



SBA Policy Notice

TO: All SBA Employees

CONTROL NO.: 5000-1348

SUBJECT: Revised Risk-Based Review Protocol for Certified Development Companies
EFFECTIVE: August 5, 2015

I. Introduction

SBA's Office of Credit Risk Management (OCRM) is updating its oversight of Certified Development Companies (CDCs) participating in SBA's 504 Loan Program. The revised Risk-Based Review (RBR) protocol described below is intended to be flexible and is capable of taking into account individual facts and circumstances. SBA will use this guidance along with judgment and Agency discretion in conducting RBRs of CDCs.

II. SMART Risk Measurement Methodology

The revised RBR protocol features a composite risk measurement methodology and scoring guide, "SMART," which SBA has developed for the oversight of CDCs. SMART is an acronym for the specific risk areas or components that SBA reviews for CDCs. The components and their measurement objectives are as follows:

Component	Measurement Objective
"S" - Solvency and Financial Condition	CDC's financial ability to operate and portfolio performance.
"M" - Management and Board Governance	Organizational structure, policies, and internal controls.
"A" - Asset Quality and Servicing	Quality of the CDC's 504 loan origination, closing, servicing and liquidation practices.
"R" - Regulatory Compliance	CDC's compliance with SBA Loan Program Requirements.
"T" - Technical Issues and Mission	Additional key metrics or items that are not included in the other components but may pose risk to SBA or present program integrity concerns.

The SMART components cover the general areas SBA reviews under the authority of 13 C.F.R. § 120.1050(a). Each SMART component includes both quantitative and qualitative factors. (See [Appendix A](#) to this Notice for a list of the quantitative and qualitative factors currently being used for each SMART component.) The quantitative factors are benchmarked and scored against risk tolerance thresholds, producing a SMART Score (described below under Lender Profile Assessment). The qualitative factors will include, but not be limited to, consideration of: compliance with SBA Loan Program Requirements (as defined under 13 C.F.R. § 120.10), changes in CDC's loan policies, management and staff capabilities and any

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other aspect of the CDC's 504 program. Review of the quantitative and qualitative factors will allow SBA to better identify a CDC's specific risk areas, assess the level of risk a CDC poses to SBA, and make recommendations for corrective action as needed. The SMART methodology, including but not limited to quantitative and qualitative factors, may be revised from time to time.¹

III. CDC Revised Risk-Based Review Protocol

SBA's revised RBR protocol for CDCs features the following levels/types of review:

1. Lender Profile Assessment
2. Analytical Review
3. Targeted Review
4. Full Review
5. Annual Report Review
6. Delegated Authority Renewal Review
7. Other Reviews

A detailed discussion of each review level follows.

1. Lender Profile Assessment

The Lender Profile Assessment (LPA) is the first level of review. It is a data-driven virtual review that computes the quantitative factors for each SMART component and then scores them against certain benchmarks.² Currently, SBA scores a quantitative factor: "1" – for performance within a "Lower Risk" range; "3" – for performance within a "Moderate Risk" range; and "5" for performance within a "Higher Risk" range. The total score for all components (SMART Score) is calculated,³ providing SBA with a high level assessment of the CDC. SMART scores in this initial version of the LPA currently range between 12, indicating the lowest risk, and 60, indicating the highest risk. SBA may use the LPA/SMART Score to assist in determining the next level of review, if any, and in connection with CDC delegated authority decisions. SBA is updating the Lender Portal screens to include SMART Scores and the underlying metrics.

2. Analytical Review

The Analytical Review is the second level of review. SBA analyzes the LPA for each SMART component, including both quantitative and qualitative factors. SBA may select a CDC for an Analytical Review based on the CDC's Lender Risk Rating, LPA or SMART Score, as well as other risk criteria, such as previous RBR assessments, the CDC's Annual Report, or whether the CDC has been reviewed recently. SBA may also conduct Analytical Reviews on a population of randomly-selected CDCs or in connection with CDC delegated authority decisions.

Analytical Reviews are generally a virtual review unless a CDC does not have virtual review capability. An Analytical Review generally will include a review of a CDC's 504 loan portfolio data rather than 504 loan files. However, in some cases a 504 loan file review may be required, and if so, SBA will notify the CDC. SBA may request documents and information

¹ The SMART methodology may also include "flags". These flags are intended to highlight additional areas that SBA may be monitoring in identifying risk. Flags will not contribute to a CDC's SMART score.

² SBA is moving to benchmarks for establishing risk tolerance thresholds.

³ SBA may weight some quantitative factors more than others in calculating the SMART Score.

relevant to any or all SMART components from a CDC. OCRM may also solicit information about the CDC from other SBA sources, such as the SBA Sacramento Loan Processing Center, the applicable SBA district office(s) and the applicable commercial loan servicing center. The results of an Analytical Review may conclude the process or may indicate the need for a subsequent level of review, such as a Targeted or Full Review.

3. Targeted Review

The Targeted Review is generally narrow in scope. In a Targeted Review, SBA generally reviews one or more SMART components or other areas of concern (including program integrity concerns) identified by SBA as requiring a focused scope of review. For example, SBA may perform a Targeted Review in connection with “Higher Risk” factor(s) or other material noncompliance identified during an Analytical Review or a Full Review. SBA may also use a Targeted Review to confirm the implementation of required corrective actions, or in conjunction with increased supervision or enforcement.

A Targeted Review may be conducted either virtually and/or at a CDC’s location depending on the CDC’s technological capabilities or other review-specific needs. A CDC selected for a Targeted Review will receive an engagement letter that advises the CDC of the review and requests documents and information relevant to the matters being reviewed. For a Targeted Review that includes a 504 loan file review, SBA may use random and/or judgmental sampling to target specific risk characteristics.

4. Full Review

SBA conducts a comprehensive analysis of each SMART component in a Full Review. Full Reviews are generally conducted at the CDC’s location, but may include a virtual review portion. SBA selects CDCs for Full Reviews based on indications of higher risk as identified through LPAs/SMART Scores, Analytical Reviews, Annual Report Reviews, or other SBA monitoring tools; whether SBA has performed an RBR recently; and/or program integrity considerations. SBA may also select a random sample of CDCs to receive Full Reviews.

A CDC selected for a Full Review will receive an engagement letter that requests documents and information relevant to each SMART component. The LPA diagnostic serves as the initial step in the Full Review. Full Reviews include reviews of 504 loan files. SBA generally selects loans for review using both random and judgmental sampling techniques. Judgmental loan file selection criteria for Full Reviews include loan characteristics such as loan size, borrower industry, loan delivery method, Small Business Predictive Score at origination, and loan performance.

5. Annual Report Review

Under 13 C.F.R. § 120.830, a CDC must submit an Annual Report within 180 days after the end of the CDC’s fiscal year. Annual Reports are submitted to the SBA district office designated as the CDC’s Lead SBA Office. As set forth in SOP 50 10 5, the Lead SBA Office performs a review of the CDC’s Annual Report and an operational review of the CDC, and forwards the Lead SBA Office review and the CDC’s Annual Report to SBA Headquarters. OCRM will perform reviews of Annual Reports for completeness and compliance with SBA’s Loan Program Requirements.

6. Delegated Authority Renewal Review

SBA performs a Delegated Authority Renewal Review prior to the CDC's delegated status expiration date. Examples of delegated status for CDCs are the Premier Certified Lenders Program (PCLP) and the Accredited Lenders Program (ALP). In general, SBA works to coordinate Delegated Authority Renewal Reviews with the timing of a CDC's Analytical Review or Full Review, if one is to be performed. Delegated Authority Renewal Reviews generally occur every two years. However, CDCs with shortened renewals (*e.g.*, those under increased supervision) may have Delegated Authority Renewal Reviews more frequently. The Delegated Authority Renewal Review will analyze the LPA along with the other Delegated Authority criteria as set forth in SBA's Loan Program Requirements. A Delegated Authority Renewal Review may result in the granting or denial of continued delegated authorities.

7. Other Reviews

OCRM may perform other reviews of CDCs from time to time. These include, for example, CDC Self-Assessments and Agreed Upon Procedure Reviews (AUP). For the CDC Self-Assessment or AUP, the CDC is responsible for conducting the review. SBA might use a CDC Self-Assessment or AUP as an alternative method to confirm corrective actions required or review a matter or deficiency of low to moderate risk. The Self-Assessments or AUPs are performed by third-party practitioners or an independent office within the CDC (*e.g.*, internal audit), upon which SBA and the CDC agree, and must follow a review protocol as prescribed or approved by SBA. SBA may review the CDC Self-Assessments or AUPs to confirm that review "assertions" and "objectives" were met, testing and results were accurate, and the report was reliable.

The RBR protocol, like the SMART methodology, may be revised and is subject to periodic adjustment. SBA will use judgment and discretion and may consider matters such as risks identified, changing economic conditions, and Agency resources in making periodic adjustments.

IV. Review Report and Assessment Categories

RBRs, particularly Analytical Reviews, Targeted Reviews, and Full Reviews, generally culminate in a Review Report (Report). In general, the Report will include a summary assessment of the CDC and may include an individual assessment for each SMART component reviewed. The summary assessment generally bears a close relationship to the SMART component assessments, but the summary assessment is not a mathematical average of the components. The RBR assessment categories of "Acceptable," "Acceptable with Corrective Action Required," and "Less Than Acceptable with Corrective Action Required" have now been amended to add a fourth assessment category of "Marginally Acceptable with Corrective Action Required." A CDC in the "Marginally Acceptable with Corrective Action Required" category requires close supervisory attention and monitoring to promptly correct the serious compliance and risk management practices in the CDC's operations that, if not corrected, will negatively impact the CDC's operations and expose SBA to an unacceptable level of financial and/or program risk. SBA will use judgment and discretion in assigning review assessments.

Questions

Questions on this revised RBR protocol for CDCs may be directed to Adrienne Grierson, Deputy Director, Office of Credit Risk Management, at Lender.Oversight@sba.gov.

Maria Contreras-Sweet
Administrator

Appendix A – Current SMART Component Factors

The quantitative⁴ and qualitative SMART factors currently analyzed for each component include, but are not limited to:

“S” – Solvency and Financial Condition

Quantitative Factors	Qualitative Factors
• 5 year cumulative net yield	• Reserves for future operations
• 12 month default rate	• Liquidity risk management
• 5 year default rate	• Balance sheet leverage

“M” – Management and Board Governance

Quantitative Factors	Qualitative Factors
• Lender Purchase Rating (LPR) ⁵	• Board-approved internal control policies, including independent loan review and loan classification system
• High risk origination rate	• Business strategy and planning
• Loans in purchase status over 3 years rate	• Audit and review programs
	• IT operations
	• Management of risk concentrations

“A” - Asset Quality and Servicing

Quantitative Factors	Qualitative Factors
• Stressed loan rate (Past Due + Delinquent + Deferred Loans)	• Credit administration
• Recovery rate (over last 5 years)	• Servicing and liquidation management
• Early problem loan rate	• Potential fraud, negligence, or misrepresentation issues on individual 504 loans

“R” – Regulatory Compliance

Quantitative Factors	Qualitative Factors
• Minimum level of 504 Loan activity	• Timely and complete submission of CDC Annual Report (and PCLP Loan Loss Reserve Report, if required)
	• Liability insurance minimums

“T” – Technical Issues and Mission

Quantitative Factors	Qualitative Factors
• Average Small Business Predictive Score (SBPS) (weighted)	• CDC support of “other economic development initiatives”
• Top industry concentration rate	• Job creation and retention documentation
	• Professional services contracts
	• Franchise concentration rate

⁴ SBA will provide definitions for each of the quantitative factors on the Lender Portal.

⁵ Also known as the Lender’s Risk Rating. *See*, SBA Lender Risk Rating System Notice, 79 FR 24053, April 29, 2014.