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# Highlights

Highlights of GAO-10-53, a report to congressional requesters

# SMALL BUSINESS ADMINISTRATION

## Actions Needed to Improve the Usefulness of the Agency's Lender Risk Rating System

## Why GAO Did This Study


The Small Business Administration (SBA) guarantees individual loans that lenders originate. The agency uses its Loan and Lender Monitoring System (L/LMS) to assess the individual risk of each loan, and SBA's contractor developed a lender risk rating system based on L/LMS data. However, questions have been raised about the extent to which SBA has used its lender risk rating system to improve its oversight of lenders. GAO was asked to examine (1) how SBA's risk rating system compares with those used by federal financial regulators and lenders and the system's usefulness for predicting lender performance and (2) how SBA uses the lender risk rating system in its lender oversight activities. To meet these objectives, GAO reviewed SBA documents; interviewed officials from three federal financial regulators and 10 large SBA lenders; analyzed SBA loan data; and interviewed SBA officials.


## What GAO Recommends

GAO recommends that SBA ensure that its contractor, consistent with industry standards, follows sound model validation practices, use its own data to assess the lender risk rating system, develop a strategy for targeting lenders for on-site reviews that relies more on its lender risk ratings, and consider revising its on-site review policies and procedures. In responding to a draft of this report, SBA generally agreed with these recommendations and outlined some steps that it plans to take to address them.


View GAO-10-53 or key components.
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## What GAO Found

SBA's lender risk rating system uses some of the same types of information that federal financial regulators and selected large lenders use to conduct off-site monitoring, but its usefulness has been limited because SBA has not followed common industry standards when validating the system—that is, assessing the system's ability to accurately predict outcomes. Like the federal financial regulators and 10 large lenders GAO interviewed, SBA's contractor developed lender risk ratings based on loan performance data and prospective, or forward-looking, measures (such as credit scores). Using SBA data, GAO undertook a number of evaluative steps to test the lender risk rating system's predictive ability. GAO found that the system was generally successful in distinguishing between higher- and lower-risk lenders, but it better predicted the performance of larger lenders. However, the system's usefulness was limited because the contractor did not follow validation practices, such as independent and ongoing assessments of the system's processes and results, consistent with those recommended by federal financial regulators and GAO's internal control standards. For example, the agency did not require a party other than the one who developed the system to perform the validation, and SBA's contractor did not routinely reassess the factors used in the system as part of its validations. Further, SBA does not use its own data to develop alternate measures of lender performance that could be used to independently assess or supplement the risk ratings, citing resource constraints. Because SBA does not follow sound validation practices or use its own data to independently assess the risk ratings, the effectiveness of its lender risk rating system—the primary system SBA relies on to monitor and predict lender performance—may deteriorate as economic conditions and industry trends change over time.

Although SBA's lender risk rating system has enabled the agency to conduct some off-site monitoring of lenders, the agency does not use the system to target lenders for on-site reviews or to inform the scope of the reviews. Unlike the Federal Deposit Insurance Corporation and the Federal Reserve, which use their off-site monitoring tools to target lenders for on-site reviews, SBA targets for review those lenders with the largest SBA-guaranteed loan portfolios. As a result of this approach, 97 percent of the lenders that SBA's risk rating system identified as high risk in 2008 were not reviewed. Further, GAO found that the scope of the on-site reviews that SBA performs is not informed by the lenders' risk ratings, and the reviews do not include an assessment of lenders' credit decisions. The federal financial regulators use the results of off-site monitoring to identify which areas of a bank's operations they should review more closely. Moreover, their reviews include an assessment of the quality of the lenders' credit decisions. Federal financial regulators are able to use review results to update their off-site monitoring systems with data on emerging lending trends. Regardless of the lender's risk rating, SBA relies on a standard on-site review form that includes an assessment of lenders' compliance with SBA policies and procedures but not an assessment of lenders' credit decisions. According to SBA officials, it is not the agency's role to assess lenders' credit decisions. Without targeting the most risky lenders for on-site reviews or gathering information related to lenders' credit decisions, SBA cannot effectively assess the risk posed by lenders or ensure that its lender risk rating system incorporates updated information on emerging lending trends.