

Evaluation Report

The SBA's Portfolio Risk Management Program Can be Strengthened





**U.S. Small Business Administration
Office of Inspector General
Washington, D.C. 20416**

**REPORT TRANSMITTAL
REPORT NO. 13-17**

DATE: July 02, 2013

TO: Jeanne A. Hult, Associate Administrator for Capital Access

Brent Ciurlino, Director of Credit Risk Management

Stephen W. Kucharski, Director of Performance and Systems Management

SUBJECT: *The SBA's Portfolio Risk Management Program Can be Strengthened*

This report presents the results of our evaluation, *Review of the Small Business Administration's Loan Data*. The evaluation was designed to (1) identify high-risk audit areas and potential fraud within the Small Business Administration's (SBA or the Agency) loan programs in order to drive future audit and investigative work; and (2) identify loan program, portfolio, and data reliability issues warranting attention by the Agency.

While conducting the evaluation and discussing our analysis and results with Agency officials, we questioned whether the Agency had established a program that analyzed risk across its \$103 billion portfolio. Therefore, we developed a reporting objective that sought to determine if the Agency had developed a portfolio risk-management program that sufficiently monitored and addressed risk across lines of business, participating lenders, and the overall portfolio. We determined that the SBA had not implemented a program or process to effectively monitor risk in its loan portfolio. Additionally, the SBA had not developed a policy to ensure identified risks were addressed. We believe that an established portfolio risk-management program could help the Agency achieve a better balance between the need to make capital available to small businesses while mitigating risk for borrowers and taxpayers.

We request that you provide your management decision for each recommendation on the attached SBA form 1824, Recommendation Action Sheet, by August 01, 2013. Your decision should identify the specific actions taken or planned for each recommendation and the target dates for completion.

We appreciate the courtesies and cooperation of the Office of Capital Access during this evaluation. Please direct any questions to me at (202) 205-7390 or Terry Settle, Director, Credit Programs Group, (703) 487-9940.

/s/
John K. Needham
Assistant Inspector General for Auditing

Evaluation Report

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EXECUTIVE SUMMARY

Report 13-17

July 02, 2013

THE SBA'S PORTFOLIO RISK MANAGEMENT PROGRAM CAN BE STRENGTHENED

What the OIG Reviewed

We performed analyses of the SBA's 7(a) loan portfolio data to (1) identify high-risk audit areas and potential fraud within the SBA's loan programs; and (2) identify loan program, portfolio, and data reliability issues warranting attention by the Agency. Additionally, we conducted interviews with Agency officials to present our analyses and determine the existing controls used to mitigate risk across the SBA's \$103 billion guaranteed loan portfolio. Finally, we reviewed the SBA's FY 2011 – 2016 Strategic Plan and mission statements for offices responsible for managing the 7(a) loan program and its risks.

What the OIG Found

In the course of our review, we determined that the SBA had not implemented a program or process to effectively monitor risk in its loan portfolio. Additionally, the SBA had not developed a policy to ensure that identified risks were addressed. We conducted four separate meetings with key senior officials in the Office of Capital Access (OCA) to discuss the results of the analyses presented in this report. During these meetings, the SBA officials informed us and corroborated that there had been no consistent risk analysis of the portfolio and the Agency had not developed a framework or process for portfolio risk management. In August 2012, when our evaluation was ongoing, the Agency developed a formal plan to manage program credit risk, monitor lender performance, and enforce lender program requirements. The SBA has not yet implemented this plan.

During our review, we performed limited analysis of franchise and industry loan data, which highlighted the types of risks that can be identified with a robust portfolio risk-management program. Our limited analysis identified three high-volume franchises with historical default rates of at least 46-percent, default values over 38-percent and loss rates over 18-percent. We determined that over the 2002-2009 period that we reviewed, the Agency disbursed nearly 1,000 loans to these three franchises, totaling \$199 million. Of these loans, 501, representing \$84 million in Agency guaranties, defaulted. We also identified five high-volume retail industries with historical default rates of at least 40-percent, default values over 30-percent

and loss rates over 16-percent. We determined that over a seven-year period from 2002 to 2009, loans to these five industries resulted in 4,415 defaults and approximately \$150 million in SBA charge-offs.

According to SBA officials, the Agency had not implemented a program or process to monitor risk in its portfolio because the SBA had traditionally focused on loan approval volume and loss rates to evaluate program performance with risk being assessed at the lender level. The SBA, therefore, did not evaluate its loan portfolio in terms of the financial and mission risks. For example, the SBA did not monitor portfolio segments to identify risk based on default statistics. Our limited analysis showed that the SBA continued to guarantee loans to high-risk franchises and industries without monitoring risks, and where necessary, implementing controls to mitigate the risks.

OIG Recommendations

We recommended that the Office of Capital Access: 1) Implement a portfolio risk-management program that analyzes risk across portfolio segments; 2) Use data from the portfolio risk-management program to support risk-based decisions in its loan programs; and 3) Develop a process within the portfolio risk-management program to ensure additional controls are implemented to mitigate identified risks where necessary. The Agency agreed with all of our recommendations and stated it had taken steps to address many of our concerns.

Actions Taken

In August 2012, the SBA drafted an *Annual Audit Plan Framework* designed to address risk across all of the Agency's lending platforms. The plan, which was recently finalized, requires analyses designed to provide a comprehensive view of the SBA's overall portfolio by lender, industry, delivery method (i.e. type of loan program), geography, franchise, and other components. Additionally, in November 2012, the Agency established the Office of Performance and Systems Management, which, along with the Office of Credit Risk Management, is responsible for managing portfolio risk. We believe these actions represent the first steps towards establishing a program that will monitor portfolio risks, and where necessary, address the types of portfolio risks identified in our evaluation.

Introduction

This report presents the results of our evaluation of the Small Business Administration's Loan Data. The evaluation was designed to (1) identify high-risk audit areas and potential fraud within the Small Business Administration's (SBA or the Agency) loan programs in order to drive future audit and investigative work; and (2) identify loan program, portfolio, and data reliability issues warranting attention by the Agency.

While conducting the evaluation and discussing our analysis and results with Agency officials, we questioned whether the Agency had established a program that analyzed risk across its \$103 billion portfolio. Therefore, we developed a reporting objective that sought to determine if the Agency had developed a portfolio risk-management program that sufficiently monitored and addressed risk across lines of business, participating lenders, and the overall portfolio.

To accomplish our objectives, we obtained SBA 7(a) loan portfolio data from Fiscal Years 2003 to 2012. We examined the default rate of 7(a) loans by franchise and industry to identify potentially high-risk areas. We conducted interviews with Agency officials to present our analyses and determine existing controls to mitigate risk across the SBA's \$103 billion guaranteed loan portfolio. We performed basic data reliability tests to assess the reasonableness of data for the purposes of this evaluation. Our scope and methodology are further detailed in Appendix I of this report.

We conducted this evaluation from March 2012 through February 2013, in accordance with the Council of the Inspectors General on Integrity and Efficiency (CIGIE) *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.

Background

Prior OIG audits and investigations of SBA loans have identified that specific industries and loan attributes pose a higher risk to the SBA. A 2004 performance [audit](#) conducted by the OIG recommended that the Agency include an analysis of industry codes as part of its monitoring system to identify areas of financial risk.¹ Subsequently, a 2011 OIG audit identified that the five worst-performing franchises had purchase rates over 22-percent.² Additionally, OIG survey work completed in 2011³ included analysis of 79 change-of-ownership loans disbursed from FY 2006 to 2009 and found that nearly 30-percent were problem loans.⁴ Further, the OIG investigations division has identified hundreds of millions of dollars⁵ of fraud related to loan agents. Finally, fraudulent statements regarding equity injections (payments required by borrowers seeking SBA financing) continue to be a significant and recurring problem.

7(a) Program Loans

The SBA is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guaranteed loans. The SBA's 7(a) loans are made by participating lenders under an agreement to originate, service, and liquidate loans in accordance with SBA's rules and regulations and prudent lending standards. Although the SBA has many loan programs, the 7(a) loan program is the largest. As of September 30, 2012, the SBA had over \$46 billion in guaranteed 7(a) loans outstanding in its portfolio.

Most of the 7(a) loans are made by lenders using delegated authority. These lenders are delegated the authority to process, close, service, and liquidate most SBA guaranteed loans without prior review. If a guaranteed loan defaults, the Lender and the

¹ Audit Report 4-37, *Memorandum Report Survey of Risk Management by Industry Code*, issued August 11, 2004.

² Audit Report 11-16, *Banco Popular Did Not Adequately Assess Borrower Repayment Ability When Originating Huntington Learning Center Franchise Loans*, issued July 13, 2011.

³ OIG Project Number 10015 – Oversight of Change of Ownership Transactions. The work performed for this project has not been published.

⁴ 'Problem loans' refers to loans that were delinquent, defaulted, charged off, liquidated, or purchased.

⁵ SBA Information Notice, Control No. 9000-1793 Issued, April 7, 2009, *Detecting Fraud in Small Business Administration Lending Programs*.

Agency share in the loss, if any, in accordance with the percentage guaranteed by the SBA. Upon loan default, the lender generally requests payment of the guaranty from the SBA. The SBA reviews the lender's actions on the loan to determine whether it is appropriate to pay the lender the guaranty, which the SBA refers to as a guaranty "purchase."

Defaulted 7(a) loans increase the risk to the Agency and taxpayers as the SBA disburses funds to the lenders to purchase its guaranties. In FY 2012, the Agency purchased more than 14,000 loans for over \$1.3 billion from the 7(a) program.

Risk Management

Balancing the need to ensure access to capital for small businesses that cannot qualify for traditional bank loans with the need to mitigate default risk is a key part of the Agency's mission. Therefore, the SBA is authorized by Congress to supervise, examine, regulate, and enforce laws against SBA lenders. Congress requires the Agency to perform annual reviews of delegated lenders in the Preferred Lenders Program (PLP)⁶, and the Agency is authorized to assign risk ratings to its lenders. Additionally, the Office of Management and Budget (OMB) requires Federal Agencies that operate credit programs, to analyze and control the risk and cost of their programs. This includes collecting data such as default rates, purchase rates, and recovery rates for program performance measures.

The SBA's Office of Inspector General (OIG) has identified the need to improve lender oversight as one of the key challenges facing the Agency.⁷ Although the Agency has recently made significant progress, the need to improve oversight has been a critical issue for more than a decade. Actions recommended by the OIG to address this challenge during

FY 2013 include the need for SBA to: (1) Expand the scope of lender oversight and improve the process for reviewing lenders and Certified Development Companies,⁸ and (2) Monitor and verify implementation of corrective actions to ensure effective resolution prior to close-out.

Importantly, the Agency has included risk management as part of its FY 2011-2016 Strategic Plan. One of the Agency's strategic objectives is to mitigate risk to taxpayers and improve oversight across SBA programs. In 2012, the Agency's Office of Credit Risk Management (OCRM), whose mission is to maximize the efficiency of SBA's lending programs by effectively managing program credit risk, reorganized and established new practices to improve oversight.

6 PLP lenders are delegated with the authority to process, close, service, and liquidate most SBA guaranteed loans without prior SBA review.

7 Report Number 13-02 issued October 15, 2012. Management Challenge 5 – The SBA needs to further strengthen its oversight of lending participants in *Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in Fiscal Year 2013*.

8 Certified Development Companies (CDCs) are non-profit corporations certified and regulated by the Small Business Administration to package, process, close, and service 504 loans.

Results

While the Agency recognizes the need for broad-based portfolio management, and has recently taken steps to broaden its risk management efforts, in the course of our review, we determined that the SBA had not implemented a program or process to effectively monitor risk in its portfolio. It also had not developed a policy to ensure identified risks were addressed. We conducted four separate meetings between July 5, 2012, and February 6, 2013, with key senior officials in the Office of Capital Access (OCA) to discuss the results of the analyses presented in this report. During these meetings, the SBA officials informed us and corroborated that there had been no consistent risk analysis of the portfolio. Further, officials stated that the Agency had not yet established a framework or process for portfolio risk management, even though risk management and improved program oversight was part of the Agency's Strategic Plan, and the OCRM's mission. In August 2012, when our evaluation was ongoing, the Agency developed a formal plan to ensure program credit risk is effectively managed. The SBA has not yet implemented this plan.

During our review, we performed limited analysis of franchise and industry loan data which highlighted the types of risks that can be identified with a robust portfolio risk-management program. Based on our interviews with SBA officials, we determined that the Agency did not monitor franchise risk or industry risk at the portfolio level and did not implement controls to mitigate this risk.

The SBA's Portfolio Risk-Management Program Can be Strengthened

With a focus on lender risk, the SBA did not evaluate its portfolio in terms of other financial and mission risks, such as identifying risky portfolio segments based on default statistics. Based on information obtained from OCA officials, in a series of meetings, we determined that the SBA was not regularly assessing the 7(a) loan program and portfolio level risk in terms of the financial and mission risks. Additionally, based on the information obtained in these meetings, we also determined that the SBA had not developed a policy for addressing identified portfolio risks.

Although the Agency monitors risk at the lender level, it had not established a program to analyze risk across its \$103 billion portfolio. Without a fully robust portfolio risk-management program, the Agency is exposed to both financial risk and mission risk.⁹ Specifically, the Agency may incur unnecessary losses for taxpayers if it continues guaranteeing loans across portfolio segments without monitoring risk, and where necessary, implementing controls to mitigate the risk of loan default. Additionally, the SBA may be unable to fully meet its mission of helping Americans start, build, and grow businesses if it cannot ensure that its core programs are high-performing, effective, and relevant. The SBA, itself, recognizes the importance of monitoring financial and mission risks. For example, on its public website, the SBA highlights that the OCA balances the need to make capital available to small businesses with the importance of providing appropriate monitoring and oversight to protect taxpayer dollars and ensure its programs remain strong.

⁹ For the purposes of this report we define financial risk as credit risk that exposes the Agency to potentially significant losses. We define mission risk as the risk that the Agency will be unable to help Americans start, build, and grow businesses.

During our review, we performed limited testing of franchise and industry segments that identified areas of poor performance and increased risk of loss, which may require mitigating controls. These serve as examples of the types of risks that could be identified with a robust portfolio risk-management program. Our limited analysis identified three high-volume franchises¹⁰ with historical default rates of at least 46-percent, default values¹¹ over 38-percent and loss rates¹² over 18-percent. See Appendix II for detailed default rate information. In comparison, similarly sized franchises had average default rates of 26-percent, average default values of 22-percent, and average loss rates of 7-percent. We determined that over the 2002-2009 period that we reviewed, nearly 1,000 SBA 7(a) loans were disbursed to these three franchises, totaling \$199 million. Of these loans, 501, representing \$84 million in Agency guaranties, defaulted and approximately \$39 million in SBA guaranties were charged-off. When presenting Agency officials with our preliminary findings, we determined that the SBA did not analyze risk at the franchise level for its portfolio. As a result, the SBA continued to guarantee loans to the identified franchises without implementing additional controls to offset the risk of loss. In FY 2012, additional 7(a) loans were made to each of these franchises.

High-Volume Franchises

Franchise	Default Rate # of Loans	Default Rate Value of Loans	Loss Rate (SBA Charge-offs)
Planet Beach	61%	49%	21%
Petland	60%	49%	23%
Cold Stone Creamery, Inc.	46%	39%	18%

Source: OIG Analysis of SBA 7(a) loan portfolio data for loans issued October 1, 2002 to May 25, 2009.

Our analysis also identified five high-volume retail industries¹³ with historical default rates of at least 40-percent, default values over 30-percent and loss rates over 16-percent. This compared with average high-volume industry default rates of 32-percent, default values of 23-percent, and loss rates of 10-percent.

We determined that over the 2002-2009 period that we reviewed, 10,529 SBA 7(a) loans were disbursed to these five industries, totaling \$860 million. Of these loans, 4,415, representing over \$300 million in Agency guaranties, defaulted and approximately \$150 million in SBA guaranties were charged-off. We also determined that poor performance within these industries did not appear to be concentrated among particular SBA lenders. Nevertheless, we recognize that further portfolio analyses could help determine root causes for poor performance. We note that in FY 2012 alone, the Agency approved 792 loans worth \$182 million to the five retail industries.

¹⁰ For the purposes of this report we defined 'high volume franchises' as franchises that received 50 or more loans and approval amounts of \$25 million or more within the time period reviewed.

¹¹ Default values represent the SBA's share of defaulted loan dollars as a percentage of SBA's share of loan dollars approved.

¹² Loss rates represent the SBA's share of defaulted loan dollars charged off as a percentage of SBA's share of dollars approved and disbursed.

¹³ For the purposes of this report we defined 'high volume industries' as industries with 1,000 or more loans and approval amounts of approximately \$50 million or more within the time period reviewed.

We recognize that the SBA is a critical source of financing for small business franchises and small retail businesses, and that the franchises and businesses identified in our evaluation represent small segments of the SBA's overall portfolio. However, based on our limited analysis, we believe these franchises and industries may exceed reasonable risk-tolerance default thresholds and may require mitigating controls. Importantly, we note that these are simply examples of the type of risk that could be identified with a robust portfolio risk-management program.

The Agency's Strategic Plan Stresses the Need to Improve Oversight

OMB policy governing federal credit programs directs agencies to prepare comprehensive reports on the status of loan portfolios and receivables to evaluate management effectiveness. Further, the OMB requirements¹⁴ state that agencies should collect data for program performance measures (such as default rates, purchase rates, recovery rates, and administrative costs) consistent with the Government Performance and Results Act of 1993 (GPRA). In addition, agencies are required to publish strategic plans that include general goals and objectives, including outcome-oriented goals, for the major functions and operations of the agency.

The SBA recognized the need for broad-based portfolio management as part of its [FY 2011-2016 Strategic Plan](#). One of the objectives in its Strategic Plan is to strengthen SBA's core programs and operations to ensure that they are high performing, effective, and relevant to the needs of the small business community. Some of the strategies the SBA has planned to meet this objective are to provide robust performance and financial management information, conduct program reviews, and maintain a rigorous internal control process. Another objective within the SBA's Strategic Plan is to mitigate risk to taxpayers and improve oversight across SBA programs. Additionally, the mission

of the SBA's Office of Capital Access, responsible for managing the Agency's guaranteed loan programs, states in part, that it must "balance the need to make capital available to small businesses with the importance of providing appropriate monitoring and oversight to protect taxpayer dollars and ensure its programs remain strong." Finally, the OCRM's mission is to maximize the efficiency of SBA's lending programs by effectively managing program credit risk, monitoring lender performance, and enforcing lending program requirements.

Importantly, in August 2012, the SBA drafted an *Annual Audit Plan Framework* designed to address risk across all of the Agency's lending platforms. We believe the plan represents a first step towards establishing a program that will monitor portfolio risks, and where necessary, address the types of portfolio risks identified in our evaluation. However, the SBA only recently finalized this plan and has yet to implement this plan.

The SBA Focused on Loan Volume and Loan Program Loss Rates Without Sufficient Consideration of Loan Program Risks

The SBA helps Americans start, build, and grow businesses primarily by providing access to capital. By law, borrowers can only receive financial assistance from the SBA if they do not qualify for traditional commercial loans. As a result, the Agency's emphasis is on providing capital to small business borrowers in need of SBA's assistance. Consistent with this goal, Agency management officials informed us that the evaluation of program performance has traditionally focused on loan approval volume and loss rates with risk being assessed at the lender level.

The focus on loan approval volume is demonstrated in statistics presented in its FY 2012 Annual Financial Report (AFR). The AFR highlights SBA loan approval volume and not loan performance. Additionally, in terms of loss, the Agency has worked to operate its

¹⁴ Office of Management and Budget Circular No. A-129 *Policies For Federal Credit Programs and Non-Tax Receivables*.

loan programs at “zero subsidy.” That is, any losses within the program are offset by lender fees, loan recoveries, and loan repayments rather than an appropriation from Congress. Therefore, according to SBA officials, SBA has traditionally focused on the overall program losses rather than other performance statistics, including loan defaults.

Further, the SBA’s traditional risk focus has been at the lender level. The majority of 7(a) loans are disbursed by lenders using delegated authority. These loans undergo little, if any, review by the SBA prior to loan approval. The Agency is required by Congress to review the performance of delegated lenders annually. To monitor lender performance, the Agency has created a risk-rating system that evaluates portfolios of individual lenders, and the OCRM is responsible for conducting hundreds of off-site and on-site reviews of lenders each year.

The OCRM’s funding structure has also contributed to a risk focus at the lender level. Funding to conduct risk review activities is based on the fees charged to lenders. According to Agency officials, the OCRM did not have the funding to conduct overall portfolio monitoring activities such as assessing the risks of poor performing franchises and industries. Additionally, because the SBA was not regularly assessing portfolio level risk, it had not developed a policy to address identified portfolio risks. Overall, there are a number of historical and financial reasons contributing to the Agency’s lack of an established portfolio risk-management program.

As previously noted, with a focus on lender risk, the SBA did not evaluate its portfolio in terms of other financial and mission risks, such as identifying risky portfolio segments based on default statistics. The SBA’s focus on approvals and loss at the program level can be better balanced with the Agency’s mission of helping its individual borrowers start, build, and grow small businesses and its other strategic objectives. We believe that if the Agency continues to guarantee loans to poorly-performing segments without appropriate controls in place, it risks not fully achieving its mission and objectives.

As noted above, the Agency has begun to take steps to analyze and manage portfolio risk. In August 2012, the SBA drafted an *Annual Audit Plan Framework* designed to address risk across all of the Agency’s lending platforms. The plan, which was recently finalized, requires analyses designed to provide a comprehensive view of the SBA’s overall portfolio by lender, industry, delivery method (i.e. type of loan program), geography, franchise, and other components. We note that the plan stressed the need to analyze delinquent and defaulted loans as a critical part of managing risk. Specifically, the plan states:

A defaulted and past due analysis is crucial to understanding risk and is made up of a balance sheet including a comprehensive data set of all loans that are defaulted and/or past due. The data should be used to target areas of highest loss, identify defaulter characteristics, and focused on early default statistics.

The goal of the plan is to help the OCRM maximize the efficiency of the Agency’s lending programs by effectively managing program credit risk, monitoring lender performance, and enforcing lender program requirements. Implementation of the plan is pending.

Conclusion

Lack of an established portfolio risk-management program at the SBA exposes the Agency to both financial and mission risks. The SBA will continue to realize defaults and incur losses on loans to poorly performing segments within its portfolio if it does not implement a process to consistently monitor portfolio risks and establish mitigating controls where necessary. Additionally, the SBA may be unable to fully meet its mission of helping Americans start, build, and grow businesses if it cannot ensure that its core programs are high-performing, effective, and relevant. Importantly, our analysis focused on two small segments that represented unmanaged risk to the Agency. Given the potential that other risk areas exist, an effective portfolio risk-management program is needed to identify weaknesses and help the Agency better manage its overall financial and mission risk. An established portfolio risk-management program could help the Agency achieve a better balance between the need to make capital available to small businesses while mitigating risk for borrowers and taxpayers.

Recommendations

We recommend that the Office of Capital Access:

- 1) Implement a portfolio risk-management program that analyzes risk across portfolio segments.
- 2) Use data from the portfolio risk-management program to support risk-based decisions in its loan programs.
- 3) Develop a process within the portfolio risk-management program to ensure additional controls are implemented to mitigate identified risks where necessary.

Agency Comments & OIG Response

On April 25, 2013, we provided a draft of this report to the Associate Administrator for Capital Access, Director of the Office for Credit Risk Management, and Director of the Office of Performance and Systems Management for comment. On June 4, 2013, the Agency submitted formal comments, which are included in their entirety in Appendix III. A summary of management's comments and our response follows.

General Management Comments

The Agency agreed with all of our recommendations and stated it had taken steps to address many of our concerns. Specifically, in November 2012, the Agency reorganized its Office of Capital Access to establish the Office of Performance and Systems Management (OPSM), which along with the Office of Credit Risk Management (OCRM), is dedicated to facilitating and managing a portfolio risk-management program. The OPSM now produces regular reports that analyze performance and risk across various portfolio segments. Further, OPSM has also provided analytics to support risk-based decisions in the OCA. The OCRM has reengineered its lender review program to better assess risk, monitor lenders, and benchmark performance thresholds. In addition, the OCRM recently drafted an Annual Audit Plan Framework that will be used by the OCA to monitor portfolio risk and refine its risk-management practices. The OCA advised that it recognizes the importance of effective portfolio risk management and is developing a robust risk management program.

OIG Response

We commend the Agency's OCA on its recent efforts to improve its risk-management activities. We briefed the Agency on the specific issues discussed in this report between July 2012 and October 2012, including our identification of industry and franchise risks for SBA loans. At that time, management officials acknowledged the issues and stated they were in the process of drafting its first annual risk management plan, which it subsequently finalized while our review was ongoing. The OPSM provided the Agency with useful insight into SBA programs and policies for a number of new program developments. We have revised the report to reflect the Agency's actions in establishing the OPSM in November, 2012. By February 2013, the Agency was performing analyses to identify major risk areas and conducting reviews to test its first annual risk management plan. While the SBA has made significant progress and recognizes the importance of effective portfolio risk management, the Agency is still in the process of developing a robust portfolio risk-management program, and utilizing analytical insights on a regular basis to reduce overall portfolio risk.

Recommendation 1

1. Implement a portfolio risk-management program that analyzes risk across portfolio segments.

Management Comments

The OCA agreed with this recommendation. The Agency stated that it is continuously improving its portfolio risk-management program. The Agency identified efforts by the recently established OPSM to analyze and report risk across portfolio segments, as well as recent developments by the OCRM to improve analyses of lender performance across portfolio segments. The Agency stated it will continue refining its practices to improve its portfolio risk-management program.

OIG Response

Management comments were responsive to the recommendation.

2. Use data from the portfolio risk-management program to support risk-based decisions in its loan programs.

Management Comments

The OCA agreed with this recommendation. The Agency stated that it uses data from its portfolio risk-management program to support risk-based decision making for all program development and policy change decisions. The Agency cited recent and ongoing program developments where risk analytics have played an important role. The Agency stated that the OCA will continue to explore new uses of data to improve SBA program management.

OIG Response

Management comments were responsive to the recommendation.

3. Develop a process within the portfolio risk-management program to ensure additional controls are implemented to mitigate identified risks where necessary.

Management Comments

The OCA agreed with this recommendation. The Agency stated that the OCRM, and the recently established OPSM, both play key roles in all program and policy initiatives to ensure that program decisions are supported by data and sound risk management practices. In addition, the Agency stated that it is working to develop an annual risk management cycle that will analyze risk across several portfolio segments at the beginning of each year and use these findings to drive lender review and program management decisions for that year.

OIG Response

Management comments were responsive to the recommendation.

Actions Required

Please provide your management decision for each recommendation on the attached SBA Forms 1824, Recommendation Action Sheet, within 30 days from the date of this report. Your decision should identify the specific action(s) taken or planned for each recommendation and the target date(s) for completion.

We appreciate the courtesies and cooperation of the Small Business Administration during this evaluation. If you have any questions concerning this report, please call me at (202) 205-7390 or Terry Settle, Director, Credit Programs Group, (703) 487-9940.

Appendix I: Scope and Methodology

To accomplish our objective, we collected data from the SBA's Loan Accounting System (LAS) for all 7(a) loans issued from FY 2003 to 2012. We used IDEA data analysis software to run queries on the data extracted from the LAS. Specifically, we examined the default rates of 7(a) loans by franchise and industry to identify potentially high-risk areas. For the default rate analysis, we established a May 2009 cutoff date to avoid counting unseasoned loans. This yielded a universe of 471,663 loans in the 7(a) program issued from October 1, 2002, to May 25, 2009, totaling \$75.3 billion. We then stratified the data by loan volume and dollar amount to better analyze the impact of defaults. For both franchises and industries, we examined default rates by loan volume (the number of records of loan default), the dollar amount of defaults, and charge-off rates (i.e. loss amounts).

For franchises, we focused on the top 20 franchises by default rate with at least 50 loans in the 7(a) program, and the top 20 franchises by default rate with at least \$25 million in 7(a) loans. For industries, we focused on the top 20 industries by default rate with at least 1,000 loans in the 7(a) program and the top 20 industries by default rate with at least \$50 million in loans. For the industry analysis, we also eliminated specific industries whose poor performance appeared to be caused largely by the recent economic recession. Finally, we narrowed the results by selecting the franchises and industries that appeared on both top 20 lists (number of records and dollar of defaults).

To verify the reliability of the collected data, we discussed data system controls with SBA officials, obtained related technical specifications documents, and conducted independent tests on the data. Specifically, we interviewed Agency officials about the controls and control environment for the SBA Mainframe system and Mainframe Extract Process, the Electronic Loan Information Processing System (ELIPS), and Electronic Transfer System (E-TRAN). We also conducted basic completeness and error testing for loan fields relevant to our default rate analysis.

We also reviewed the SBA's FY 2011 – 2016 Strategic Plan and mission statements for offices responsible for managing the 7(a) loan program and its risks. Finally, we conducted interviews with Agency officials to present our analyses and determine existing controls to mitigate risk across the SBA's \$103 billion guaranteed loan portfolio.

Appendix II: High-Volume Franchises

Franchise	Number of Approvals	Number of Defaults	SBA Approved Dollars	SBA Portion of Defaulted Dollars	SBA Portion of Dollars Charged-Off	Default Rate Number of Loans	Default Rate Dollar Value of Loans	Loss Rate (SBA Charge-offs)
PLANET BEACH	226	137	\$38,735,335	\$19,078,487	\$8,321,199	61%	49%	21%
PETLAND	72	43	\$29,124,574	\$14,403,079	\$6,586,539	60%	49%	23%
COLD STONE CREAMERY, INC.	700	321	\$131,073,296	\$50,787,407	\$24,235,397	46%	39%	18%

Source: OIG Analysis of SBA 7(a) loan portfolio data for loans issued October 1, 2002, to May 25, 2009.

Appendix III: Agency Comments—SBA Office of Capital Access



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

To: John K. Needham
Assistant Inspector General for Auditing

From: Jeanne Hult
Associate Administrator, Office of Capital Access
Brent Ciurlino
Director, Office of Credit Risk Management
Steve W. Kucharski
Director, Office of Performance and Systems Management

Subject: Response to Draft Report on Analytical Review of the Small Business Administration's Loan Data, Project No. 12009A

Executive Summary

The Office of Inspector General (OIG) states that the agency has not implemented a program or process to effectively monitor risk in its loan portfolio or to ensure that identified risks are addressed. OCA agrees with the importance of monitoring and managing risk to SBA's loan programs and has taken significant steps to improve its portfolio risk management program.

Response to Draft Report

The Office of Capital Access is building a robust portfolio risk management program.

OCA takes portfolio risk management seriously. In November 2012, OCA completed reorganization and now has two offices dedicated to facilitating and managing a portfolio risk management program: the Office of Performance and Systems Management (OPSM) and the Office of Credit Risk Management (OCRM). This reorganization was completed in response to recognized challenges facing the SBA in terms of financial and mission risks, and will help the Agency better serve the needs of small businesses,

and effectively oversee lender and portfolio performance.

Office of Performance and Systems Management

The Office of Performance and Systems Management's mission is to supply SBA leadership and stakeholders with business intelligence, sound project management, and critical information systems for the purpose of initiating, maintaining, evaluating, and improving loan programs and initiatives.

OPSM responsibilities include:

- Assist in program and policy development
- Evaluate, reassess, and improve programs based on performance metrics
- Provide metrics and data to support policy decisions, and regulatory and policy changes
- Produce standardized data and reporting for the Office of Capital Access
- Manage critical SBA information systems

OPSM produces weekly, monthly, and quarterly reports that analyze performance and risk across various portfolio segments to support OCA program offices. For example, the weekly 'Performance Dashboard' monitors performance of the 7(a), 504, Microloan, and Surety Bond programs. Risk and performance are segmented based on loan size, lender, region, and delivery method based on OCA stakeholder needs. The monthly 'PAC Report' provides stakeholders balance sheet and cash flow information to monitor the outstanding 7(a) and 504 portfolios. Risk is further broken down in terms of origination, servicing, and resolution risk. Both reports are continuously updated based on the needs of OCA management.

OPSM provides data-driven insight to all program and policy initiatives. Several examples demonstrate how OPSM analytics support risk-based decision making in OCA:

 CAPLine Reinvigoration – In November 2011, SBA revamped its CAPLine program to reach more small businesses that needed working capital. OPSM provided OCA policymakers with extensive analysis on the performance of CAP-

Lines and revolving lines of credit, which demonstrated that these loans often default when they enter the term out stage. This data supported changes to the rules around refinancing working capital under the CAPLine program.

SLA 2.0 – In June 2012 SBA launched SLA 2.0 to increase its lending and creditworthiness of loans under \$350,000. OPSM worked with OCA extensively to demonstrate that term loans under \$350,000 perform similarly whether the lender follows SBA’s guidelines for the conventional 7(a) program versus a lender’s own policies and procedures under the SBA Express program. This analysis proved that SBA could lower transaction costs for loans under \$350,000 without adding financial risk to SBA’s programs. These program changes have supported SBA’s mission by making it easier for lenders to reach underserved markets with loans under \$350,000.

SLA 2.0 – Additionally, OPSM performed extensive analysis on the performance of small dollar loans based on the Small Business Predictive Score (SBPS) at time of disbursement. This data demonstrated that SBPS scores were a highly reliable predictor of future default and loss to SBA. Further, the analysis showed that requiring borrowers to meet a minimum credit score for SBA eligibility would have vastly reduced historical losses in small dollar lending programs such as Community Express. OPSM’s analysis supported the implementation of a risk management control that restricts lending to businesses with SBPS credit scores below 140.

SBA One – OPSM is heavily involved with OCA’s ongoing SBA One initiative. In addition to lowering the cost of doing business with SBA, one important purpose of SBA One is to create a document management system that will enhance OCA’s ability to collect loan documentation at origination, including collateral and loan agent data, at origination. This initiative aims to provide OPSM and OCRM a strong tool to manage program risk and facilitate access to loan documentation to inform decisions concerning program risk.

Office of Credit Risk Management

OCRM's mission is to promote confidence in the integrity of SBA's credit programs through proactive risk assessment, risk management strategies, and stakeholder communications.

OCRM responsibilities include:

- Establish and maintain processes for proactive lender oversight and risk management
- Develop risk mitigation procedures
- Conduct lender risk modeling
- Maintain quality assurance standards and controls for comprehensive risk management
- Recommend and implement supervisory and enforcement actions when appropriate.

OCRM has utilized SBA's loan portfolio data to identify SBA's riskiest lenders since 2002. For FY 2013 and 2014, OCRM has identified approximately 300 high risk SBA lenders that will be assessed using OCRM's new review protocol. These lenders account for 70% of the outstanding SBA portfolio. OCRM also plans to align delegated authority reviews with its risk-based reviews when possible. An additional 1,700+ lenders with delegated authority, accounting for 22% of the SBA portfolio, will receive delegated authority reviews.

OCRM's new 7(a) PARRiS and 504 SMART review protocols leverage SBA performance data to create advanced metrics, which will isolate lender/CDC behaviors that drive risk to the SBA. For each PARRiS and SMART rating component, OCRM has identified a set of risk metrics that will measure risk to SBA. Benchmarks for each metric are in final development and will define SBA's risk appetite by defining preferred, acceptable, and less than acceptable lender behavior, and improve communication to the SBA lending community. OCRM is currently in the process of performing developmental

reviews to further refine the PARRiS and SMART review processes. PARRiS and SMART will assist OCRM in identifying high risk lenders and ensuring that lender oversight drives meaningful review activities, findings, and corrective actions that reduce risk to the SBA.

7(a) Rating Components

P	• Portfolio Performance
A	• Asset Management
R	• Regulatory Compliance
Ri	• Risk Management
S	• Special Items

504 Rating Components

S	• Solvency and Financial Condition
M	• Management and Governance
A	• Asset Quality and Servicing
R	• Regulatory Compliance
T	• Technical Issues and Mission

OCRM has engaged in a rigorous updating (from 2008-2012) of the Lender Risk Rating Model resulting in significant adjustment of variables and measurement of risk rating applied to lenders and CDCs. Additionally, OCRM has engaged in a detailed benchmarking analysis project that will serve to establish quantitative performance metrics and indicators of quality (Preferred, Acceptable and Less than Acceptable) to be incorporated into each area of risk assessment identified in the PARRiS and SMART protocol measurement attributes. Further, as stated in the OIG's report, OCRM has also drafted an Annual Audit Plan Framework for OCA that will be used to monitor portfolio risk and refine OCA's risk management practices on an annual basis. This annual analysis will inform both OCRM's lender reviews and OCA's policy decisions and SOP changes.

Conclusion

In the draft report, the OIG states that their limited analysis “determined that the SBA had not implemented a program or process to effectively monitor risk in its loan portfolio” and that SBA “had not developed a policy to ensure identified risks were addressed.” The Office of Capital Access recognizes the importance of effective portfolio risk management. OCA devotes significant time and resources to portfolio analysis and is developing a robust risk management program.

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

- 1. Implement a portfolio risk-management program that analyzes risk across portfolio segments.***

OCA concurs with this recommendation. OCA is continuously improving its portfolio risk-management program to better manage SBA portfolio risk. OPSM generates weekly, monthly, and quarterly reporting that analyzes risk across portfolio segments such as loan size, lender, delivery method, credit score, and region and breaks down origination, servicing, and resolution risk. OCRM has developed 7(a) PARRiS and 504 SMART review protocols designed to analyze lenders' performance and risk across numerous portfolio segments. OCA will continue refining its reporting and review protocols to improve its portfolio risk-management program.

2. Use data from the portfolio risk-management program to support risk-based decisions in its loan programs.

OCA concurs with this recommendation.

OCA uses data from its portfolio risk-management program to support risk-based decision making for all program development and policy change decisions. Risk analytics have played an important role in recent projects including CAPLine reinvigoration, SLA 2.0, and SBA One. OCA will continue to explore new uses of data to improve SBA program management.

3. Develop a process within the portfolio risk-management program to ensure additional controls are implemented to mitigate identified risks where necessary.

OCA concurs with this recommendation.

OPSM and OCRM both play key roles in all program and policy initiatives to ensure that program decisions are supported by data and sound risk management practices. OCA is further working to develop an annual risk management cycle that will analyze risk across several portfolio segments at the beginning of each year and use these findings to drive lender review and program management decisions for that year.

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.