

Improvement is Needed to Ensure Effective Quality Control at Loan Operation Centers





**U.S. Small Business Administration
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TO: John Miller, Director, Office of Financial Program Operations
Brent Ciurlino, Director, Office of Credit Risk Management

SUBJECT: Improvement is Needed to Ensure Effective Quality Control at Loan Operation Centers

This report presents the results of our evaluation of the Quality Control Program at the National Guaranty Purchase Center (NGPC) and Loan Operation Centers.

We conducted this evaluation 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 inspections, present all factual data accurately, fairly, and objectively, and that we present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objective.

We appreciate the courtesies and cooperation of the SBA extended to the staff during this audit. Please direct any questions to me at (202) 205-6587 or Terry Settle, Director, Credit Programs Group at (703) 487-9940.

/s/
Robert A. Westbrook
Acting Assistant Inspector General for Auditing



EXECUTIVE SUMMARY:

Improvement is Needed to Ensure Effective Quality Control at Loan Operations Centers

Report Number 14-08

What the OIG Reviewed

The SBA is authorized under Section 7(a) of the Small Business Act and Section 504 of the Small Business Investment Act to provide assistance to small businesses in the form of government-guaranteed loans and debentures. The 7(a) Loan Guaranty program is the SBA's largest lending program and is the principal vehicle for providing small businesses with access to credit that cannot be obtained elsewhere. The SBA's 504 Loan program provides small businesses with long-term financing for the purchase of land, buildings, machinery, and other fixed assets.

Given the importance of loan programs to the SBA's mission, the Agency established operation centers to perform loan origination, servicing, purchasing, and liquidation activities. In 2004, the National Guaranty Purchase Center (NGPC) developed a quality control plan to review the quality of the guaranty purchase process. Since this time, the OIG has performed multiple audits and engagements that assessed loan operation center activities and their compliance with SBA requirements. Based on material deficiencies noted by the OIG, the need to establish an effective quality control program at the loan centers has been an SBA Management Challenge since Fiscal Year (FY) 2007. In 2010, the SBA established a quality control program to ensure that centers accurately and consistently apply statutory, regulatory, and procedural loan program requirements. The goals of the program are to improve loan operation center services and reduce management waste, fraud, and abuse.

Our initial survey objective was to determine whether the Office of Financial Program Operations's (OFPO) Quality Control Program for the NGPC and Loan Operation Centers was effectively designed and implemented to (1) mitigate the SBA's risk of loss, and (2) assure stakeholders on the quality of the centers' deliverables. During our initial survey work we identified deficiencies in the OFPO's quality control program and that material actions within the program were not being performed. As a result, we developed a reporting objective to determine the status of the Quality Control Program and whether all elements of the program were being completed.

What the OIG Found

Over the past three years the SBA made significant progress in implementing a quality control program for its loan centers. Our evaluation verified that the SBA established a quality control program and developed quality control

review activities at each of its loan operation centers. However, our evaluation found that quality control activities were not being performed at the Centers in accordance with SBA's overall Quality Control and Center specific guidance.

Specifically, we found that Centers omitted required quality control reviews of significant functions. Additionally, the NGPC discontinued regularly scheduled quality reviews for about five months during FY 2012 to focus on reviews required by the Improper Payments Elimination and Recovery Act (IPERA) of 2010. Further, corrective actions on deficiencies identified by the Center quality control teams were not appropriately tracked until resolution, as required.

Finally, we determined that the SBA's quality assurance program, responsible for ensuring that quality control activities at loan operation centers are working as intended, had not been established. We have reported this issue as an Other Matter.

OIG Recommendations

We recommended that the Director of the Office of Financial Program Operations:

- Ensure the proper allocation of resources and scoping of the quality control program to complete required quality control activities at the loan operation centers.
- Ensure that corrective actions related to quality control findings are appropriately documented and completed within required timeframes.

We recommended that the Director of the Office of Credit Risk Management:

- Establish and implement a plan to conduct quality assurance activities at SBA loan operation centers.

Management Response and Actions Taken

The SBA agreed with each recommendation. The OFPO initiated projects to address long-standing deficiencies within the existing quality control program. Specifically, OFPO dedicated projects to (1) ensure adequate staffing is available to perform quality activities and (2) enhance quality control corrective action processes.

Additionally, the OFPO recently developed and implemented a new system to aggregate data, track risk, and improve communication over quality control activities.

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Introduction

This report presents the results of our limited scope evaluation of the quality control program at the National Guaranty Purchase Center and Loan Operation Centers for 7(a) Loans. Our initial survey objective was to determine whether the Office of Financial Program Operation's Quality Control Program for the NGPC and Loan Operation Centers was effectively designed and implemented to (1) mitigate the Small Business Administration's (SBA) risk of loss, and (2) assure stakeholders on the quality of the centers' deliverables. During our initial survey work we identified deficiencies in the OFPO's quality control program and that material actions within the program were not being performed. As a result, we developed a reporting objective to determine the status of the Quality Control Program and whether all elements of the program were being completed.

To answer our reporting objective, we interviewed Agency officials within the Office of Financial Program Operations (OFPO) and the Office of Credit Risk Management (OCRM). Additionally, we reviewed the SBA and loan operation center-specific quality control program guides. Further, we analyzed monthly quality control metric reports from three different SBA loan operation centers for the period of Fiscal Year (FY) 2012 through May 2013. Finally, we analyzed select loan operation center training logs and feedback and corrective action logs for the periods of FY 2011 through March 2013 and FY 2011 through February 2013 respectively.

We conducted this evaluation from March 2013 through September 2013, in accordance with the Council of the Inspectors General on Integrity and Efficiency (CIGIE) *Quality Standards for Inspection and Evaluation*. Those standards require that we adequately plan inspections, present all factual data accurately, fairly, and objectively, and that we present findings, conclusions, and recommendations in a persuasive manner.

Background

Loan Programs and Loan Operation Centers

The SBA is authorized under Section 7(a) of the Small Business Act and Section 504 of the Small Business Investment Act to provide assistance to small businesses in the form of government-guaranteed loans and debentures. The 7(a) Loan Guaranty program is the SBA's largest lending program and is the principal vehicle for providing small businesses with access to credit that cannot be obtained elsewhere. Under this program, SBA guarantees a portion of loans made and administered by commercial lending institutions.

The SBA's 504 Loan program provides small businesses with long-term financing for the purchase of land, buildings, machinery, and other fixed assets. These loans are issued through a partnership with Certified Development Companies (CDCs) and private sector third-party lenders, and are funded through the issuance of government-guaranteed debentures. At the end of FY 2012, the SBA's combined 7(a) and 504 loan portfolio totaled \$87 billion.

Given the importance of loan programs to the SBA's mission, the Agency has established operation centers to perform loan origination, servicing, purchasing, and liquidation activities.

The figure below provides an overview of the loan operation centers included in the scope of this evaluation:

Figure 1 SBA Loan Operation Centers



Quality Control Program

Recognizing the importance of ensuring the quality of its deliverables, in 2004 the NGPC developed a quality control plan to review the quality of the guaranty purchase process. In 2010, the SBA established a Quality Control program to assess quality for all of its loan operation centers. The quality control program was designed to ensure that centers accurately and consistently apply statutory, regulatory, and procedural loan program requirements. The goals of the program are to improve services provided by the loan operation center and reduce waste, fraud, and abuse.

Prior Audits

An OIG survey of the quality assurance review process at the NGPC in 2006, noted that implementation of the quality control (QC) plan had not been achieved and that the QC program had not been appropriately staffed and was not conducting reviews as required.¹ Further, a 2006 audit of backlogged loans purchased at the NGPC noted the poor quality of the SBA reviews performed on these loans.²

Subsequent audits performed by the OIG on the guaranty purchase process, high-dollar early default loans, and the SBA's improper payment reviews have continued to identify weaknesses in loan center operations. For example, a 2007 audit determined that the SBA purchased guaranties for 25 out of 58 (43%) loans reviewed by the OIG without adequately ensuring all SBA requirements were met.³ The OIG estimated that the SBA made approximately \$36 million in erroneous payments during the scope of this audit.

¹ Report Number 6-26, Advisory Memorandum: *Survey of the Quality Assurance Review Process*.

² Report Number 6-35, *Audit of Deficiencies in OFA's Purchase Review Process for Backlogged Loans*.

³ Report Number 7-23, *Audit of the Guarantee Purchase Process for Section 7a Loans at the National Guaranty Purchase Center*.

Additionally, an audit of the Fiscal Year 2008 Improper Payment Rate for the 7(a) Guaranty Loan Program found a high rate of improper payments on loans reviewed.⁴ The OIG estimated the improper payment rate for loan guaranties purchased between April 1, 2007, and March 31, 2008, to be 27 percent, or approximately \$234 million of the \$869 million purchased.

Further, an audit of the Fiscal Year 2011 Improper Payment Rate for the 7(a) Guaranty Loan Program found improper payments for 6 of the 30 sampled 7(a) guaranty purchase loans reviewed.⁵ The audit determined that the SBA did not detect all improper payments when conducting improper payment reviews to estimate its FY 2011 improper payment rate for 7(a) guaranty purchases. The audit also noted that quality control team guidance used to conduct improper payment reviews was inconsistent with SBA requirements. The OIG determined that while the SBA reported an improper payment rate of 1.73 percent or \$40.7 million in its FY 2011 Agency Financial Report, the rate could have been as high as 20 percent, or about \$472 million.

Finally, between November 2010 and February 2013 the OIG has conducted a series of audits focused on SBA guaranty purchase reviews over high-dollar early-defaulted loans. These audits noted (1) the need for the NGPC to apply increased scrutiny to high-dollar early defaults, (2) significant weaknesses in the SBA's assessment of delegated lender underwriting, and (3) recoveries of over \$10 million in improper payments were warranted.

The need to establish an effective quality control program at the loan centers has been an SBA Management Challenge since FY 2007.⁶ The OIG initiated this evaluation in large part to assess the Agency's status for this Management Challenge, which requires the Agency to implement a Quality Control program for all of its loan operation centers.

Nature of Limited or Omitted Information

We did not limit or omit information from this report.

Results

Over the past three years, in response to the OIG's Management Challenge, the SBA made significant progress in implementing a quality control program for its loan centers. Through our limited evaluation work, we verified that the SBA established a quality control program and developed quality control review activities at each of its loan operation centers. However, our evaluation found that the Office of Financial Program Operations is currently redesigning certain aspects of the program. Our evaluation also found that quality control activities were not being performed at the Centers in accordance with SBA's overall Quality Control and Assurance Program Guide and Center specific guidance. Specifically, we found that Centers omitted required quality control reviews of significant functions. Additionally, the NGPC discontinued regularly scheduled quality reviews for about five months during FY 2012 to focus on reviews

⁴ Report Number 9-16, *The Small Business Administration's Fiscal Year 2008 Improper Payment Rate for the 7(a) Guaranty Loan Program*.

⁵ Report Number 13-07, *The Small Business Administration's Improper Payment Rater for 7(a) Guaranty Purchases Remain Significantly Underestimated*.

⁶ Report Number 14-01, *Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in Fiscal Year 2013 – Management Challenge #4*.

required by the Improper Payments Elimination and Recovery Act (IPERA) of 2010. Finally, corrective actions on deficiencies identified by the Center quality control teams were not appropriately tracked until resolution as required. Without an effective quality control program the SBA cannot verify that its loan centers are in compliance with statutory, regulatory, and procedural loan program requirements and mitigating the SBA's risk of loss.

Status of the SBA's Quality Control Program at its Loan Operation Centers

To address the OIG's management challenge, the SBA's Office of Financial Program Operations (OFPO) made significant progress over the last three years and successfully established a quality control program that identified quality control review activities to be performed at each of its loan operation centers. In August 2012, after observing quality control processes at a leading lending institution, the OFPO's quality control manager began efforts to improve and redesign the existing quality control program. The OFPO management officials have titled this effort the Quality Improvement Program (QIP).

During our evaluation, OFPO management provided the OIG with a listing of 11 QIP projects meant to establish new, or significantly enhance existing quality control activities. These projects included planned activities to address long-standing deficiencies within the existing quality control program. Specifically, OFPO has dedicated projects to (1) ensure adequate staffing is available to perform quality activities and (2) enhance quality control corrective action processes. A complete listing of these projects is listed below:

OFPO Quality Improvement Program (QIP) Projects

- Enhanced Review Criteria (Identify and Define Root Causes and Critical versus non-critical);
- Determine the impact or materiality of deficiencies within risk tolerance;
- Robust and standardized sampling methodology and target audit criteria;
- Ensure adequate staffing is made available for QIP;
- Developing reporting and communication process on evaluations;
- Bi-weekly and monthly training;
- Enhanced recapture and tracking process;
- Develop process to capture first line staff input and suggestions;
- Department quality reports/state of the center quality;
- Develop trend analysis on deficiencies impacting process and policy; and
- Coordinate committee to review standards across Office of Capital Access offices for corrective actions.

Additionally, to further enhance its quality control efforts, the OFPO recently developed and implemented a new data collection tool. According to plans provided by OFPO, the Quality Based Evaluator and Risk Tracker (QBERT) system will be used for the purpose of aggregating data, tracking risk, and improving communication over quality control activities. We commend the SBA on taking actions to improve its quality control program and address longstanding weaknesses within the program. As these projects were either ongoing or in development at the time of our evaluation, we did not assess Agency progress towards completing these projects.

SBA Loan Operation Center Quality Control Activities were Not Being Performed

The SBA's Quality Control and Assurance Program Guide established the guidance and framework for its loan operation center quality control activities. In turn, each loan operation center developed its own center specific guide to detail (1) the center activities which require quality reviews, (2) the number of reviews required (daily or monthly), (3) compliance goals, and (4) the required corrective action activities. During our evaluation, we determined that multiple SBA loan operation centers were not performing required quality control activities established either in the SBA Quality Control and Assurance Program Guide or in their center specific guide(s).

National Guaranty Purchase Center - Herndon, VA

We determined that the SBA's National Guaranty Purchase Center (NGPC) did not perform reviews to assess quality in the majority of its loan purchase and liquidation oversight operations during FY 2013. Specifically, the majority of the NGPC reviews covered 182 or 65-percent of the 279 high-dollar early-defaulted loans⁷ (HDEDs) required for review.⁸ As the NGPC focused on HDEDs, it generally did not perform required quality control reviews over other loan purchases, care and preservation of collateral (CPC) expenses, offers in compromise (OIC), and loan charge-offs. These additional areas totaled 69-percent of the required quality control activities in the center. As a result, the NGPC only conducted 31-percent⁹ of the required quality control reviews during the period from October 2012 through May 2013. Table 1 below provides further details on the NGPC review activities during this period:

Table 1 NGPC Quality Control Activities October 2012-May 2013

NGPC Activity	NGPC Required Metric	Frequency	# Processed at NGPC During Period	# Required for QC Review During Period	# Reviewed by QC During Period	Percent of Activity Reviewed by QC
Random Purchases	10% previous day purchases	Daily	1,884	188	55	29%
HDEDs	100% previous day purchase recommendations	Daily	279	279	182	65%
CPC Expenses	10% previous months CPC actions	Monthly	1,057	106	0	0%
OICs	10% previous months OIC actions	Monthly	781	78	3	4%
Charge-Offs	10% of previous months charge-off actions	Monthly	1,127	113	0	0%
Total			5,128	764	240	31%

⁷ High dollar early default loans are defined as loans in the amount of \$500,000 or more that default within the first eighteen months of initial disbursement.

⁸ As provided in Table 1, the NGPC guide requires a 100 percent review of all HDED loans.

⁹ This percentage does not include quality control reviews over guaranty purchase denials and repairs due to inconsistencies in the NGPC's documentation of these activities.

Finally, we determined that the NGPC performed some level of quality control reviews over guaranty purchase denials and repairs (i.e., partial denials). However, we identified inconsistencies in the NGPC's documentation of these review activities and determined that the NGPC did not meet the required quality control review metric of 100 percent.

Loan Guaranty Processing Center – Citrus Heights CA; Hazard KY

We determined that the Loan Guaranty Processing Center (LPGC) had not performed quality control reviews of new programs as required. The SBA Quality Control and Assurance Program Guide states that new processes and complex transactions must be monitored. Specifically, the program Guide states that as new loan products and practices are introduced, Center practices must be developed to implement the program changes. As part of the implementation processes, the Centers must identify the risk characteristics and ensure that procedures, reporting, controls, and employee training are focused in these areas.

The SBA's Small Loan Advantage (SLA) program was revised and expanded on May 25, 2012. The maximum loan amount for SLA loans under the new program was \$350,000 and the LGPC has responsibility for reviewing the credit worthiness and eligibility of SLA loans, and for issuing the loan authorization for SLA loans. Based on documentation provided by the Agency and the LGPC's quality control selection criteria of loans valued at \$1.5 million or more, we determined that the LGPC did not conduct any quality control reviews of SLA program loans. Additionally, the SBA re-launched its Dealer Floor Plan pilot loan program on February 8, 2011. However, we determined that the LGPC quality control team did not conduct reviews of LGPC Dealer Floor Plan loan approvals from October 2012 through February 2013.

Commercial Loan Servicing Centers (CLSCs) – Little Rock, AR; Fresno, CA

We determined that the CLSCs in Little Rock and Fresno were not conducting required reviews over 504 loan liquidation activities. Specifically, the CLSC quality control guides states that 100 percent of 504 loan protective bids are to be reviewed and reported on monthly.¹⁰ Based on documentation provided by OFPO, we determined that from October 2012 through May 2013, the CLSCs, on average, only reviewed 10 percent of 504 loan protective bids. This coverage was significantly less than the 100 percent requirement established by the CLSCs.

Improper Payments Elimination and Recovery Act Reviews

The OFPO's responsibilities over SBA's compliance with the Improper Payments and Elimination Recovery Act (IPERA) of 2010 significantly impacted the FY 2012 quality control activities for the NGPC. The IPERA requires agencies to conduct improper payment reviews for all programs and activities susceptible to significant improper payments, and to report their improper payment results. The SBA's IPERA review is designed to test the Agency's compliance with loan program requirements and includes a qualitative assessment of center loan approval and purchase decisions.

¹⁰ Protective bid means an offer made by a secured creditor to pay a designated price for property at a foreclosure sale to "protect" the secured creditor's interest in the property that might otherwise be eliminated by the foreclosure sale.

The OFPO utilized their quality control teams to assist with assessing improper payments in the SBA's 7(a) and 504 loan approval and purchase activities. As a result, the NGPC's regularly scheduled quality control activities, with the exception of HDEDs, were generally suspended for a five-month period during FY 2012. The quality control activities impacted at the NGPC from May through September 2012 included live repairs, random purchases, CPCs, OICs, and loan charge-offs.

Officials from OFPO stated that a lack of staffing resources impacted its ability to conduct planned activities under its quality control program. However, we note that previous OIG audit findings and recommendations issued in 2006¹¹ addressed similar deficiencies regarding incomplete reviews and a lack of resources allocated to the quality control program. While SBA management initially satisfied the OIG recommendations as intended, it did not maintain appropriate resources to ensure required quality control activities continued. These repeated deficiencies in the quality control program demonstrate that improvements are still needed in the SBA's management oversight and resource allocation for this program.

Further, OMB Circular A-123, *Management's Responsibility for Internal Control* provides guidance to Federal Managers on improving the accountability and effectiveness of Federal Programs. The guidance states that management is responsible for maintaining internal controls and that monitoring the effectiveness of internal controls should occur in the normal course of business (i.e. periodic reviews, reconciliations, or comparisons of data). The quality control program as outlined in the Agency's quality control program guide establishes the method used by the SBA loan operation Centers to monitor internal controls by verifying and documenting compliance with SBA loan regulatory, statutory, and policy requirements. As a result, not performing required quality control activities significantly impacts the SBA's ability to maintain effective internal control and achieve its quality control program's desired objective and goals.

Corrective Action Activities at the NGPC were Not Performed as Required

The NGPC center specific guide states that the Center's corrective action plan should identify and track (1) quality control errors, (2) root causes of the errors, (3) sources of the errors, and (4) error resolutions and or associated recovery amounts. As discussed above, a very limited number of quality control reviews were performed at the NGPC. However, we determined that when reviews were conducted, for the period of October 2010 through February 2013, the NGPC did generally identify quality control errors. Nevertheless, the NGPC did not appropriately document the root causes of the errors, the sources of the errors, and error resolutions as required.

Based on the NGPC corrective action logs and discussions with OFPO management officials, we determined that OFPO management did not effectively monitor the loan operation center corrective action activities. Specifically, management did not ensure that all attributes associated to quality control errors were documented and tracked as required. Appropriate tracking of corrective actions on quality control errors is critical to ensure that weaknesses in

¹¹ Report Number 6-26, Advisory Memorandum: *Survey of the Quality Assurance Review Process.*

loan operation center activities are resolved and that dollar losses are either mitigated or recovered.

Importantly, the Agency has taken action to address the weaknesses in this area. Specifically, the OFPO has drafted a plan to improve its quality control corrective action activities at each of the loan operation centers. The plan highlights the need to identify deficiencies, establish milestones for corrective action, and measure the effectiveness of actions taken. Finally, the OFPO plans to have Center quality control specialists track corrective actions in its QBERT system. Specifically, OFPO officials stated that quality control specialists will enter deficiencies, sources of the errors, root causes, dollar impacts, and corrective action(s) into the QBERT system.

Other Matter

The SBA's Quality Assurance Program had Not Been Established

The SBA's Quality Control and Assurance Program Guide provides guidance and establishes the framework for the SBA's loan operation centers' quality assurance activities. The guide also establishes the roles and responsibilities for quality assurance within the SBA's Office of Financial Program Operations (including its loan operation centers), Office of Risk Management, and Office of Financial Assistance. According to the Guide, the Office of Risk Management's (ORM) role is to conduct quality assurance reviews based on statutory, regulatory, and procedural guidelines. The ORM is no longer a functional office within the SBA and was reorganized into the Office of Credit Risk Management (OCRM).

The guide defines quality assurance as the processes used to provide oversight of quality control activities. Quality assurance (QA) provides the checks and balances to ensure that quality and internal controls are working as intended. Quality assurance activities, as they relate to the SBA loan operation centers, include peer reviews, documentation reviews, quality assurance reviews, and improper payment testing. We determined through interviews with OFPO and OCRM management officials that quality assurance activities had not been planned or conducted since the Quality Control and Assurance Program Guide was established in September, 2010.

The SBA has recently begun efforts to establish the required QA program. Specifically, the OCRM agreed to take responsibility for conducting the QA activities. Further, the OCRM assigned a financial program analyst to lead quality assurance activities. However, as noted above, the OCRM has not established any formal plans for QA or conducted any of the associated activities. During discussions with the OIG, management officials within the OCRM cited a lack of resources to implement and perform the QA activities as required. The absence of quality assurance activities over the loan operation center's quality control program prevents the SBA from ensuring that the quality control program is functioning effectively to achieve its objectives.

Conclusion

The OFPO established a quality control program and developed quality control review activities at each of its loan operation centers. However, we determined that critical loan operation

center activities were not being monitored for quality and that corrective action activities were not being documented and tracked as required. Without an effective quality control program the SBA cannot verify that its loan centers are in compliance with statutory, regulatory, and procedural loan program requirements and mitigating the SBA's risk of loss.

We acknowledge the SBA's recent efforts to address the historic weaknesses within its quality control activities at the loan operation centers. However, improvements are still needed in the SBA's management oversight and resource allocation to ensure the quality control program is achieving its objectives and goals.

Recommendations

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

1. Ensure the proper allocation of resources and scoping of the quality control program to complete required quality control activities at the loan operation centers.
2. Ensure that corrective actions related to quality control findings are appropriately documented and completed within required timeframes.

We recommend that the Director of the Office of Credit Risk Management:

3. Establish and implement a plan to conduct quality assurance activities at SBA loan operation centers.

Agency Comments and OIG Response

On November 6 2013, we provided a draft of this report to the Director of the Office of Financial Program Operations and the Director of the Office of Credit Risk Management for comment. On January 8, 2014, the Agency submitted formal comments, which are included in their entirety in Appendix II. A summary of management's comments and our response follows.

Summary of Management Comments

The Agency agreed with all of our recommendations and stated it takes quality control in its centers very seriously and is committed to continual improvement in its quality control program. The OFPO acknowledged that NGPC activities were not always reviewed for quality, but stated available resources were utilized to continue reviews of higher-risk transactions, especially high-dollar early-defaulted (HDED) loans. The OFPO committed to update center QC guides as it makes risk based decisions on QC activities.

Additionally, the OFPO acknowledged that QC reviews were not performed in accordance with the NGPC's guide for a five month period in FY 2012 to focus on reviews required by the Improper Payment Elimination and Recovery Act (IPERA). However, it is OFPO's position that QC activities did not cease and that the reviews were merely substituted during this time period with the IPERA audit reviews, which assess compliance with loan program requirements. Further, the OFPO noted that due to the sampling methodology established at the LGPC, loans made under the Small Loan Advantage (SLA) or Dealer Floor Plan (DFP) were not selected for

quality reviews. The OFPO recognizes this issue as an area of improvement, and will amend the LGPC's sampling methodology to ensure new processes and complex loan transactions are not unintentionally excluded.

The OFPO acknowledged weaknesses in tracking corrective actions and initiated a project to re-develop the corrective action process, which resulted in the development and implementation of the Corrective Action Tracker. Additionally, the OFPO noted that in July 2013, it launched the Quality-Based Evaluator and Risk Tracker (Q-BERT). This web-based platform unifies all of the centers' QC review finding details and related documentation in a single, centralized repository. Finally, the OFPO noted that it continuously evaluates the effectiveness of the QC program to ensure its quality approach is consistent and effective across centers.

OIG Response

We commend the OFPO on its efforts to improve its QC program and have discussed within this report that the Agency has made significant progress in implementing a QC program for its loan centers. We note that the Agency generally agreed with our findings and with all of our recommendations. Further, we have revised this report to incorporate the Agency's comment that the SBA's IPERA review is designed to test the Agency's compliance with loan program requirements and includes a qualitative assessment of center purchase decisions. However, we continue to support our position that regular QC activities at the NGPC were discontinued and disagree that IPERA reviews serve as an adequate substitute for all regular QC activities established by the NGPC.

The SBA's FY 2012 IPERA review was generally conducted at the NGPC from May 2012 through September 2012. During this timeframe, regular QC reviews at the NGPC were generally suspended. Additionally, the SBA's FY 2012 IPERA review considered loans purchased at the NGPC from April 1, 2011, through March 31, 2012. However, the NGPC's QC guide required daily reviews of random purchases or high-dollar early defaults conducted the previous day. Further, the SBA's IPERA reviews conducted at the NGPC were focused on whether loans were purchased in accordance with SBA's rules and regulations and if the payment amount issued by SBA was appropriate. As a result, these reviews were not focused on assessing the quality of other significant activities conducted at the NGPC. These activities include CPC Expense reimbursement, OICs, Charge-Offs, or guaranty purchase denials and repairs, which were required to be reviewed monthly in accordance with the NGPC's QC guide.

Recommendation 1 - Ensure the proper allocation of resources and scoping of the quality control program to complete required quality control activities at the loan operations centers.

Management Comments

The OFPO agreed with this recommendation. The OFPO stated that it has hired quality control specialists and initiated a process improvement project dedicated to ensure adequate staffing is available. The OFPO stated it is updating the quality program guides for each center to ensure that necessary activities are reviewed by Quality Control. Finally, the OFPO stated it is exploring the development of review ranges for transactions performed by the quality control program. This will support the centers' ability to complete reviews at various resource levels and will ensure the required reviews are conducted.

OIG Response

Management's comments were responsive to the recommendation. The management decision for this recommendation is considered resolved and the recommendation will remain open pending final action.

Recommendation 2 - Ensure that corrective actions related to quality control findings are appropriately documented and completed within required timeframes.

Management Comments

The OFPO agreed with this recommendation. The OFPO stated that it initiated a process improvement project in April 2013 to enhance its corrective action process. The OFPO stated that this initiative led to the development of the Corrective Action Tracker (Tracker) system which tracks all quality incidents that can escalate into more serious matters. The OFPO stated that the Tracker has the capability to track and report the status of the corrective actions to successful implementation and closure. The OFPO began implementing Tracker in the loan operation centers in October 2013, and anticipates full implementation by January 2014.

OIG Response

Management's comments were responsive to the recommendation. The management decision for this recommendation is considered resolved and the recommendation will remain open pending final action.

Recommendation 3 - Establish and implement a plan to conduct quality assurance activities at SBA loan operation centers.

Management Comments

The OCRM agreed with this recommendation. The OCRM stated that providing adequate oversight of SBA's loan center QC program implementation is essential to assure effective loan center operations. The OCRM stated that it is finalizing its FY 2014 Risk Management Plan, which will address the development of a Quality Assurance plan. In addition, the OCRM stated that it has designated resources within its Supervision and Enforcement Division to lead quality assurance activities. Finally, the OCRM noted that it will conduct a review of the quality program guides for each center and establish an initial quality assurance plan by March 30, 2014.

OIG Response

Management's comments were responsive to the recommendation. The management decision for this recommendation is considered resolved and the recommendation will remain open pending final action.

Appendix I: Scope and Methodology

To determine if the Office of Financial Program Operations' Quality Control Program for the NGPC and Loan Operation Centers was effectively designed and implemented, we reviewed the Overall Quality Control Program Assurance Guide; National Guaranty Purchase Center Specific Quality Program Guide; Commercial Loan Servicing Center Specific Quality Program Guide; and the Loan Guaranty Processing Center Specific Quality Control Program Guide.

Additionally, we gathered and evaluated select Center quality control monthly metric reports for the period from October 1, 2011, through May 31, 2013. Further, we interviewed Agency officials within the Office of Financial Program Operations and Office of Credit Risk Management regarding their quality control and assurance activities and oversight. Finally, we analyzed select loan operation center training logs and feedback and corrective action logs for the periods of FY 2011 through March 2013 and FY 2011 through February 2013 respectively.

Use of Computer Processed Data (Update)

The evaluation did not rely on computer-processed data to identify the conditions reported. The evidence used for the evaluation consisted primarily of policy guides and tracking documents as well as interviews with Agency management officials.

Prior Coverage (Update)

The OIG last performed an engagement focused on the quality control process at SBA loan operation centers in 2006. In Audit Report 6-26, *Survey of the Quality Assurance Review Process*, issued July 12, 2006, the OIG determined that implementation of the quality control plan at the National Guaranty Purchase Center had not been achieved. Additionally, the survey found that the quality control program had not been appropriately staffed and was not conducting reviews as required.

Since this time, the OIG has performed multiple engagements to evaluate SBA loan center operations over 7(a) and 504 loan origination, purchase, and liquidation activities. Significant reports issued within the past 5 years can be accessed on the internet at <http://www.sba.gov/oig>, and include the following:

The Small Business Administration's Fiscal Year 2008 Improper Payment Rate for the 7(a) Guaranty Loan Program, [Audit Report 9-16](#), issued July 10, 2009

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

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

Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in FY 2013, [Report 13-02](#), October 15, 2012

The Small Business Administration's Improper Payment Rate for 7(a) Guaranty Purchases Remains Significantly Underestimated, [Audit Report 13-07](#), issued November 15, 2012.

Appendix II: Agency Comments



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

MEMORANDUM
January 8, 2013

To: Robert A. Westbrook
Acting Assistant Inspector General of Auditing

From: John A. Miller
Director, Office of Financial Program Operations

Brent M. Ciurlino
Director, Office of Credit Risk Management

Subject: Response to Draft Report on Improvement is Needed to Ensure Effective Quality Control at Loan Operations Centers, Project No. 13004

Thank you for the opportunity to review the draft report. We appreciate the role the Office of Inspector General (OIG) plays in assisting management in ensuring that programs are effectively managed, and for the feedback provided in this draft report.

The OIG draft report concluded that the Office of Financial Program Operations (OFPO) “made significant progress in implementing a quality control program for its loan centers.” OFPO agrees that significant progress has been made in the quality control (QC) program, and is committed to continual improvement in the program.

OFPO takes QC in its centers very seriously. In October, 2008, OFPO began designing a comprehensive quality program across all of its centers. Previously quality control was conducted within each center at various levels of sophistication. OFPO identified the need for a more robust, consistent, and independent quality control program. One year later, in October 2009, the OIG published the *Fiscal Year 2010 Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration*, expanding Management Challenge #4 from citing the need to establish a quality program in the National Guaranty Purchase Center (NGPC), to a quality program across all centers. OFPO, consistent with its QC program design and the expanded Management Challenge #4, made tremendous and purposeful strides in implementing a robust QC program in its loan centers. The program

provides a comprehensive and effective approach for quality and accuracy in all operations. It provides for independence in reporting and functioning, without separating quality from center operations.

The QC program is led in each center by a designated QC Specialist; this individual is responsible for managing the program and processes in their respective center. The QC program collaborated with the loan centers to establish center specific QC review (review) activities and targets, and determined that any action deemed “complex” would be subject to review. The finalized QC process, including information such as transactions reviewed, monthly sampling thresholds, allocation of resources, reporting, and review checklists were subsequently documented in each centers’ quality program guide (guide). The QC program leverages center professional staff to conduct monthly sampling reviews.

The OIG’s draft report indicated that all QC activities were not being performed in accordance with OFPO’s overall QC and center specific guides. The draft report states that, “[c]enters omitted required quality control reviews of significant functions.” Specifically, the report states, “[a]s the NGPC focused on [high-dollar early-defaulted loans], it generally did not perform required quality control reviews...” OFPO acknowledges that actions in the NGPC were not always reviewed as detailed in the centers’ guides; however, in these instances, QC utilized the resources available to continue reviews of the higher-risk transactions – especially high-dollar early-defaulted (HDED) loans. It should be noted that the OIG cited the NGPC for deficiencies on HDED loans in a previous audit, resulting in the management decision for QC to review 100 percent of HDED loans submitted for guaranty purchase. OFPO management prudently targeted higher risk activities identified through audit feedback, but did not update the guide to reflect the adjustment. Going forward, OFPO commits to update the center QC guides as it makes responsible, risk-based decisions on QC activities.

Further, the draft report states that the NGPC ceased QC activities for a five month period in FY 2012 to focus on reviews required by the Improper Payment Elimination and Recovery Act (IPERA). While OFPO does not dispute that QC reviews were not performed in accordance with the NGPC’s guide during this time period, it does not agree with the assertion that QC activities were not performed. The IPERA audit represents a statistically valid random sample designed to test the Agency’s compliance with loan program requirements, and essentially mirrors the QC review process. As such, it is OFPO’s position that QC activities were not ceased; the reviews were merely substituted during this time period with the IPERA audit reviews.

The SBA Quality Control and Assurance Program Guide states that the QC program will monitor new processes and complex transactions. The OIG references this requirement in the draft report, and concludes that the 7(a) Loan Guaranty Processing Center (LGPC) did not conduct QC reviews of loans made under the Small Loan Advantage (SLA) or Dealer Floor Plan (DFP) programs, as required by OFPO’s overarching quality program guidance. OFPO analyzed its reports and confirmed the OIG’s assertion that no SLA or DFP loans were reviewed during the specified timeframe; however, the lack of QC reviews in the aforementioned loan programs occurred because of the sampling methodology employed by the LGPC. The sampling methodology documented in the Center’s program guide requires the Center to review 3

percent of all loan approvals exceeding \$1.5 million performed the previous month. The sampling methodology does not consider delivery method when determining the monthly sample, and therefore, would not exclude any 7(a) delivery methods. Rather, in conformance with the Center's sampling methodology, QC reviews were not conducted on SLA loans as loans approved under this delivery method do not meet the dollar threshold in which the loan sample is determined. QC reviews were not conducted on DFP loans during this timeframe as they were not selected for QC review due to the limited number of loans approved under this delivery method, even though the sampling methodology did not exclude DFP loans. As such, it is OFPO's position that the lack of QC reviews on the SLA and DFP was consistent with the sampling methodology identified in the guide. Though the annual IPERA loan samples included SLA and DFP loans, OFPO recognizes this issue as an area of improvement, and will amend the LGPC's sampling methodology to ensure new processes and complex loan transactions are not unintentionally excluded due to the Center's established parameters.

The draft report indicates that corrective actions identified during the QC review process were not adequately tracked to completion between October 2010 and February 2013. While the corrective actions were being tracked to completion by the QC program in FY 2011 and FY 2012, the process in place did not require QC to capture the enhanced level of detail, which was later implemented in FY 2013. In the initial development stages of the program, deficiencies identified through the QC review process were recorded by the QC specialists into their center's tracking tool. The tracking tool was represented through a spreadsheet or database and acted in compliance with the initial corrective action guidance. However, as the process evolved, the QC program identified additional deficiency tracking details and characteristics to collect for analysis and reporting purposes. In April 2013, OFPO initiated a project to redevelop the corrective action process, which resulted in the development and implementation of the Corrective Action Tracker.

The Corrective Action Tracker (Tracker) maintains and provides consistent data for tracking and analyzing loan-level deficiencies status and trends across centers. It tracks all quality incidents that can escalate into more serious matters, such as Lender, Borrower, CDC complaints, audit findings, and policy noncompliance, and includes details regarding the action taken, source of the error (SBA vs. lender), dollar impact, lender information, and loan type which were not tracked in the initial process. The Tracker has the capability to maintain a systematic approach for tracking and reporting the status of the corrective actions to successful implementation and closure, and involves all appropriate staff and stakeholders in the corrective action process.

In July 2013, the QC program launched the Quality-Based Evaluator and Risk Tracker (Q-BERT). This web-based platform unifies all of the centers' QC review finding details and related documentation in a single, centralized repository using Microsoft Access. The combined data from all centers provides greater analytics and reporting, resulting in a complete, accurate picture of the centers' risk landscape across all loan product lines throughout the loan lifecycle. Q-BERT's reporting capability increases management awareness and provides assurance that center risk tolerance thresholds are being followed for all risk-related activities.

OFPO continuously evaluates the effectiveness of the QC program to ensure its quality approach is consistent and effective across centers. Through this process, QC has identified several opportunities to enhance center processes, leading to a more efficient and effective quality program. The OIG commends OFPO for its efforts to address longstanding issues in the draft report, and it is OFPO's objective to continually improve the QC program.

Management's response to the recommendations in the draft report is noted as follows:

1. *Ensure the proper allocation of resources and scoping of the quality control program to complete required quality control activities at the loan operations centers.*

OFPO concurs with this recommendation and has hired a Quality Control Specialist in its loan operation centers. OFPO has also initiated a process improvement project dedicated to ensuring adequate staffing is available for quality reviews. OFPO is currently evaluating potential staffing methods to determine the most effective approach for each loan processing center. Additionally, OFPO is engaged in updating the quality program guides for each center to ensure that necessary activities are reviewed by Quality Control, and is exploring the development of review ranges for transactions performed by the quality control program as an option. Establishing a minimum and maximum percent of monthly transaction reviews anticipates the centers' ability to complete reviews at various resource levels, and will ensure the required reviews are conducted as center demands change.

2. *Ensure that corrective actions related to quality control findings are appropriately documented and completed within required timeframes.*

OFPO concurs with this recommendation and initiated a process improvement project in April 2013 to enhance its corrective action process. This initiative led to the development of the Corrective Action Tracker (Tracker), designed to maintain and provide consistent data for tracking and analyzing loan-level deficiencies status and trends across loan operation centers. It tracks all quality incidents that can escalate into more serious matters, such as Lender, Borrower, CDC complaints, audit findings, and policy noncompliance, and includes details regarding the action taken, source of the error (SBA vs. lender), dollar impact, lender information, and loan type which were not tracked in the initial process. The Tracker has the capability to maintain a systematic approach for tracking and reporting the status of the corrective actions to successful implementation and closure, and involves all appropriate staff and stakeholders in the corrective action process.

OFPO began implementing the Corrective Action Tracker in the loan operation centers in October 2013, and anticipates full implementation by January 2014.

3. *Establish and implement a plan to conduct quality assurance activities at SBA loan operation centers.*

OCRM concurs with this recommendation and understands that providing adequate oversight of SBA's loan center's QC program implementation is essential to assure effective loan center operations. OCRM has not yet developed a formal quality assurance program due to limited staff resources and a departmental reorganization. OCRM's efforts in FY 2013 were focused on extensive improvements in its lender monitoring and Risk Based Review processes and the implementation of a formal Supervision and Enforcement program. OCRM is finalizing its FY 2014 Risk Management Plan, which will address the development of a Quality Assurance plan. As part of the reorganization, the Quality Assurance function has been consolidated into OCRM's Supervision and Enforcement Division and a Financial Analyst has been designated to lead quality assurance activities. OCRM will conduct a review of the quality program guides for each center and establish an initial quality assurance plan by March 30, 2014.

Again, thank you for the opportunity to review the draft report. Please let us know if you need additional information or have any questions regarding our response.