U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Eric R. Zarnikow
Associate Administrator for Capital Access

Date: December 28, 2009

From: Debra S. Ritt **/S/ original signed**
Assistant Inspector General for Auditing

Subject: SBA's Administration of the Microloan Program under the Recovery Act
ROM-10-10

This memorandum presents the results of the initial phase of our audit of the Small Business Administration's (SBA) administration of the Microloan program under the American Recovery and Reinvestment Act of 2009 (Recovery Act). Under the Recovery Act, SBA received $6 million for direct loans and $24 million for the marketing, management, and technical assistance grants for the Microloan program. These funds were in addition to the $22.5 million that SBA was appropriated for the Microloan program in fiscal year (FY) 2009.

The audit was initiated in response to Recovery Act language directing Offices of Inspectors General (OIG) to perform audits of their respective agencies to determine whether safeguards exist over the use of Recovery Act funds. The objectives for the initial phase of the audit were to determine the adequacy of SBA's (1) oversight of intermediaries, (2) performance data, and (3) program metrics for managing the Recovery Act funds authorized for the Microloan program. The next phase of the audit will determine the quality of microloans made with Recovery Act funds and SBA's progress in addressing the oversight weaknesses identified in this report.

To determine the adequacy of SBA's oversight, we reviewed a judgmental sample of intermediary loan files and interviewed SBA officials from the Offices of Capital Access and General Counsel. To assess the adequacy of microloan performance data, we analyzed historical data maintained in the Microloan Program Electronic Reporting System (MPERS). To determine the sufficiency of program measurement, we also reviewed performance metrics established for the program both prior and subsequent to the Recovery Act. Lastly, we reviewed a judgmental sample of microloan borrower loan files to determine compliance with SBA's policies and procedures. We conducted our review from June 2009 to September 2009 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

We found that SBA had not conducted adequate program oversight, validated the reliability of program data, accurately reported program performance, or established meaningful outcome-oriented performance measures. To ensure that microloans made with Recovery Act funds are properly monitored and the program has meaningful performance measures, we recommended that the Associate Administrator for Capital Access: (1) revise the review process to include an analysis of the sources and uses of MRF and LLRF funds based on monthly financial statements; (2) examine, verify, and test microloan data reported in MPERS; (3) develop a staffing plan and hire and train the additional staff required to provide an adequate level of program oversight; (4) correct the processes for calculating the number of small businesses assisted and jobs created and retained; (5) develop additional performance metrics; and (6) collect and analyze technical assistance data.

Management agreed with all six recommendations and stated that it was committed to effective administration of the Microloan program. Management stated that since January 2009, it has made significant progress toward drafting Standard Operating Procedures, launching an automation initiative to provide standardization and consistency of data reported by intermediaries, and developing a risk mitigation plan for the Microloan program. In addition, SBA recently awarded contracts to: (1) obtain advice on program and performance metrics; (2) conduct training for intermediaries on proper data collection and reporting; and (3) train intermediaries on assisting microloan borrowers in establishing credit histories.

BACKGROUND

The Small Business Administration (SBA) is authorized under Section 7(m) of the Small Business Act to make direct loans to intermediaries (nonprofit, community-based lenders). An intermediary may obtain multiple SBA loans; however, the total amount outstanding and committed may not exceed $750,000 in the first year of participation, and $3.5 million in the remaining years. In addition, each intermediary is required to contribute at least 15 percent of each loan from non-borrowed, non-federal sources.

The intermediaries use SBA loan funds to make fixed-rate loans of $35,000 or less to startup, newly-established, and growing small business concerns for working capital and the acquisition of materials, supplies, furniture, fixtures, and equipment. SBA also awards grants to intermediaries to provide marketing, management, and technical assistance to potential and actual microloan borrowers.

Intermediaries are required to deposit their SBA related funds in two interest-bearing deposit accounts–the Microloan Revolving Fund (MRF) and the Loan Loss Reserve Fund (LLRF). The MRF holds the intermediary's SBA loans and contributions, as well as payments from microloan borrowers. Permissible withdrawals from the MRF include microloan disbursements, payments on intermediary loans, and funds to establish the LLRF. Until an intermediary is in the Microloan program for at least five years, it is required to reserve a balance in its LLRF equal to 15 percent of the outstanding balance of the notes receivable from its microloan borrowers.[1] The LLRF is used to cover any shortage in the MRF due to microloan delinquencies and defaults.

In May 2003, we reported that: (1) SBA was not adequately monitoring the Microloan program to identify duplicate and ineligible microloans; (2) the program lacked Standard Operating Procedures (SOP); and (3) performance standards for intermediaries were inadequate. In April 2009, we reported that SBA had not taken final action to develop a comprehensive Microloan program SOP, set program goals, or require outcome-oriented data from all program participants. Despite these risk factors, SBA is now using the $6 million in Recovery Act funds to provide additional loans to intermediaries.

RESULTS

Oversight Activities Are Not Sufficient to Ensure Effective Operation of the Microloan Program

Because intermediaries are not regulated lenders, effective SBA oversight is needed to ensure program integrity and that intermediaries are not imposing an unacceptable credit risk on the program. SBA, however, does not adequately monitor intermediary performance to ensure the program is operating as intended. For example, SBA's oversight is focused on the intermediaries' ability to repay their SBA loans and is limited to a cursory review of quarterly financial reports supported by only one monthly bank statement. SBA had been receiving all monthly bank statements from the intermediaries, but did not have the resources to adequately evaluate the sources and uses of funds reported on the statements. SBA policies now require that intermediaries submit only their last monthly bank

[1] After an intermediary has been in the program for 5 years, it may request a reduction in its LLRF balance to an amount equal to the actual average loan loss rate during the preceding 5 year period, but not less than 10 percent of the intermediary's portfolio.

statements for their Microloan Revolving Funds and Loan Loss Reserve Funds.[2] The bank statements are used to simply verify the outstanding balances reported on the intermediaries' quarterly reports. This review process does not allow SBA to analyze the sources and uses of funds in the MRF and LLRF throughout each quarter, which is necessary to detect inappropriate fund transfers between the intermediaries' accounts that are indications of program weaknesses and misuses of funds.

More thorough reviews of intermediaries' quarterly financial reports are also important because SBA does not conduct regular onsite reviews of intermediaries to identify misuse of program funds and noncompliance with program policies and procedures. Onsite reviews are conducted only when an intermediary defaults on its SBA loan. The Agency believes that this practice is adequate because only three to four intermediaries have defaulted since the onset of the program in 1992. However, our audit revealed that one of the three intermediaries we reviewed was not in compliance with program policies.

Inadequate staffing of the Microloan program has impacted SBA's ability to provide the necessary level of oversight to ensure that program goals are met and the program's integrity is maintained. The program operates with 6 analysts who oversee more than 160 intermediaries, 460 intermediary loans, and approximately 2,500 microloans per year. In addition, these analysts are responsible for reviewing all technical assistance grant reports. This workload limits the staff's time to perform thorough reviews of intermediary reports and data. Furthermore, inadequate staff led to SBA's decision to cease collection of some information that was necessary to monitor the intermediaries' performance. Given the increased funding provided under the Recovery Act, SBA needs to develop a staffing plan to determine the resources required to address the weaknesses identified in this and prior OIG reports.[3]

The Reliability of SBA-Reported Performance Data is Questionable

SBA reported an average historical microloan default rate of 12 percent from FY 2004 to FY 2008, which appeared low given the high-risk nature of the program. We found that (1) one intermediary made 1,182 microloans valued at over $11 million since 1993 and only reported slightly more than a 1-percent historical default rate, and (2) 39 other intermediaries, including one that made 242 loans

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[2] A description of these funds is provided in Appendix I.

[3] OIG Report 3-26, *The Microloan Program: Moving Toward Performance Management*, issued May 13, 2003; and OIG ROM 09-1, *Review of Key Unresolved OIG Audit Recommendations in Program Areas Funded by the American Recovery and Reinvestment Act of 2009 and Related Activities Needed to Safeguard Funds*, issued April 30, 2009.

valued at over $3 million since 2001, reported that none of the loans in their portfolios had defaulted.

Further, our audit identified: (1) duplicate loan reporting, (2) multiple loans to microloan borrowers in the same amount, indicating the use of revolving lines of credit, which is disallowed by program regulations, and (3) 92 microloan borrowers with outstanding microloan balances exceeding the $35,000 limit as of May 2009. As a result, there may be errors in the data that are not being detected and addressed.

We noted that all of the data used by SBA to report on Microloan program performance is based on unverified information that is self-reported by intermediaries. Although Recovery Act guidance issued by the Office of Management and Budget (OMB) makes clear the importance of data verification by requiring an unprecedented level of transparency and accountability in reporting how Recovery Act funds are used, SBA does not test or verify the reliability of loan performance data reported in MPERS. As a result, SBA cannot ensure that the reported microloan default rates are accurate and comply with the statutory requirement.[4]

A detailed analysis of the intermediaries' bank statements would help identify whether intermediaries are using other funds to keep microloans current or paying them off to avoid reporting loan defaults. This analysis would allow SBA to accurately assess program performance rather than taking the unsupported information reported in MPERS at face value. Default rates reported by intermediaries should be validated to ensure the program is meeting policy goals in order determine the real risk of the program. We plan to test the default rates reported by intermediaries during the next phase of our audit to determine the reliability of the information that is reported.

Management Inaccurately Reported Program Performance and Has Not Established Outcome–Oriented Performance Measures

SBA measures program performance based on the number of microloans funded and small businesses assisted. SBA inaccurately reported the number of small businesses assisted in FY 2008 because it assumed that every microloan made represented a single assisted business, which was not the case. We determined that at least 72 microloan borrowers received multiple microloans in FY 2008, resulting in SBA overstating the reported number of small businesses assisted by at least 4 percent. If corrections are not made to SBA's reporting process, the

[4] Program regulations require intermediaries to maintain a maximum microloan default rate of 15 percent.

number of businesses assisted will continue to be overstated as the MPERS data shows borrowers also received multiple loans in FY 2009.

Pursuant to Recovery Act reporting requirements, SBA also reports job creation and retention data. Our audit determined that reported job creation and retention statistics were overstated because jobs claimed duplicated that which had been previously reported for the same borrower within the same fiscal year. Furthermore, as of June 26, 2009, intermediaries reported that 47 borrowers had received multiple microloans in FY 2009, which created 141 and retained 203 jobs. However, 12 of these loans appeared to be duplicates, resulting in an overstatement of 22 jobs created and 40 jobs retained. Additionally, many other loans showed questionable job creation and retention statistics. For example, one borrower received 2 loans totaling $3,300 within a 2-month period and the intermediary reported that 9 jobs were created and 3 jobs were retained for each loan. We question how such small loans could help a business collectively create 18 jobs. SBA will not be able to accurately report the use of Recovery Act funds without making corrections to its existing reporting processes and providing guidance to intermediaries on how to report job creation and retention data.

The performance metrics established for the program also do not ensure the ultimate program beneficiaries, the microloan borrowers, are truly assisted by the program. For example, the program does not measure the number of microloan borrowers who remain in business after receiving a microloan to measure the extent to which the loans contributed to the success of borrowers. Furthermore, an important facet of the Microloan program is the opportunity for microloan borrowers to receive marketing, management, and technical assistance from intermediaries via SBA grants. However, SBA does not determine the effect that technical assistance may have on the success of microloan borrowers and their ability to repay their microloans. This could be accomplished by requiring intermediaries to report in MPERS the technical assistance provided in relation to each microloan made. Without the appropriate metrics, SBA cannot ensure the Microloan program is meeting policy goals and truly assisting the program's target population.

RECOMMENDATIONS

We recommend that the Associate Administrator for Capital Access:

1. Require intermediaries to provide 3 months worth of bank statements with each quarterly financial report submitted to SBA and revise the review process to include an analysis of the sources and uses of MRF and LLRF funds. This process should assist in detecting inappropriate fund transfers

between the intermediaries' accounts, which are indications of program weaknesses and misuses of funds.

2. Develop a staffing plan and hire and train the additional staff required to provide an adequate level of program oversight.

3. Examine, verify, and test microloan data reported by the intermediaries in MPERS to ensure loan defaults are accurately reported and that obvious inaccuracies and questionable transactions reported by intermediaries are identified and resolved.

4. Provide guidance to intermediaries and correct the processes used to calculate the number of small businesses assisted and jobs created and retained under the Microloan program to ensure accurate reporting on the use of Recovery Act funds.

5. Develop additional performance metrics to measure the program's achievement in assisting microloan borrowers in establishing and maintaining successful small businesses.

6. Require intermediaries to report in MPERS the technical assistance provided in relation to each microloan made and use this data to analyze the effect technical assistance may have on the success of microloan borrowers and their ability to repay microloans.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On November 19, 2009, we provided a draft of this report to SBA for comment. On December 16, 2009, SBA submitted its formal comments, which are contained in their entirety in Appendix II. Management agreed with all six recommendations and stated that it was committed to effective administration of the Microloan program. Management further stated that since January 2009, it has taken several steps to improve program administration, including making significant progress towards drafting SOPs, launching an automation initiative to provide standardization and consistency of data reported by intermediaries, and developing a risk mitigation plan for the Microloan program. In addition, SBA recently awarded a contract to the Aspen Institute to advise on program and performance metrics and to conduct training for intermediaries on proper data collection and reporting. Finally, SBA recently awarded a contract to Credit Builder's Alliance to work with intermediaries to assist microloan borrowers in establishing credit histories.

Specific management comments on the report recommendations, and our evaluation of them, are summarized below.

Recommendation 1

Management Comments

Management agreed that a more detailed review of the financial information provided to SBA was appropriate. As part of this review, management will collect three months of bank statements each quarter from intermediaries. Further, the revised SOPs will incorporate appropriate guidance as to what information must be submitted and how it will be reviewed by financial analysts to evaluate an intermediary.

OIG Response

Management's comments were responsive to the recommendation.

Recommendation 2

Management Comments

Management stated that it is committed to adequately staffing the Microloan program and indicated that it has taken several actions in this area. For example, SBA conducted a staffing analysis and added three additional staff to support increased program participation. SBA is also recruiting a Branch Manager for the program and will reassess the overall staffing needs of the program once the manager is in place and the procedural guidance and oversight structure is finalized.

OIG Response

The actions taken and planned by management are responsive to the recommendation.

Recommendation 3

Management Comments

Management agreed with the need for accurate program data and stated that microloan data will be evaluated as part of the Office of Capital Access' overall Recovery Act data quality initiative to identify areas for improvement. SBA is currently considering MPERS modifications through the microloan automation initiative, which will help ensure that the data collected is accurate. Furthermore, Management stated that the revised SOPs will include guidance on data review and procedures for following up with intermediaries to resolve data discrepancies.

OIG Response

Management's comments were responsive to the recommendation.

Recommendation 4

Management Comments

Management stated that it is committed to accurate reporting on small businesses assisted and on job creation and retention. Management al so stated that it will include the Microloan program in any actions taken to address reporting of this data.

OIG Response

Management's comments were responsive to the recommendation.

Recommendation 5

Management Comments

Management stated it has contracted with the Aspen Institute to advise on appropriate program and performance metrics for both microloans and technical assistance grants. The program metrics will assist SBA in measuring the effectiveness of the program in assisting microloan borrowers.

OIG Response

Management's actions are responsive to the recommendation.

Recommendation 6

Management Comments

Management stated that it is currently considering modifications to existing systems under its automation initiative to collect additional technical assistance data and to provide reports that will assist in analyzing the effectiveness of technical assistance. Furthermore, the Agency's contract with Credit Builders' Alliance will provide training to enable intermediaries to better assist borrowers increase their financial knowledge, improve their financial performance, and create credit histories and/or improve their credit scores so that they may graduate to traditional sources of credit.

OIG Response

Management's comments were responsive to the recommendation.

ACTIONS REQUIRED

Please provide your proposed management decision for each recommendation within 30 days from the date of this report on the attached SBA Forms 1824, *Recommendation Action Sheet*.

We appreciate the courtesies and cooperation of the Office of Capital Access during this audit. If you have any questions concerning this report, please call me at (202) 205-[FOIA ex. 2] or Debra Mayer, Director, Recovery Oversight Group, at (202) 205-[FOIA ex. 2]

APPENDIX I. DESCRIPTION OF INTERMEDIARY FUNDS

Microloan Revolving Fund:

13 CFR 120.709 defines the Microloan Revolving Fund (MRF) as an interest-bearing deposit Account into which an intermediary must deposit the proceeds from SBA loans, its contributions from non-federal sources, and payments from its microloan borrowers. An intermediary may only withdraw from this account the money needed to establish the Loan Loss Reserve Fund (described below), proceeds for each microloan it makes, and any payments to be made to SBA.

Loan Loss Reserve Fund:

13 CFR 120.710 defines the Loan Loss Reserve Fund (LLRF) as an interest-bearing deposit Account which an intermediary must establish to pay any shortage in the MRF caused by delinquencies or losses on microloans. An intermediary must maintain the LLRF until it has repaid all obligations it owes SBA. Until an intermediary is in the Microloan program for at least 5 years, it must maintain a balance on deposit in the LLRF equal to 15 percent of the outstanding balance of the notes receivable owed to it by its microloan borrowers. This required reserve percentage is equivalent to the maximum 15 percent microloan default rate allowed under the program. After an intermediary has been in the Microloan program for 5 years, it may request a reduction in the percentage of its portfolio which it must maintain in its LLRF to an amount equal to the actual average loan loss rate during the preceding 5 year period. The reduced amount cannot be less than 10 percent of the intermediaries' portfolio.

APPENDIX II. AGENCY COMMENTS

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

DATE: December 16, 2009

TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: Eric R. Zarnikow **/S/ original signed**
Associate Administrator for Capital Access

SUBJECT: Draft Report on SBA's Administration of the Microloan Program under the Recovery Act, Project 9510

Thank you for providing the opportunity to comment on this report.

The Small Business Administration is committed to effective administration of the Microloan program and we appreciate your input on the issues provided in your report.

We believe that both regular appropriated funding and Recovery Act funding of the SBA's Microloan program will play a significant role in boosting access to capital and helping to create and retain jobs for those very small businesses that the microloan program is designed to reach. We believe that program management and oversight are important means to identify and manage risk in the microloan portfolio. We have taken several steps to improve program administration, including significant progress toward drafting Standard Operating Procedures (SOP) for the Microloan program, launching an automation initiative to provide standardization and consistency of data reported by the microloan intermediaries, and developing a risk mitigation plan for the Microloan program. In addition, SBA recently awarded a contract to the Aspen Institute to advise on program and performance metrics, and conduct training for microloan intermediaries on proper data collection and reporting. Finally, SBA recently awarded a contract to Credit Builders' Alliance to work with intermediaries to assist microloan borrowers in establishing credit histories.

We appreciate the Inspector General's recommendations in this report, and we are taking additional steps to help enhance program management and oversight. As we shared with your staff, SBA has been working since January 2009 to enhance the administration of the program and to develop a more robust approach to oversight.

Following are the Agency's responses to the IG's recommendations:

Recommendation 1: Require intermediaries to provide three months worth of bank statements with each quarterly financial report submitted to SBA and revise the review process to include an analysis of the sources and uses of MRF and LLRF funds. This process should assist in detecting inappropriate fund transfers between the intermediaries' accounts, which are indications of program weaknesses and misuses of funds.

- We agree that a more detailed review of the financial information provided to SBA is appropriate. As part of this review, SBA will collect three months of bank statements each quarter from intermediaries. The revised SOPs will incorporate appropriate guidance as to what information must be submitted and how it will be reviewed by the financial analysts to evaluate an intermediary.

Recommendation 2: Develop a staffing plan and hire and train the additional staff required to provide an adequate level of program oversight.

- SBA is committed to adequately staffing the microloan program.
    - A staffing analysis has been conducted and we have added three additional staff for the Recovery Act program to support increased program participation.
    - In addition, a permanent employee was hired to replace a former staff member.
    - SBA is also currently recruiting for a Branch Manager for the microloan program. Once a Branch Manager is in place and the procedural guidance and oversight structure is finalized, the overall staffing needs of the microloan program will be re-assessed.

Recommendation 3: Examine, verify, and test microloan data reported by the intermediaries in MPERS to ensure loan defaults are accurately reported and that obvious inaccuracies and questionable transactions reported by intermediaries are identified and resolved.

- SBA agrees with the need for accurate program data. As part of Capital Access' overall ARRA data quality initiative, microloan data will be evaluated to identify areas for improvements.

- SBA is currently considering MPERS modifications through the microloan automation initiative that is underway. This initiative will allow the Agency to optimize and automate the microloan program including helping to ensure that the correct data is being collected and that the data collected is accurate.
- SBA will include in the revised SOPs guidance on data review and procedures for following up with intermediaries to resolve discrepancies for both loan level and technical assistance data reporting.

Recommendation 4: Provide guidance to intermediaries and correct the processes used to calculate the number of small businesses assisted and jobs created and retained under the Microloan program to ensure accurate reporting on the use of Recovery Act funds.

- As noted in previous OIG audit reports, SBA is committed to accurate reporting on small businesses assisted and job creation and retention. SBA will include the microloan program in any actions taken to address reporting of this data.

Recommendation 5: Develop additional performance metrics to measure the program's achievement in assisting microloan borrowers in establishing and maintaining successful small businesses.

- SBA has contracted with the Aspen Institute, a recognized leader in the microfinance area with two decades of public policy expertise, to advise on appropriate program and performance metrics for both microloans and technical assistance grants. The program metrics will assist SBA in measuring the effectiveness of the program in assisting microloan borrowers.

Recommendation 6: Require intermediaries to report in MPERS the technical assistance provided in relation to each microloan made and use this data to analyze the effect technical assistance may have on the success of microloan borrowers and their ability to repay microloans.

- SBA is currently considering modifications to existing systems under our automation initiative to collect additional technical assistance data and provide reports that will assist SBA management in analyzing the effectiveness of technical assistance.
- As noted above, SBA recently awarded a contract to Credit Builders' Alliance to work with intermediaries to assist microloan borrowers in establishing credit histories. The training will enable intermediaries to better assist borrowers with (a) increasing their financial knowledge; (b) improving their financial performance; and (c) creating a credit history and/or improving their credit scores so that they may graduate to traditional sources of credit.

Thank you again for your review. We look forward to continued engagement and discussion with you on the Microloan program.