

**AUDIT OF**  
**504 LOAN PROGRAM OVERSIGHT**  
**WASHINGTON, DC**  
**AUDIT REPORT NO. 3-10**  
**FEBRUARY 6, 2003**

**The findings in this report are the conclusion of the OIG's Auditing Division based on testing of SBA operations. The findings and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.**



US SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
Washington, DC 20416

<b>AUDIT REPORT</b>
<b>ISSUE DATE: February 6, 2003</b>
<b>REPORT NUMBER: 3-10</b>

**To:** Janet Tasker, Associate Administrator  
Office of Lender Oversight  
*Robert G. Seabrooks*

**From:** Robert G. Seabrooks, Assistant Inspector General  
for Auditing

**Subject:** Audit of 504 Loan Program Oversight

Attached is a copy of the subject audit report. The report contains two findings and three recommendations addressed to your office. Corrective actions addressing the recommendations have been completed, are in process, or are planned for the near future.

The recommendations in this audit report are based on the conclusions of the Auditing Division. The recommendations are subject to review, management decision and action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide us your management response for each recommendation within 30 days. Your management decisions should be recorded on the attached SBA Forms 1824, "Recommendation Action Sheet," and show your proposed corrective action and target date for completion.

Any questions or discussion of the findings and recommendations contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.

Attachment

**AUDIT REPORT  
504 LOAN PROGRAM OVERSIGHT  
WASHINGTON, DC**

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## SUMMARY

The 504 Loan Program was established to foster economic development, create or preserve job opportunities, and stimulate growth, expansion, and modernization of small businesses. Office of Management and Budget (OMB) Circular A-129, "Policies for Federal Credit Programs and Non-Tax Receivables", requires agencies to conduct on-site lender and servicer reviews. The SBA Office of Lender Oversight was established in August 1999 to ensure that the oversight system, among other things, provided a more effective means of identifying risk to the Federal government. The agency issued Standard Operating Procedure (SOP) 50 50 4B, "Loan Policy and Program Oversight Guide for Lender Reviews" effective October 1, 1999. The guide was intended to provide operating procedures for assessing the level of compliance of SBA's lending partners.

The objective of the audit was to determine if SBA's oversight of the 504 Loan Program provided a thorough and reliable evaluation of Certified Development Companies (CDCs) to assess and anticipate financial risk to the loan portfolio.

Although the 504 Loan Program appears to be operating efficiently, as evidenced by a low default rate, we identified areas of program oversight that could be improved. Specifically:

- SBA oversight did not adequately address financial risk and incomplete annual reports were used in compliance reviews.
- Lender oversight reviews were not tracked to ensure accomplishment once every three years.

We recommended that the Associate Administrator for Lender Oversight (AA/LO) take action to design a separate review guide for the 504 Loan Program, ensure annual reports submitted by CDCs are complete, and implement a review tracking system.

The AA/LO agreed to develop a review guide specific to the needs and requirements of the 504 Loan Program. The response indicated that a new tracking system for monitoring oversight reviews has already been implemented. The AA/LO proposed that the Office of Lender Oversight rather than district offices assure annual reports are complete (see Appendix C).

## INTRODUCTION

### A. Background

The Certified Development Company (CDC) Loan Program (504 Loan Program) was created to give small business owners the means to expand, modernize, and compete in the economy by providing long-term, fixed-asset financing. Typically, at least 10 percent of the loan proceeds are provided by the borrower, at least 50 percent by an unguaranteed bank loan, and the remainder by an SBA-guaranteed debenture from a CDC.

Most CDCs are private, non-profit corporations set up to contribute to the economic development of their communities or regions. The maximum SBA debenture is \$1 million. The minimum debenture is \$50,000. Generally, projects range from \$500,000 to \$1.5 million in total project costs. For every \$35,000 of debenture financing in the CDC's portfolio, SBA requires that an average of one job be created or retained within two years of the project's funding.

In October 1999, SBA implemented a lender oversight program for all 7(a) and 504 Loan Program delivery methods. Due to declining personnel levels and a growth in the loan portfolio, SBA adapted its programs and procedures to rely more on the program's lenders for operational support. This increased reliance on the lender also increased the need for an effective SBA lender oversight program. To ensure effective oversight an Office of Lender Oversight (OLO) was established and began risk-based approach to oversight of SBA's lenders. In October 2000, a draft Strategic Plan was developed to set the direction and approach for OLO.

The OLO, a component of the Office of Capital Access, is responsible for the lender oversight program. The oversight program is defined as a "framework through which the SBA reviews and anticipates risks to the portfolio." The OLO monitors and oversees SBA's lending partners to ensure they receive consistent and appropriate supervision as they assist in the delivery of SBA programs. The OLO has two major functions: off-site analysis of SBA's lenders and SBA's loan portfolios and on-site lender reviews.

Lender performance is evaluated by using a six-section checklist composed of application forms, eligibility, credit quality, loan authorization and closing, servicing and liquidation actions, and oversight. Based on the scoring results, lenders are assigned one of the following levels of compliance: "substantially in compliance," "generally in compliance," "minimally in compliance," or "not in compliance."

The 504 Loan Program's FY 2001 budget was \$3.75 billion, making it the second largest loan program in SBA. As of November 2000, there were 261 CDC lenders in the program with 27,553 outstanding loans in their portfolios. The FY 2000 currency rate was 96.5 percent, significantly higher than those of both the 7(a) and the disaster loan programs.

**B. Objective**

The objective of the audit was to determine if SBA's Oversight of the 504 Loan Program accomplishes a thorough and reliable evaluation of CDCs to assess financial risk to the portfolio.

**C. Scope and Methodology**

We conducted audit fieldwork at eight district offices, ten Certified Development Companies, and SBA headquarters. Three of the CDCs had not been previously reviewed by the district office. We reviewed loans that were included in the most recent district office oversight reviews for the seven CDCs that had been reviewed. For the other three CDCs, we judgmentally selected loans to review.

To answer the audit objective, we obtained and reviewed annual reports and third party contracts for all CDCs reporting to eight district offices. We tested seven judgmentally selected SBA lender reviews, made ten site visits to CDCs and their responsible SBA district office, and interviewed SBA officials and CDCs' representatives. Fieldwork was performed from April 2001 through May 2002. The audit was performed in accordance with Government Auditing Standards.

## RESULTS OF AUDIT

### FINDING 1 CDC Lender Oversight Needs Improvement

SBA's oversight of Certified Development Companies (CDCs) did not adequately address financial risk to, or compliance with, requirements of the 504 Loan Program. The oversight consisted primarily of completing a checklist that was more relevant to the 7(a) Program than to the 504 Program. In addition, incomplete CDC annual reports were used for the compliance reviews. As a result of a less than optimum oversight evaluation, SBA was not in a position to take necessary corrective action to minimize financial risk.

#### *Program goals*

SBA's oversight program anticipates a review of both financial and lender-based portfolio risk. Financial risk includes composite risk posed by loans and guarantees actually booked to SBA's portfolio as well as historical loan performance. Lender-based risk includes (i) loans that the lender has recently made and will be making, (ii) loans already booked to the SBA portfolio, and (iii) public policy risk associated with lender's non-compliance.

#### *Financial risks not identified*

The current CDC review process is a compliance review designed to evaluate only the first and third elements of lender-based risk. Financial risk and the second element of lender-based risk (loans already booked) were not assessed.

Our analysis included reviews made by district offices for 33 loans from seven CDCs. In each of the reviews, the district offices determined that the CDC's portfolio posed no financial risk. This assumption was made without the benefit of considering SBA established lender performance benchmarks. Such performance benchmarks were established by SBA's Risk Management Committee to determine lender performance. Since benchmarks are based directly on financial risk, their exclusion from the annual review scoring process prevents the assessment of financial and lender-based risk. Four of the seven CDCs failed four or more of the established benchmarks that addressed currency, delinquency, default, liquidation, and loss rates. Failing this number of benchmarks should have alerted district offices of potential SBA risk.

The reviews also did not detect all of the weaknesses that should have been identified. SBA teams found 52 non-compliances. An OIG analysis of the same CDCs disclosed 246 non-compliances. In our review of the 33 loans we found three loans with questionable repayment ability, 22 loan files with missing credit determinations of either the individuals or the businesses, 11 lacking evidence that insurance requirements were current, and 18 instances of missing IRS verifications. Each of these deficiencies indicated some financial risk to the SBA. Many of these were not identified by the districts because the related questions had been omitted. The SBA position towards the

omitted questions was that reviewing areas that had previously been approved by SBA would be reviewing their own work, not the CDC's.

The differences were partially caused by the district review teams omitting 64 percent of the questions when conducting the reviews. Questions were determined to be "not applicable" because (i) district offices were instructed not to complete section one of the checklist for loans that were not processed as Premier Certified Lender Program (PCLP) loans, (ii) some questions referred to forms not required in the 504 Program, (iii) other questions were applicable only to PLP or Section 7(a) loans, and (iv) liquidation questions were omitted.

Appendix A summarizes the results of the District and OIG reviews.

### ***Incomplete Annual CDC Reports***

The Code of Federal Regulations requires a CDC to submit an annual report to the SBA district office within 90 days after the end of the CDC's fiscal year. District offices were not ensuring that the annual reports were complete, as required by SBA guidance. SBA procedures state that the annual reports are to be used to:

- Evaluate the CDC's performance in delivering and servicing SBA loan programs;
- identify CDC strengths and weaknesses and recommendations for improvement; and
- address persistent problems that have been identified without correction, set a final deadline for such correction(s) and, if necessary, start the decertification process.

The determination as to the completeness of the annual report is a district office responsibility. If an annual report has not been properly completed, the CDC must be notified in writing. A completed annual report then must be submitted within 30 days. In the case of incomplete or missing reports, SBA may cease accepting or processing loan applications if the CDC fails to comply with the annual report requirements. SBA district offices were accepting incomplete annual reports from the CDC's included in our review. This included missing or incomplete exhibits or data. For example, information required on CDC memberships and board of directors, such as phone numbers, addresses, group represented, etc. were not always complete. There were shareholders listed who were deceased or who had moved and left no forwarding address. Also, CDC staff members were inappropriately serving on credit committees, financial statements were missing, or accounting footnotes to the financial statements were not always included.

The missing annual report information is summarized by district office in Appendix B. Of a possible 731 data elements or exhibits required to be included in the annual reports, 147 (20 percent) were either missing or incomplete.

## ***Conclusion***

After interviewing field and program officials, we concluded that it was generally believed that the review process needed to be redesigned to specifically address the 504 Loan Program and should be both a financial and compliance review. SBA management stated that it intends to design a separate review for the 504 Loan Program.

## **Recommendations**

We recommend that the Associate Administrator for Lender Oversight take the following actions:

1A. Design a CDC review guide to: (i) incorporate performance aspects to address financial risk; (ii) address the specific requirements of the 504 Loan Program; and (iii) incorporate a scoring system that emphasizes the most important performance issues.

1B. Require district offices to obtain and analyze complete annual CDC reports.

## **Management Comments**

The OLO agreed with recommendation 1A and partially agreed with recommendation 1B. For recommendation 1A, the OLO stated that the development of a redesigned approach to CDC lender reviews was underway. For recommendation 1B, management agreed to implement adequate review of the CDC annual reports in its lender review process; however, did not believe it necessary to require the district offices to perform this function.

## **Evaluation of Management Comments**

We consider management's responses to the recommendations to be adequate. While management's response to 1B did not agree with requiring district offices to ensure the adequacy of annual reports, it did state that adequate review of annual reports would be accomplished as part of the lender review process. The intent of the recommendation was that an adequate review be performed to ensure that annual reports were complete. We consider it acceptable to accomplish this through the OLO lender review process rather than by district offices.

## **FINDING 2 An Oversight Review Tracking System is needed**

SBA had not established a tracking system to monitor CDC oversight reviews. In FY 2000, SOP 50 50 4B established an oversight requirement that each CDC be reviewed at least once every three years. The lack of a tracking system provides no assurance reviews will be accomplished, as required.

### ***Monitoring CDC Reviews***

District offices electronically submitted the results of each CDC review to a lender oversight electronic mailbox. We found that SBA retained the electronic copy of the reviews but did not compile the data. Therefore, management was unable to identify which CDCs were reviewed due to the unavailability of the data. Because this information was unavailable, we could not readily determine whether SBA was completing a review of all CDCs at least once within the required three-year cycle.

Establishing a system to capture the appropriate data would allow SBA to monitor trends such as groups of questions that are continually omitted during reviews, if CDC performance is improving, common problem areas among CDCs, and whether loans in liquidation are included in the sample and if the sample sizes are appropriate.

### **Recommendation**

- 2A. We recommend that the Associate Administrator for Lender Oversight implement an oversight tracking system to monitor the scheduling and performance of oversight reviews.

### **Management Comments**

The AA/LO agreed with the recommendation and stated that a tracking system has already been implemented. The tracking system identifies and tracks CDC status, district codes, performance benchmarks, review requirements, date review forwarded to OLO, number of loans reviewed, overall rating, and individual responses to review questions.

### **Evaluation of Management Comments**

We consider the response to the recommendation acceptable.

Summary of District and OIG Lender Reviews

	Johnson County	Wakarusa	Delaware	Central Mississippi	Rural Enterprises, Inc.	Amador	Speden
District Office	Kansas City	Kansas City	Philadelphia	Jackson	Oklahoma City	Sacramento	Minnesota
<b>SBA</b>	<b>ASSIGNED</b>	<b>REVIEW</b>	<b>RATING</b>	<b>VERSUS</b>	<b>FAILED</b>	<b>BENCH</b>	<b>MARKS</b>
Rating Assigned by the District Review	Generally in compliance	Substantially in compliance	Minimally in compliance	Substantially in compliance	Substantially in compliance	Generally in compliance	Substantially in compliance
Currency Rate	97.0%	████	████	████	93.86%	████	99.9%
Delinquency Rate	3.0%	████	████	████	████	████	████
Loss Rate	████	0.0%	2.3%	1.6%	████	████	0.0%
Liquidation Rate	3.0%	0.0%	████	████	████	████	0.0%
Purchase Rate	9.0%	0.0%	████	████	████	n/a	████
		<b>DISTRICT</b>	<b>VERSUS</b>	<b>OIG</b>	<b>REVIEW</b>		
Total Non-compliances per SBA District Review	9	9	11	0	4	9	10
Number of questions omitted from district review	257 out of 330	105 out of 255	359 out of 405	246 out of 330	268 out of 405	295 out of 405	188 out of 555
Total Non-compliances from OIG Review	30	38	31	41	24	39	43
Sample Size	4	3	5	4	5	5	20 *

Note: Passing benchmarks are as follows:

- Currency Rate= 90% or higher
- Delinquency Rate= 5% or lower
- Loss Rate= 3% or lower
- Liquidation Rate= 5% or lower
- Default Rate= 9% or lower

\* Minnesota District reviewed 20 loans. We reviewed 7 of those 20 loans.

APPENDIX B

Missing Elements on CDC Annual Reports

	Sacramento District Office	Birmingham District Office	Puerto Rico District Office						
<b>Number of CDCs In the District</b>	9	6	8	4	2	6	4	4	43
<b>MISSING ELEMENTS:</b>									
<b>MANAGEMENT REPORT</b>									
1. Summary of Loan Activity and Job Creation	0	0	1	0	0	4	2	1	8
2. Schedule of Economic Activity	4	3	1	2	0	1	3	1	15
3. Schedule of Programs and Activities other than 804 Program	0	1	0	0	0	0	0	0	1
4. A Success Story	4	0	1	1	1	2	1	0	10
<b>OPERATION REPORT</b>									
5. Overview of CDC Activity	2	1	0	0	0	0	0	0	3
6. Economic Development Activity	0	0	0	0	0	0	0	0	0
7. Each Officer and Director	5	1	1	0	1	2	2	4	16
8. Each Member	6	5	2	0	1	2	3	4	23
9. Each Individual Who Performs Staff Functions	3	0	3	0	1	2	2	1	12
10. CDC Board Meetings	1	0	1	0	0	1	2	3	8
11. Contractual Agreements	0	0	0	1	1	0	1	0	3
12. Analysis of Income	2	3	2	1	1	0	1	0	10
13. Legal	1	3	1	1	1	2	1	0	10
<b>FINANCIAL REPORT</b>									
14. Balance Sheet	3	0	1	0	0	1	0	0	5
15. Income/Expense Statement	3	0	2	0	0	0	0	0	5
16. Change in Financial Condition	2	1	3	0	0	1	0	1	8
17. Accountant's Report	5	3	0	0	0	1	0	1	10
<b>TOTAL</b>	<b>41</b>	<b>21</b>	<b>19</b>	<b>6</b>	<b>7</b>	<b>19</b>	<b>18</b>	<b>16</b>	<b>147</b>
<b>POSSIBLE DATA ELEMENTS (17/CDC)</b>	<b>153</b>	<b>102</b>	<b>138</b>	<b>68</b>	<b>34</b>	<b>102</b>	<b>68</b>	<b>68</b>	<b>731</b>
<b>% OF MISSING ELEMENTS</b>	<b>27%</b>	<b>21%</b>	<b>14%</b>	<b>9%</b>	<b>21%</b>	<b>19%</b>	<b>26%</b>	<b>24%</b>	<b>20%</b>



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

Appendix C

**DATE:** January 28, 2003

**TO:** Robert G. Seabrooks  
Assistant Inspector General for Auditing

**FROM:** Janet A. Tasker *Janet A. Tasker*  
Associate Administrator for Lender Oversight

**SUBJECT:** Management Response to the Draft Audit Report of 504 Loan Program Oversight

Attached please find Management's Response to the Draft Audit Report of 504 Loan Program Oversight.

Please call Janet Tasker at (202) 205-3049 or Felicia Smith at (202) 205-7522 should you have any questions or need additional information.

Attachment

cc: Ronald Bew, ADA Capital Access  
James Rivera, AA/Financial Assistance  
David Frederickson, AA/Field Operations

**MANAGEMENT RESPONSE TO  
DRAFT AUDIT REPORT OF 504 LOAN PROGRAM OVERSIGHT**

**FINDING 1: CDC Lender Oversight Needed Improvement**

**Recommendation 1A:** Design a CDC review guide to: (i) incorporate performance aspects to address financial risk; (ii) address the specific requirements of the 504 loan program; and (iii) incorporate a scoring system that emphasizes the most important performance issues.

**Program Response:** Agree

The Office of Lender Oversight (OLO) agrees with the need to develop a review guide specific to the needs and requirements of the 504 loan program. Development of a redesigned approach to CDC lender reviews is underway. The enhanced approach will be specific to 504 lending and will consider and evaluate a CDC's loan portfolio performance, portfolio administration, underwriting and origination practices, servicing activities and compliance with SBA requirements, including annual report requirements. A separate review guide is currently being drafted for the 504 loan program to implement this new approach. The enhanced 504 review process will not, however, evaluate how well District Offices accomplish their responsibilities with regard to 504 loan underwriting and utilization of CDC annual reports. OLO believes that its responsibility is to review the lending practices relative to the 504 loan program. It is not within OLO's charter to evaluate the adequacy of lending decisions and relationship management determinations made by District Offices relative to the CDCs in their area.

It is important to note that the Office of Field Operations (OFO) conducts Quality Service Reviews (QSR) of the District Offices. The QSR includes a review of the District Office's performance in the underwriting and processing of 504 loan applications. QSR reviews are also required to document that the District Office has received, reviewed and forwarded to Headquarters all the CDC annual reports for the CDCs assigned to their respective office.

As part of the Agency's transformation efforts, OFO will be piloting the centralization of 504 loan processing in the Sacramento PLP Loan Processing Center. The Center's underwriting and processing will be periodically reviewed by a team consisting of both Capital Access and OFO staff. District Offices will continue to have the responsibility for CDC relationship management and as such will continue to collect, review and forward the annual reports to Headquarters.

**Recommendation 1B:** Require district offices to obtain and analyze complete annual CDC reports.

**Program Response:** Partially Agree

The redesigned approach to reviews of 504 lenders will include a review and assessment of a CDC's annual report to SBA, including its adequacy relative to SBA requirements. OLO views its responsibility as lender oversight. District Offices are responsible for lender relationship management. As such, the two offices use the annual CDC reports for different purposes. CDCs are required to submit reports on an annual basis to SBA. OLO will assess the timeliness, adequacy and responsiveness of an individual CDC's submission as part of the 504 lender review process. District Offices utilize the annual report in their day to day relationships with CDCs. OLO agrees with the need to have an adequate review of CDC annual reports and is addressing this need through the redesigned 504 lender review process. OLO does not believe that the existing requirement for CDCs to submit the annual reports needs to be modified to require specific District Office review and analysis.

**FINDING 2: An Oversight Review Tracking System is Needed**

**Recommendation 2A:** Recommend that the Associate Administrator for Lender Oversight implement an oversight tracking system to monitor the scheduling and performance of oversight reviews.

**Program Response:** Agree

OLO agrees with the need to track compliance review results to ensure that reviews are accomplished as required. In fact, OLO has already implemented a tracking system for monitoring CDC oversight reviews. The system identifies and tracks CDC status, district codes, performance benchmarks, review requirements, date review forwarded to OLO, the number of loans reviewed, the overall rating and the individual responses to review questions. This system is in place and being maintained within OLO.

**Audit Report Distribution**

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