA on a guaranteed loan is $750,000 unless otherwise authorized by statute for a specific loan program.

To participate in the 7(a) program, lenders must meet certain basic requirements, including (1) having staff experienced in commercial lending, (2) maintaining a good character and reputation, and (3) having the financial capacity to disburse funds on loans. In addition, SBA regulations require that lenders be subject to supervision and examination by a state or federal regulatory authority acceptable to SBA. According to SBA, for a period prior to January 1982, it licensed a number of nondepository institutions, known as Small Business Lending Companies (SBLC), that are not subject to state or federal supervision or examination other than oversight conducted by SBA. SBA's regulations provide that, to meet its regulatory oversight requirement, these entities are to be subject to periodic audits by SBA's Office of Inspector General. According to SBA, it licensed 16 SBLCs, and 12 are currently active in the 7(a) program as preferred lenders. As of December 31, 1997, SBLCs accounted for about 19 percent of outstanding 7(a) loans.

Results in Brief

Prior to December 1997, SBA's operating procedures for the 7(a) program required annual on-site reviews of lenders having more than three outstanding guaranteed loans. We could not determine from the district offices' files which lenders met this criterion and should have been reviewed. However, in five SBA district offices we visited, about 96 percent of the lenders had not been reviewed by SBA in the past 5 years. Further, for some lenders that had participated in the program for more than 25 years, we found no evidence that they had ever been reviewed. Without conducting periodic on-site lender reviews, SBA has no systematic means to help ensure that lenders' actions do not render loans ineligible, uncreditworthy, or uncollectible, thus increasing the risk of loss to the agency. Such monitoring is particularly important as the agency moves from direct involvement in loan approvals to increased reliance on participating lenders to perform the approval and other functions related to the loan process. In addition, in the last 5 years, SBA's Inspector General conducted audits at only 3 of the 12 current SBLCs that operate as preferred lenders.

Beginning December 1997, SBPIA required SBA to review preferred lenders annually or more frequently. SBPIA did not change the oversight requirements for regular and certified lenders. As of May 1998, SBA was in the process of implementing a central review program for preferred lenders, but SBA had not yet conducted any reviews because of delays in developing the program. Although the central review program may offer a more comprehensive and systematic approach to assessing lender compliance with SBA's standards, it is too early to tell how successful the program will be until reviews are conducted and information on the program is available.

SBA Policy Requires Periodic Reviews of Lender Performance, but Few Have Been Done

Within SBA's headquarters, the Office of Financial Assistance has responsibility for developing the policies and procedures that govern the 7(a) loan program. SBA's 69 district offices are responsible for implementing the 7(a) program, including maintaining oversight of participating lenders' compliance with SBA's loan standards. The district offices report to the Headquarters Office of Field Operations and provide it with information on loan default rates and recoveries from liquidations. The district offices are not required to report on their lender oversight activities.

According to SBA's operating procedures, on-site reviews of lenders' policies and practices are a central mechanism for ensuring that lenders

are processing loans according to its standards. Prior to December 1997, the procedures required district offices to conduct annual reviews of participating lenders having more than three outstanding SBA guaranteed loans. The current policy requires a review at least once every 3 years for regular and certified lenders with three or more loans and annually for preferred lenders.

The objective of the reviews is to determine whether lenders are complying with SBA's 7(a) loan policies and procedures. The emphasis of the reviews is to be on inspecting lenders, using a checklist, to determine whether they have fulfilled requirements, such as documenting loan collateral and credit files. Reviewers are to determine, for example, whether collateral has been obtained and properly secured and whether required insurance has been obtained. Without conducting periodic lender reviews, SBA has no systematic means to evaluate lenders' determinations of loan eligibility, creditworthiness, or collectibility, thus increasing the risk of loss to the agency. In addition, reviews could also help deter lenders from extending guaranteed loans to applicants who could obtain funding through other means. Such monitoring becomes more important as the agency moves from direct involvement in each loan guarantee transaction to increased reliance on participating lenders in processing, servicing, and liquidating loans.

In spite of the policy requiring periodic reviews of participating lenders, SBA had conducted few on-site reviews of the 7(a) lenders in the district offices included in our review. In the 5 district offices we visited, SBA staff had not conducted reviews of 778 of 812 lenders,[3] or about 96 percent, in those districts in the past 5 years: 1993 through 1997. As shown in table 1, four of the five district offices we visited reviewed fewer than 3 percent of their participating lenders in that period of time.

[3]SBA's policy required annual on-site reviews of lenders having more than three outstanding loans. We could not determine from the district offices' files which lenders met this criterion and should have been reviewed.

Table 1: Comparison of Lenders Receiving On-Site Reviews to Total Lenders for Selected Districts, 1993-1997

District	Total lenders	Lenders reviewed	Percent
Kansas City, MO	300	1	0.3
Los Angeles, CA	199	0	0
Richmond, VA	191	2	1.0
Sacramento, CA	43	1	2.3
San Francisco, CA	79	30	38.0
Total	**812**	**34**	**4.2**

Source: GAO analysis of SBA files.

The Los Angeles District Office, the largest district office for loan approvals in fiscal year 1997, had not performed any on-site reviews in the last 5 years; and the Richmond District Office had conducted two during the same period. However, the San Francisco District Office had reviewed 61 percent of its preferred lenders, 82 percent of the certified lenders, and 20 percent of the regular lenders during the same time period.

In the 5 district offices, of the 744 lenders that had been in the program at least 1 year, we found no evidence that 625 had ever been reviewed since they began participating in the 7(a) program. Also, there was no documentation in the files to indicate that some lenders that had participated in the program for over 25 years had ever been reviewed. For example, one lender in the Los Angeles District Office had become a regular lender in 1980 and a preferred lender in 1987 and had never been reviewed by SBA. Another lender in the Kansas City District was certified over 29 years ago, but there was no documentation to indicate that it had ever been reviewed. The records at the 5 district offices also indicated that, of 147 lenders that entered the program between October 1, 1992, and September 30, 1996, only 3 were reviewed.

Our analysis of the files did not indicate that any specific types of lenders—regular, certified or preferred—received special emphasis in the review process. Table 2 shows the lenders reviewed in the past 5 years by the type of lender for each district.

Table 2: Lenders' Reviews, by Type, for Selected Districts

	Number of lenders reviewed since 1993-1997		
	Preferred	Certified	Regular
District	Reviewed/Total	Reviewed/Total	Reviewed/Total
Kansas City, MO	1/11	0/8	0/281
Los Angeles, CA	0/53	0/19	0/127
Richmond, VA	2/16	0/6	0/169
Sacramento, CA	1/7	0/5	0/31
San Francisco, CA	11/18	9/11	10/50

Source: GAO analysis of SBA files.

SBA's procedures state that reviews can be waived but that this waiver privilege should be used only when workload priorities preclude conducting a review. During the last 5 years, three of the five districts we had visited waived some field reviews. According to file documentation, the Kansas City District Office waived 182 reviews because of higher priority work, and the Los Angeles District Office waived 147 reviews because staff were not available. The San Francisco District Office waived 68 reviews for a number of reasons, including that the balances due on lenders' loans outstanding were low; lenders' offices were not located in the district; and the quality of lenders' 7(a) loan portfolios was considered good by the district staff.

District officials also told us that, although on-site reviews are not regularly performed, they do maintain contact with lenders through a number of mechanisms: telephone contact; periodic training seminars; and SBA visits to lenders to discuss the loan program, changes in SBA procedures, or a specific loan. For example, the Richmond District Office made 15 visits to lenders in 1997 to explain changes in SBA's liquidation procedures; the Kansas City District Office's records showed that staff made 25 visits to 22 lenders in the last 5 years, primarily to promote the 7(a) loan program.

When SBA conducted on-site reviews, SBA's checklist was used by staff, and they found deficiencies in lenders' compliance with SBA's loan standards. These deficiencies included inadequate loan collateral, loans written with maximum maturities with no documentation as to why lesser maturities would not be proper, and loans lacking documentation that credit was not otherwise available to borrowers.

Factors Affecting Oversight Operations

SBA district directors told us that staff downsizing had made it difficult to conduct on-site reviews of lenders. In the five districts we reviewed, increases in the number of loan approvals ranged from 24 to 255 percent from the beginning of fiscal year 1994 to the end of fiscal year 1997. During the same period, the Sacramento and San Francisco districts had staffing increases, while the other three districts experienced staff reductions. In Los Angeles, loan approvals increased from 973 to 2,073, while staff size decreased from 49 to 40.

In addition, the district directors said that the agency's emphasis on promoting the growth of small businesses and increasing the number of loans to groups that have been underserved by the private marketplace had resulted in less emphasis on oversight issues. The district offices are responsible for both promoting the interests of small businesses and, at the same time, conducting oversight of participating lenders to ensure the integrity of the program. District officials told us that they find it difficult to maintain a balance between these objectives because they are given explicit annual goals by SBA headquarters for increasing the number of loans to categories of the population that have been underserved by the marketplace.

SBA officials told us that, in addition to goals for loan volume and program promotion, SBA has annual goals related to loan performance. These performance goals may not measure the effectiveness of SBA oversight activities for two basic reasons. First, most loan defaults do not occur during the year a loan is originated. Second, and more importantly, for any one district office, economic conditions in the district have a major impact on default rates from previously originated loans, and this is true even in districts where SBA may perform effective oversight.

We also noted that neither SBA's headquarters program office nor its Office of Field Operations monitors field offices' compliance with the lender review requirement or requires district offices to provide headquarters with information on the extent to which they are doing lender reviews and on the results of lender reviews. In addition, SBA does not have a mechanism to evaluate how well reviews are done. However, SBA is piloting a Quality Service Review program that assesses field office activities, including whether lender reviews are being performed. In 1997, when SBA began the program, it reviewed the operations of 13 district offices and plans to conduct 20 reviews in 1998. The objective of the reviews is to ensure that critical program risks areas are reviewed; employees are motivated, informed, and treated fairly; customers are

satisfied with the delivery of SBA's programs; and SBA's relationships with its partners are healthy. SBA plans to review each district office's operations every 3 years.

SBA Is Planning Actions to Improve Lender Oversight

SBA officials told us that they recognize the need to adequately oversee lender compliance with its standards, are in the process of evaluating the oversight function, and will decide what changes are needed in the agency's oversight of 7(a) lenders. According to SBA's Five-Year Strategic Plan (fiscal year 1998-fiscal year 2002), dated September 30, 1997, SBA has a fiduciary responsibility to monitor the performance of lenders and to take steps against those lenders who are not performing in a manner consistent with the laws and regulations governing SBA's programs. In this regard, SBA plans, among other things, to develop a protocol for lender oversight that begins with the gathering and analysis of performance data from participating lenders and to establish loan program credit standards, as well as mission standards to measure lender performance.

One element of SBA's oversight plans is the development of a loan monitoring system to support off-site monitoring of lenders. The system is also intended to help support SBA's oversight of increased lender responsibility for servicing loans. In a June 27, 1997, report[4] on SBA's efforts to develop the system and a congressionally mandated risk management database, we concluded that SBA had not performed the essential planning needed to provide a basis for Congress to fund the development of the loan monitoring system. SBA disagreed with our recommendation to delay funding the system's development until the necessary planning was completed. However, Congress, in the Small Business Reauthorization Act of 1997,[5] mandated that SBA complete the planning steps and required it to report on its progress by June 1998. The act also requires us to evaluate SBA's report for compliance with the mandate.

SBA Is Implementing a Preferred Lender Review Program

Prior to the enactment of SBPIA, SBA decided to consolidate its processes for managing the preferred lender program. SBPIA required SBA to implement a program to provide a review, at least annually, of each lender participating in the Preferred Lenders Program. The requirement was based on this Committee's concern about SBA's past failure to provide

[4]Small Business Administration: Better Planning and Controls Needed for Information Systems (GAO/AIMD-97-94, June 27, 1997).

[5]P.L. 105-135, 111 Stat. 2592 (1997).

timely and regular reviews of lenders participating in the 7(a) loan program.

In April 1995, SBA consolidated the processes for preferred lender certification, approval for geographic expansion, and renewal of preferred lender status in its Sacramento Processing Center. In October 1995, SBA decided to develop a centralized preferred lender review process in its Kansas City, Missouri, Review Branch. In addition, SBA has incorporated the preferred lender oversight requirements that were included in SBPIA, which became effective on September 30, 1996. The act required SBA to establish a preferred lender review program not later than 90 days after the act became law. The review program is to include annual or more frequent assessments of the participation of lenders in the program, including defaults, loans, and the recoveries of loans that lenders make under the program.

The stated objectives of SBA's new preferred lender review program are to determine (1) whether preferred lenders are processing, servicing, and liquidating loans according to SBA standards, and (2) whether such lenders should continue to participate in the preferred lender program. The review requirements are to be more extensive than those governing on-site reviews of regular and certified lenders. According to SBA's Preferred Lender Program review manual, reviews are to focus on a sample of loans approved by lenders and a sample of loans for which lenders have taken servicing or liquidation actions. The reviews are also to include an assessment of lenders' loan policies and procedures, their internal routine and controls, and any responses to previous reviews.

The preferred lender reviews are to be conducted by a review team comprising an SBA Review Branch representative and one or more contract reviewers. SBA contracted with a private sector partner to provide support for the review and oversight activities. Contract reviewers are to conduct the reviews of lenders' SBA loans under the supervision of an SBA representative. The review team is to be responsible for reviewing lenders' loan policies and practices, their internal routine and controls, and any responses to previous reviews. Contractor costs are to be reimbursed directly to the contractor through a fee assessed to preferred lenders when they are reviewed. The fees are to be based on the number of preferred lender program loan approvals and are projected to range between $1,800 and $23,000. SBA plans to review, by the end of fiscal year 1998, all preferred lenders that had originated at least one loan under the program

in fiscal year 1997. These reviews are to be done either on-site or off-site, depending on the loan volume of the lenders.

As of the end of March 1998, SBA staff conducted nine preliminary reviews to test the review methodology and determine the length of time needed to conduct on-site reviews. In commenting on a draft of this report, SBA stated that the reviews are under way, with 60 off-site reviews started in early May and on-site reviews to commence in mid-May. SBA's Review Branch plans to conduct reviews of each lender institution by the end of fiscal year 1998 as required by SBPIA. The preferred lender review program may offer a more comprehensive and systematic approach to assessing lender practices. However, it is too early to tell how successful it will be until reviews are conducted and information on the program is available.

Lender Oversight and Economic Conditions Affect Financial Risks

On-site lender reviews are an essential element to ensure that participating SBA 7(a) lenders are complying with SBA loan standards and thereby mitigating risks to SBA. When a financial institution provides a loan to a borrower, credit risk (i.e., the possibility of financial loss resulting from default by the borrower) is present over the life of the loan. In a 1997 study conducted under contract to SBA, defaults on 7(a) loans were found to occur most often 3 to 5 years after origination.[6] Therefore, default rates observed through off-site monitoring during a current period of time do not indicate whether a lender is currently following prudent lending practices. In addition, economic and business conditions affecting small business borrowers affect loan performance on loans made by all lenders, including those that follow more prudent lending practices. The SBA loan performance study found that default rates for 7(a) loans originated in the 1986 through 1990 time period were in the 20-percent range. According to the study, default rates have declined since 1990. The decline is consistent with the strong performance of the national economy over the past 5 to 6 years.[7] In the future, if economic conditions were to become less favorable, such conditions would likely place upward pressure on 7(a) default rates.

[6]Walker & Company, Independent Study of 7(a) and 504 Loan Programs for the Eleven Cohort Years Ended September 30, 1996 (June 16, 1997).

[7]Likewise, the number of problem financial institutions insured by the Federal Deposit Insurance Corporation (FDIC) and failures of those institutions have both declined over the past 6 years, consistent with the strong performance of the national economy. In 1991, FDIC defined 1,426 institutions with assets of $819 billion as problem institutions; in 1997, the respective measures were 92 institutions with assets of $7 billion. In 1991, 271 FDIC-insured financial institutions with assets of $142 billion failed; in 1997, the respective measures were 1 institution with assets of $27 million.

Although lenders who follow prudent practices for originating and servicing 7(a) loans can experience defaults, such risks to SBA would be expected to be lower than risks associated with lenders following less prudent practices. In order to monitor lenders without conducting on-site reviews, SBA has tended to rely on information from individual 7(a) loans provided at the time of application and at the time of liquidation on loans that default. These data do not provide systematic information on the extent to which each lender follows prudent lending practices, for two basic reasons: (1) even the most prudent lenders make loans that default, and (2) prudent lending requires observation of lender practices and collecting information over the life of performing and defaulted loans. Furthermore, over time, SBA has delegated greater authority and responsibility to all lenders and a larger proportion of lenders have become preferred lenders.

Careful oversight by the institution's board, stockholders, and regulators can help ensure prudent lending practices. Many 7(a) lenders are regulated by financial institution regulators, such as the Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), Federal Deposit Insurance Corporation (FDIC), and Federal Reserve Board (FRB). These regulators provide risk-focused supervision to help ensure that financial institutions under their supervision have sufficient controls for risk management as well as other practices that foster safe and sound operations. In addition, these regulators have a continuing examination presence that helps them monitor changes in the institution's lending practices and scope future examinations to emphasize activities that may entail higher risks.

Although financial institution regulators help ensure safe and sound operations, their oversight does not necessarily ensure that 7(a) portfolios are managed prudently. According to an OCC official, in providing risk-focused supervision, examiners would not necessarily focus on a regulated institution's 7(a) portfolio unless it were identified as endangering the overall soundness of the financial institution. Therefore, from SBA's perspective, lenders subject to such regulation still require effective SBA oversight.

Perhaps of greater importance, the SBLCs licensed by SBA are generally not subject to oversight by financial institution regulators.[8] SBLCs are nondepository lending institutions that are licensed by SBA. To satisfy SBA's

[8]To the extent that any of these SBLCs are, or become, subsidiaries of bank holding companies, they could be subject to FRB oversight. We did not analyze the implications of such potential oversight during the course of this assignment.

supervision and examination requirement, SBLCs are subject to direct supervision and examination by SBA. SBA regulations provide that SBLCs are subject to periodic audits by SBA's Inspector General and that SBA will assess the cost of the audit, based on asset size, against the SBLC, except for the first audit.[9] In the last 5 years, SBA's Inspector General conducted audits at three SBLCs. Audits at two of the SBLCs involved a review of their lending practices for compliance with SBA's requirements. The audit at one of these SBLCs concluded that the SBLC was in compliance with applicable SBA requirements. The second audit concluded that the SBLC's originating and servicing of SBA loans needed improvement, and that some required internal controls had not been implemented. The third audit was requested by an SBA district office and was limited to a review of three guaranteed loans. The audit concluded that one of the three loans did not qualify for the guarantee, and that interest collected by the lender should have been returned to SBA.

In the future, it is possible that economic conditions could become less favorable and that such conditions then could place upward pressure on 7(a) default rates. SBA's knowledge of how prudently each lender's 7(a) portfolio is managed and how the portfolio would perform under less favorable economic conditions is more limited without on-site reviews. In addition, effective oversight of SBLCs could help SBA assess how prudently their overall operations are managed and how these institutions would perform under less favorable economic conditions.

Conclusions

In the five district offices included in our review, SBA had not conducted the regular, periodic reviews of lender compliance with its 7(a) loan standards as required under its operating procedures. Without such systematic oversight, SBA cannot ensure that participating lenders are complying with its loan standards and thereby mitigating risks to the agency. In addition, SBA does not have clear organizational responsibilities and mechanisms in place to ensure that information on the lender review process is collected, reported, and analyzed. Without such information, SBA cannot measure and monitor the impact of its oversight of lenders' compliance with its loan policies and procedures.

As of the end of March 1998, SBA was in the process of implementing its centralized review program for preferred lenders, but it had not yet conducted any reviews. It had developed and tested a review methodology and is planning to conduct annual reviews of preferred lenders as required

[9] 13 C.F.R.§120.475.

by SBPIA. In commenting on a draft of this report, SBA stated that the planned reviews were under way. SBA's preferred lender review program should provide improved oversight of preferred lender practices.

The audits conducted at three SBLCs in the last 5 years do not appear to satisfy SBA's audit frequency and continuing supervision and examination requirement. Because these SBLCs are not subject to supervision or examination by a financial institution regulator, we believe oversight by SBA is especially important.

SBA officials told us that they recognize the need to adequately oversee lenders' compliance with its 7(a) loan standards and are planning actions to improve oversight of lenders' practices; however; it is too early to tell how successful the initiatives will be.

Recommendations

We recommend that the Administrator of the Small Business Administration ensure that the required 7(a) lender oversight reviews are conducted. In this regard, the Administrator should establish organizational responsibilities and a mechanism for ensuring that information on the lender review process is collected, reported, and analyzed. This information should be useful in assessing the results of the review process and determining whether additional initiatives may be needed.

We also recommend that the Administrator develop and implement a mechanism to satisfy its supervision and examination function for SBLCs.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from SBA, which provided written comments that are reproduced in appendix I. SBA's comments did not specifically address our recommendations, but they stated that the funds it has requested for loan system modernization are essential for it to institute the oversight we endorse in the report. In general, SBA also expressed a concern that the report may give an incomplete picture of its oversight activities.

SBA stated that it was important to highlight the improvement in the credit quality of its loan portfolio. It stated that, although the excellent economy has contributed to this improvement, SBA believed that its recent changes to the 7(a) program have mitigated the degree of vulnerability to an economic downturn. These changes included increasing lenders'

economic interest in loans and revising program operating procedures. We acknowledged in the report that SBA's default rates have declined, but it was beyond our scope either to determine how much of this decline is based on the state of the economy or on SBA's practices or to project how its portfolio would likely perform under less favorable economic conditions.

SBA commented that the results of our review at 5 of its district offices are not necessarily representative of activities throughout the 69 SBA district offices. We visited the Los Angeles and San Francisco, California, and Kansas City, Missouri, district offices because they are three of the largest districts in terms of the number of loans outstanding. We also visited a medium and a smaller sized office—Sacramento, California, and Richmond, Virginia, respectively. We do not know how representative these offices are. SBA's district offices are not required to report on their lender oversight activities, and the resulting lack of information regarding on-site reviews makes it difiicult to determine whether the districts we visited were representative or not.

SBA commented that, although it has placed a high priority on improving oversight, on-site lender reviews have a limited role. SBA stated that, other than on-site reviews, it performs oversight in a number of other ways, which it states provide a systematic means of mitigating risk imposed as a result of lenders' decisions. That is, it verifies eligibility in all loan decisions, considers lender performance in decisions to relicense certified and preferred lenders, and reviews loans when a lender requests an SBA purchase. SBA said that it is also modernizing its loan system as part of its efforts to improve its monitoring of individual loans and individual lenders. We agree that these activities, including off-site monitoring, provide a measure of oversight; however, they do not provide the type of systematic assessment of a lender's practices that periodic on-site reviews provide. Our experience in evaluating financial institution regulators indicates that off-site monitoring is helpful when it is used to perform risk assessments to target on-site reviews, but that it is not an effective substitute for such reviews. In addition, we are reporting on SBA's noncompliance with its own requirement for lender oversight reviews. SBA's operating procedures state that on-site lender reviews are necessary to maintain the integrity of its loan programs and are a critical component of its oversight requirement.

SBA said it was also working with banking regulatory agencies, which examine the vast majority of its lenders, to explore opportunities for

partnership in regulation and oversight and for them to play an important role in examining its lenders' overall performance in making creditworthy loans. As the report states, although financial institution regulators help ensure lenders' safe and sound operations, their oversight does not necessarily ensure that 7(a) portfolios are managed prudently. In addition, it should be noted that SBA currently has no access to the findings of examinations conducted by bank regulators.

With regard to SBLCs, which are not subject to supervision and examination by a state or federal financial regulatory authority, SBA said that, in addition to specific audits by its Inspector General, oversight is provided in a number of ways, including a requirement that SBLCs submit annual audited financial statements. We agree that audited financial statements can help examiners focus on specific aspects of a financial institution in its on-site examinations. However, the purposes of external audits and safety and soundness examinations differ and are guided by different standards and methodologies. For example, federal financial regulators require examiners to evaluate the adequacy of methodologies used by financial institution auditors to estimate loan loss reserves.

Scope and Methodology

As requested by the Chairman of the Senate Committee on Small Business, our objectives were to determine (1) how SBA conducts on-site reviews to monitor participating lenders' compliance with its 7(a) loan program policies and procedures, and (2) what actions SBA is taking to comply with the preferred lender oversight provisions of the Small Business Programs Improvement Act of 1996.

To determine how SBA has assessed whether lenders are managing loans according to its standards, we examined SBA's standard operating procedures relating to reviews of regular and certified lenders, as well as its manual for examining preferred lenders. We reviewed other related guidance pertaining to the 7(a) loan program and interviewed staff from SBA headquarters, Office of Inspector General, and 5 of the 69 SBA District Offices. We also interviewed staff from the Sacramento Loan Processing Center in Sacramento, California, and the Preferred Lender Review Branch in Kansas City, Missouri. Finally, to obtain a perspective on the extent to which SBA field offices have conducted assessments of lender compliance, we reviewed lender files from the five SBA district offices. We visited the Los Angeles and San Francisco, California, and Kansas City, Missouri, district offices because they are three of the largest districts in terms of the number of loans outstanding. We also visited a medium and a smaller

sized office—the Sacramento, California, and Richmond, Virginia, offices, respectively. We also selected these district offices to visit to help conserve travel funds.

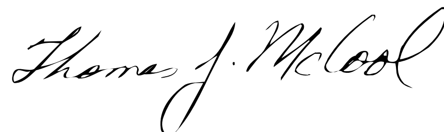
To determine SBA's compliance with the preferred lender oversight requirements of SBPIA, we reviewed documentation relating to SBA's implementation of a centralized review program for preferred lenders. We discussed the program with staff from SBA headquarters and the Preferred Lender Review Branch in Kansas City. We also reviewed reports of reviews of preferred lenders that were done on a test basis by the Kansas City Review Branch.

We conducted our work in Washington, D.C.; Los Angeles, Sacramento, and San Francisco, California; Kansas City, Missouri; and Richmond, Virginia, between September 1997 and March 1998 in accordance with generally accepted government auditing standards.

As arranged with your office, unless you publicly announce the contents of this letter report earlier, we plan no further distribution until 14 days after its issue date. At that time, we will send copies of this report to the Ranking Minority Member of the Committee on Small Business; the Chairmen and Ranking Minority Members of other interested congressional committees; the Administrator, Small Business Administration; the Director, Office of Management and Budget; and other interested parties. Copies will also be made available to others upon request.

Please contact me or Bill Shear at (202) 512-8678 if you or your staff have any questions. Major contributors to this report are listed in appendix II.

Sincerely yours,



Thomas J. McCool
Director, Financial Institutions
and Markets Issues

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Abbreviations

FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
OCC	Office of Comptroller of the Currency
OTS	Office of Thrift Supervision
SBA	Small Business Administration
SBLC	Small Business Lending Company
SBPIA	Small Business Programs Improvement Act of 1996

Comments From the Small Business Administration

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

OFFICE OF THE ADMINISTRATOR

MAY 19 1998

Mr. Thomas J. McCool
Director
Financial Institutions and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the opportunity to respond to U.S. Government Accounting Office's (GAO) draft report on the U. S. Small Business Administration's (SBA) on-site reviews of our 7(a) lenders, and the steps SBA is taking to comply with the preferred lender oversight provisions of the Small Business Programs Improvements Act of 1996 (SBPIA).

I very much appreciate all the cooperation we received from the GAO staff involved in this report. I do have some concerns that it may paint an incomplete picture for the general public. SBA has changed our loan programs and improved program management. We have a number of efforts underway that will augment SBA's ability to manage the overall risk of our lending programs while maintaining the integrity of our public purpose mission.

First, it is important to highlight the fundamental improvement in credit quality of SBA's loan portfolio. Though some of the improvements in credit quality are clearly due to the excellent economy, SBA believes that important changes in our programs mitigate our degree of vulnerability to any economic downturn. In recent years, significant program changes have increased the economic interest of lenders in individual loans; strengthened, clarified, and enhanced program guidelines for all loans but particularly those made through the Preferred Lender Program (PLP); improved liquidation recoveries; and significantly enhanced data quality. These improvements are all reflected in the lower subsidy rate which better utilizes the taxpayer dollars supporting SBA loan programs. SBA is developing the analytical capacity to use econometric modeling to assess the relative importance of underwriting decisions and economic conditions on portfolio performance.

Second, as you indicate, the world of SBA lending has changed a great deal in recent years. In the past, private-sector lenders were used to deliver SBA loans, but control of the underwriting rested with SBA because our employees reviewed and approved each loan. Thus, there was little need for the degree of oversight called for in today's environment. PLP loans have grown, for example, from 14 percent of our dollar

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volume in 1993, to 52 percent today. As SBA increasingly privatizes loan-making functions, managing our lending programs merits a different type of oversight.

I have established a goal of making SBA a 21st century leading edge financial institution. As part of this objective, I have placed a high priority on improving oversight. It must be recognized, however, that on-site lender reviews play only a limited role in the oversight SBA must exercise. Just as the financial regulatory agencies increasingly emphasize off-site monitoring using highly sophisticated analytical tools, SBA must exercise its oversight responsibilities in an effective, cost-efficient manner.

Of our approximately 7,000 lenders, some 2,500 make only one SBA loan per year. Another 2,500 make between two and five SBA loans each year. Instead of concentrating on an on-site review by SBA employees of each of these lenders, I want to leverage the work of the financial regulatory agencies, who are already performing examinations of the vast majority of these lenders. SBA is working with the bank regulatory agencies to explore opportunities for partnership in regulation and oversight.

Our collection of relevant information will allow SBA to effectively monitor and manage the risk of our entire portfolio, as well as individual loans and individual lenders. In this regard, new reporting systems have greatly improved SBA's ability to monitor loan status. We have moved from a quarterly, paper-based reporting system, to monthly reports that can be submitted electronically. The information from these reports is used by both headquarters and field staff. The loan system modernization efforts underway will facilitate the prompt corrective action that can minimize SBA's risk exposure. The funds SBA has requested for system modernization are essential for SBA to institute the oversight GAO endorses in this report.

I want to state emphatically that SBA does have a systematic mean of mitigating risk imposed as a result of lenders' decisions. It is, in part, due to these measures that our subsidy rate has substantially improved, decreasing from 2.19 in the current fiscal year to 1.39 in FY 99.

Other than our on-site reviews, SBA performs lender oversight through other means. First, in all loan decisions, including PLPs, SBA verifies eligibility. Second, the quality of lenders' determinations are reviewed regularly within the process of re-licensing CLP and PLP lenders. Third, SBA conducts a review of each loan for which a purchase is requested. This review provides SBA the opportunity to deny liability if a lender has failed to comply with SBA regulations and standard operating procedures. Similarly, the statistics related to on-site reviews by the five District Offices visited are not necessarily representative of activities throughout the 69 District Offices, and suffer from a lack of recognition of the factors cited above. Additionally, I believe GAO has underestimated the important role played by the primary financial regulators such as the Federal Reserve (the Fed), Office of the Controller of the Currency (OCC), and the Federal Depository Insurance Company (FDIC) in examining our lenders' overall performance in making creditworthy loans.

GAO note: We did not reproduce the enclosure.

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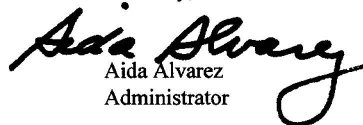
Your report notes that it is too early to tell how successful the PLP review program will be. While comprehensive data from a full cycle of reviews will not be available until fiscal year 1999, the reviews are underway, with 60 desk reviews of Preferred Lenders started in early May, and on-site reviews commencing this week. Since Congress passed SBPIA, SBA has planned the program, hired an outside contractor to assist with the reviews, trained the outside contractor on SBA's PLP program, hired staff to assist and oversee contractor reviews, trained that staff, set review fees, drafted and published the PLP Review Guide, and scheduled the reviews.

With regard to audits of the Small Business Lending Companies (SBLC) by SBA's Office of Inspector General (OIG), I am enclosing a March 25, 1998, letter from Karen Lee, SBA's Acting Inspector General, to Senator Bond. This letter highlights relevant oversight activity beyond individual SBLC audits by the OIG.

As part of our efforts to transform SBA into a 21st century, leading edge financial institution, further modifications are underway. I look forward to the opportunity to discuss these changes with the GAO and with the House and Senate Small Business Committees.

Sincerely,



Aida Alvarez
Administrator

Enclosure

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