

Independent Loan Review Guide

Overview

Independent Loan Reviews play an important role in a Certified Development Company's (CDC) internal control of the 504 loan portfolio. Periodic objective independent reviews of credit risk levels and risk management processes are essential to effective portfolio management, and assist a CDC's Board in carrying out its responsibility to monitor the CDC's portfolio performance on a regular basis (13 CFR § 120.823(d)(7)). SBA regulations require a CDC to have a Board-approved internal controls policy that, among other things, directs the operation of a program to review and assess the CDC's 504 loans (13 CFR § 120.823(d)(13) and 13 CFR § 120.826(b)(3)). SOP 50 10 requires a CDC's internal control policy to ensure satisfactory monitoring and management of the 504 loan portfolio, including but not limited to, providing for a periodic loan review function to be performed at least annually by a person that is not directly or indirectly responsible for loan making or by outside contractors. Tab 2.F. of SBA Form 1253 (CDC Annual Report Guide) requires a CDC to include in its Annual Report an Independent Loan Review Package that contains, at a minimum, the following: (1) a copy of the engagement letter from the reviewer (if performed by an outside contractor); (2) a copy of the completed Independent Loan Review Report which follows the content and reporting guidelines set forth in this Independent Loan Review Guide and includes a description of the individuals conducting the review demonstrating their independence from the function that they are responsible to review (if conducted internally), the loan selection methodology or criteria used for the sample, and a copy of the checklist that was used in the loan review; and (3) evidence that the Board acknowledged receipt of the results of the Independent Loan Review Report and approved CDC Management's plan to remedy the findings from the loan review.

Internal Controls Policy for Independent Loan Reviews (13 CFR § 120.826(b)(3))

A CDC's internal controls policy should establish Independent Loan Review guidelines specifying:

- frequency of the review (no less than annually);
- independence of the loan reviewers and credentials of the reviewers;
- review sample size;
- standards for scope of selection;
- sampling methodology for loans and appraisals originated in the last 12 months for underwriting/closing requirements;
- sampling methodology for reviewing loans in servicing based on loans that are current, delinquent, in intensive servicing or liquidation;
- loan review standards;
- loan-related collateral review standards;
- appraisal review standards;
- requirements for work papers and supporting documentation;
- loan quality classification standards consistent with the standardized classification systems used by the Federal Financial Institution Regulators;
- specific control requirements for the CDC's oversight of Professional Services Contractors; and
- standards for training to implement the loan review program.

Frequency of Reviews

An Independent Loan Review should be conducted at least annually, by someone qualified to conduct such a review and independent of the function being reviewed.

Loan Reviewers

The CDC is not required to hire an outside contractor to conduct this independent review, if it can be done in-house by a person or persons independent of the function being reviewed (i.e., not directly or indirectly responsible for the function). For example, a CDC employee involved in loan underwriting should not be reviewing the loan underwriting area. However, a CDC employee whose duties are limited to loan servicing could conduct the loan underwriting review. To ensure independence in the review process, the reviewer(s) should report to the CDC's Board or to an audit committee at the Board level. Results of the review should be communicated to both the Board and CDC Management. The Board should discuss and review performance evaluation from the review and approve CDC Management's plan to act on the review's findings.

Loan Review

The review should include both new and legacy loans (defined as loans funded over 12 months ago), and should include compliance with SBA Loan Program Requirements. The review of new loans (funded in the past 12 months) should focus on underwriting and closing, and the review of legacy loans should focus on servicing and liquidation, if applicable. The review should also include an assessment of the loan classification (a/k/a loan risk rating) to ensure loans are risk-classified appropriately and that risk classifications are updated in a timely manner (either annually or earlier if new information is obtained).

Each 504 loan file in the sample should be reviewed for:

- Eligibility;
- Credit analysis;
- Credit documentation;
- Collateral documentation;
- Proper lien perfection;
- Adherence to loan covenants;
- Loan Authorization, Closing and Disbursement;
- Appraisals;
- Environmental reports;
- Servicing and Liquidation;
- Compliance with internal policies and procedures, and applicable laws and regulations, including SBA Loan Program Requirements; and
- The accuracy and timeliness of risk rating/loan classification assigned by loan officers.

Core Analysis Phase

Core analysis phases during the Independent Loan Review must include:

- 1) Determining whether deficiencies noted in last Independent Loan Review and the most recent internal/external audit/review have been addressed and/or corrected by CDC management; and
- 2) Determining if any members of CDC management or the CDC's Board have the ability to override credit grades or decisions, and, if so, whether any such overrides have occurred on the sampled loans.

Outcome of an Independent Loan Review

The following objectives generally should be addressed in an effective CDC Independent Loan Review process and should serve as potential points for improvement:

- To provide the CDC's Board and CDC management with an objective assessment of the overall portfolio quality;
- To assess the adequacy of compliance with and adherence to SBA's Loan Program Requirements, and to monitor compliance with other applicable laws and regulations;
- To promptly identify loans with credit weaknesses so that timely action can be taken to minimize credit loss, including review of the CDC's loan classifications;
- To identify relevant trends affecting the collectability of the loan portfolio and isolate potential problem areas;
- To provide essential information for determining the adequacy of the Premier Certified Lenders Program (PCLP) loan loss reserve fund, if applicable;
- To evaluate the activities of CDC lending personnel; and
- To provide CDC management with information related to credit quality that can be used for financial and regulatory reporting purposes.

Loan Quality Classification Standards Used by Federal Financial Institution Regulators

The Independent Loan Review should discuss the risk-rating of each loan reviewed, determine whether the risk rating is correct or should be up-graded or down-graded, and provide an explanation for this finding. Timely and accurate classification of loans allows the CDC to better manage its 504 loan portfolio.

An example of a loan classification system used by a Federal Financial Institution Regulator is the Uniform Classification System (UCS) referenced by the Farm Credit Administration on their website at:

<https://ww3.fca.gov/readingrm/exammanual/General%20Guidance/Classifying%20Assets%20Using%20the%20UCS.pdf>

Control Requirements for the CDC's Oversight of Professional Services Contractors

CDCs are expected to oversee their Professional Services Contractors to ensure that the services provided are in compliance with SBA Loan Program Requirements. There must be no actual or appearance of a conflict of interest or self-dealing on the part of any of the CDC's officers, management, and staff, including members of the Board and any Loan Committee. The CDC's internal control policy for Independent Loan Reviews must include specific control

requirements for the CDC's oversight of Professional Services Contractors, including monitoring and review of the 504 loans involving Professional Service Contractors. The requirement for independence in the review function applies to oversight of Professional Services Contractors.

Standards for Training to Implement the Independent Loan Review Program

Training procedures are essential to maximize the benefit of the Independent Loan Review program. Training procedures should include, at a minimum: who is being trained; what information is provided in the training; how often the training will occur; and the manner in which ongoing training will take place based on the findings of the Independent Loan Reviews.

CDC Board Follow up on Results of Independent Loan Reviews

The Board must acknowledge receipt of the results of the Independent Loan Review Report, and approve CDC Management's plan to remedy the findings from the review. The Board and CDC Management should also use the results of the Independent Loan Reviews to improve the current and future loan-making and monitoring functions.

Summary Reporting Elements for Independent Loan Review Reports

The following items should be addressed in the Independent Loan Review Report:

1. ***Date of Independent Loan Review.***
2. ***Name and title (and company name if review is conducted by an external entity) of individual(s) who carried out the review.*** If the reviewer(s) is an employee of the CDC and the review is done “in-house,” describe how the reviewer(s) is independent of the function being reviewed. If the reviewer is conducted by an external entity, a copy of the engagement letter must be included.
3. ***Portfolio details at the time of review:***
 - Number of total outstanding 504 loans.
 - Gross Principal Balance of outstanding 504 loans.
 - Number of total new 504 loans (less than 12 months since funding).
 - Gross Principal Balance of new 504 loans.
 - Number of total legacy 504 loans (greater than 12 months since funding).
 - Gross Principal Balance of legacy 504 loans.
 - Total number of active default 504 loans (where debenture has been purchased but not charged off by SBA).
 - Gross Principal Balance of active default 504 loans.
4. ***Loan Review details:***
 - List all 504 loans included in the review sample with SBA loan number and SBA Loan Name.
 - Total number of 504 loans reviewed.
 - Gross Principal Balance of all 504 loans reviewed.
 - Number of new 504 loans reviewed.
 - Gross Principal Balance of new 504 loans reviewed.
 - Number of legacy 504 loans reviewed.
 - Gross Principal Balance of legacy 504 loans reviewed.
 - Number of active default 504 loans reviewed.
 - Gross Principal Balance of active default 504 loans reviewed.
 - Describe how the sample is sufficient in size to represent the condition of the portfolio.
5. ***Provide details on the specific selection criteria used for the review sample:***
 - Name, title, and company (if applicable) of the individual who selected the loans.
 - Details on the methodology used to decide which loans were to be selected.

6. ***Provide details on the specific review criteria used in the review:***
 - Materials used in the review such as work papers, checklists, etc.
 - Include copies of completed checklists and work papers

7. ***Synopsis of the Deficiencies identified by the reviewer during the Independent Loan Review with list of loans by deficiency and recommended Corrective Actions within the following categories:***
 - Eligibility
 - Credit analysis
 - Credit documentation
 - Collateral documentation
 - Proper lien perfection
 - Adherence to loan covenants
 - Loan Authorization, Closing and Disbursement
 - Appraisals
 - Environmental reports
 - Servicing and Liquidation
 - Compliance with internal policies and procedures, and applicable laws and regulations, including SBA Loan Program Requirements
 - The accuracy and timeliness of risk rating/loan classification assigned by loan officers

8. ***Discussion of Core Analysis Phase, Loan Quality Classification Standards, and Professional Services Contractor Oversight***
 - Reviewer's determination of whether deficiencies noted in last Independent Loan Review and the most recent internal/external audit/review have been addressed or corrected by CDC Management.
 - Reviewer's determination if any members of CDC Management or the CDC's Board have the ability to override credit grades or decisions, and, if so, whether any such overrides have occurred on the sampled loans.
 - Reviewer's discussion of the risk-rating of each loan reviewed, whether the rating is correct or should be up-graded or down-graded, and an explanation for any such finding.
 - Reviewer's discussion of any findings regarding oversight of Professional Services Contractors.

9. ***Evidence that the report was presented to the CDC Board of Directors and the Board acknowledged receipt of the results.***

10. ***Evidence that the CDC Board of Directors approved CDC Management's plan to remedy the findings from the review.***