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Report to Congressional Requesters

March 2014

SMALL BUSINESS ADMINISTRATION

Actions Needed to Ensure Planned Improvements Address Key Requirements of the Development Company (504) Loan Program

GAO-14-233

GAO Highlights

Highlights of GAO-14-233, a report to congressional requesters

March 2014

SMALL BUSINESS ADMINISTRATION

Actions Needed to Ensure Planned Improvements Address Key Requirements of the Development Company (504) Loan Program

Why GAO Did This Study

Title V of the Small Business Investment Act of 1958 established what is commonly referred to as the "504 loan program" to provide small businesses with financing for long-term fixed assets, such as land and buildings. SBA oversees the program, and about 270 CDCs issue "504 loans" that generally cover up to 40 percent of project costs. The program aims to encourage economic development primarily by enabling small businesses to create or retain jobs within their communities. This report examines (1) the lending standards and performance measures SBA has established to help ensure that loans meet key requirements, as well as 504 loan performance, and (2) SBA's processes for reviewing CDCs' eligibility to participate in the program, loan applications, and CDCs' compliance with program requirements. GAO analyzed SBA data, SBA's lending standards and compliance process documentation, and interviewed SBA officials and 10 CDCs selected based on factors such as size and location.

What GAO Recommends

GAO recommends that SBA issue guidance on calculating jobs created and retained, expand its review of CDCs' annual reports and risk-based reviews of selected CDCs to include assessment of data on jobs supported and compliance with the retained-earnings requirement, and expand its process for renewing the delegated authority of certain CDCs to include a review of CDCs' certifications of borrowers' ability to repay made prior to loan closing. SBA generally agreed with the recommendations and outlined steps it plans to take in response.

View GAO-14-233. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

The Small Business Administration (SBA) has established lending standards to protect against default and has measured program performance, but lacks guidance on determining the number of jobs supported by 504 program-funded projects. SBA's guidance for certified development companies (CDC)—nonprofits that provide funding to small businesses to promote local economic development in their communities and are certified by SBA—includes credit underwriting standards for determining ability to repay. SBA also has established performance indicators—such as the number of small businesses assisted and jobs supported—for the 504 loan program. However, SBA does not describe how CDCs should calculate jobs created and retained by 504 projects, a key program requirement. Federal internal control standards require control activities that help participants report information accurately. Without specific guidance, SBA cannot ensure that CDCs are calculating this information consistently or accurately. GAO's analysis of SBA data showed that 504 loans approved in fiscal years 2006 through 2008 had the highest 18-month default rates, which correlated with trends in the private sector for commercial real estate loans.

SBA has processes to review (1) CDCs' eligibility to participate in the 504 program, (2) loan applications, and (3) CDCs' compliance with program requirements. The agency is revising some of these processes and expects to finalize the changes by June 2014. However, GAO identified two key areas where additional improvement is needed:

- *Jobs supported and retained earnings*. SBA has guidance for reviewing CDCs' annual reports (used to assess CDC eligibility) and for risk-based reviews of CDCs' compliance with program requirements. However, this guidance does not require SBA staff to review supporting documentation on jobs supported or assess whether CDCs are investing retained earnings in local economic development, as required by regulation. Federal internal control standards require control activities to ensure that program participants report information accurately and comply with requirements. Without reviewing CDCs' information on jobs data and compliance with the retained-earnings requirement, SBA cannot be assured that information on jobs supported is accurate and CDCs are supporting economic development activities as required.
- *Certification by CDCs with delegated authority*. SBA provides initial approval for a 504 loan upon application, but the 504 loan is not closed until after project-related construction is complete (which can be up to 4 years after initial approval). SBA has delegated to certain CDCs additional authority to close a 504 loan. For example, at closing CDCs with this delegated authority can certify that borrowers are still able to repay a 504 loan rather than submit documentation to SBA for approval, as regular CDCs are required to do. SBA renews delegated authority periodically but does not verify that CDCs can support these certifications. Federal internal control standards require agencies to verify compliance with requirements. Without verifying these certifications, SBA lacks assurance that CDCs with delegated authority are following program requirements.

Contents

Abbreviations

ALP	Accredited Lenders Program
ASM	Abridged Submission Method
CDC	certified development company
HUBZone	Historically Underutilized Business Zone
OCA	Office of Capital Access
OCRM	Office of Credit Risk Management
OFA	Office of Financial Assistance
SBA	Small Business Administration
SLPC	Sacramento Loan Processing Center
SOP	Standard Operating Procedure

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
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March 6, 2014

The Honorable Sam Graves
Chairman
Committee on Small Business
House of Representatives

The Honorable Mike Coffman
Member
House of Representatives

Small businesses play a critical role in the health of the U.S. economy and employ a large number of U.S. workers. Given their importance, the U.S. government has established programs that provide credit and other support to new and existing small businesses. One such program is a loan guarantee program authorized by Title V of the Small Business Investment Act of 1958, commonly referred to as the “504 loan program” and overseen by the Small Business Administration (SBA).[1] Certified development companies (CDC), which are nonprofit organizations that promote economic development in their communities, are certified by SBA to issue loans to small business borrowers under the 504 loan program.[2] The program provides long-term, fixed-rate financing for long-term fixed assets, such as land and buildings, to new or growing small businesses.[3] The goal of the program is to encourage economic development by providing small businesses with access to credit to enable them to create or retain jobs within their communities. As of November 30, 2013, there were approximately 270 CDCs, and SBA’s 504 loan program portfolio included over 61,000 active loans with an outstanding balance of approximately $27.2 billion.

[1]*See* 15 U.S.C. §§ 695-697g.

[2]SBA grandfathered for-profit CDCs existing as of January 1, 1987, into the program. 13 C.F.R. § 120.820. There are six for-profit CDCs participating in the 504 loan program.

[3]To qualify as a small business under the 504 loan program, a business and its affiliates must either meet the same size standards that apply to SBA 7(a) business loans set forth in 13 C.F.R. § 121.301(a) or must have a tangible net worth of $15 million or less and an average net income of $5 million or less after federal income taxes (excluding any carryover losses) for the preceding 2 completed fiscal years.

GAO and the SBA Inspector General have previously reported on the need for SBA to strengthen oversight of its lenders.[4] In recent oversight hearings, Congress emphasized the importance of improving the effectiveness and oversight of SBA programs and reducing costs.[5] You requested that we review the 504 loan program. This report discusses (1) the lending standards and performance indicators that SBA has established to help ensure that loans meet key requirements, as well as 504 loan program performance, (2) the extent to which SBA has implemented procedures to help ensure that CDCs are eligible to participate in the program and that loan applications comply with program requirements, and (3) the extent to which SBA has implemented procedures to monitor CDC compliance with program requirements.

To address these objectives, we reviewed relevant laws and regulations; GAO and SBA Inspector General reports; and SBA guidance, including Standard Operating Procedures (SOP). We also interviewed SBA staff and officials at 10 CDCs. We selected these CDCs to ensure a range of CDCs based on factors such as size and location. Due to ongoing litigation related to a subset of CDCs known as Premier Certified Lenders, we did not assess loans made using the specific additional authority that SBA may provide to these lenders.[6]

To respond to our first objective, we analyzed SBA 504 loan data for fiscal years 2003 through 2013 (as of Mar. 31, 2013) to determine the

[4]GAO, *Small Business Administration: Actions Needed to Improve the Usefulness of the Agency's Lender Risk Rating System*, GAO-10-53 (Washington, D.C.: Nov. 6, 2009). SBA, Office of Inspector General, *Addressing Performance Problems of High-Risk Lenders Remains a Challenge for the Small Business Administration*, Report no. 12-20R (Washington, D.C.: Sept. 28, 2012).

[5]*See, e.g., Entrepreneurial Assistance: Examining Inefficiencies and Duplication Across Federal Programs: Hearing Before the H. Comm. on Small Business*, 113th Cong. (2013) (statement of Rep. Sam Graves, Chairman, H. Comm. on Small Business); *SBA's Management of its Capital Access Programs: Hearing Before the H. Comm. on Small Business*, 112th Cong. (2012) (statement of Rep. Sam Graves, Chairman, H. Comm. on Small Business).

[6]*See United States ex rel. U.S. Small Bus. Admin. v. EDF Res. Capital, Inc.*, No. 2:13-cv-01158 (E.D. Cal.). The litigation is an enforcement action by SBA against EDF for, among other things, EDF's alleged failure to pay amounts owed as a Premier Certified Lender to SBA. Under GAO's policy to avoid addressing disputed factual or legal matters pending in litigation, we did not evaluate these matters, including the liquidation of defaulted loans, enforcement actions, or any loans made using Premier Certified Lender legal authority.

composition and performance of the current 504 loan portfolio.[7] We assessed the reliability of the data by interviewing knowledgeable officials, reviewing documents about the sources of the data, and completing electronic testing. We determined that the data were sufficiently reliable for the purpose of reporting on portfolio composition and performance. We also assessed whether SBA's performance measures were consistent with GAO standards for performance measurement.[8] To address our second and third objectives, we reviewed SBA's compliance processes, including its procedures for oversight of CDC eligibility and loan approval and for monitoring CDCs. We also reviewed SBA data and documentation on its compliance activities to determine the extent to which the agency had implemented these procedures and whether the procedures were consistent with internal control standards.[9] Appendix I contains additional information on our scope and methodology.

We conducted this performance audit from January 2013 to March 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

As authorized by Congress, SBA established the 504 loan program to foster economic development; create or preserve job opportunities; and stimulate the growth, expansion, and modernization of small businesses.

[7]Data as of March 2013 were the most recent data available at the time of our request. The 504 data set we analyzed does not include any data on loans issued by CDCs using Premier Certified Lender Program authority or any non-Premier Certified Lender Program loans issued by the CDC with Premier Certified Lender Program authority that is involved in the pending litigation. The amount excluded totaled 9,233 loans and approximately $5.9 billion. The data set provided by SBA included 80,080 loans totaling approximately $47 billion. However, based on conversations with SBA officials, we limited the analysis to loans that had been disbursed—61,171 loans totaling about $34 billion.

[8]GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1996).

[9]GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

The 504 loan program provides long-term, fixed-rate financing to new or growing small businesses for fixed assets such as owner-occupied real estate or long-term equipment and machinery. Small businesses may apply for 504 financing through a CDC serving the area where the 504 project is located. CDCs are generally nonprofit corporations that provide funding to small businesses in order to contribute to economic development within their communities.[10] There are about 270 existing CDCs located throughout the United States and Puerto Rico. A CDC must obtain certification from SBA to operate in a designated state; however, a few CDCs offer 504 funding in contiguous states contingent upon approval from SBA.[11] The 504 loan program is intended to serve small businesses that might otherwise not have access to privately financed credit. Similar to other SBA loan guarantee programs, the 504 program has a "credit elsewhere" requirement, which means that small business applicants must be unable to obtain credit on reasonable terms from a nonfederal source.[12]

In 1994, Congress authorized SBA to implement two programs to provide qualified CDCs with delegated authority to carry out certain functions associated with 504 loans that had previously been reserved for SBA.[13] These two programs are the Accredited Lenders Program (ALP) and the Premier Certified Lenders Program. The two programs allow participating CDCs, in some cases, to unilaterally make decisions related to various loan activities. As discussed previously, the scope of this review does not include issues related to the Premier Certified Lenders Program. SBA

[10]As previously mentioned, some for-profit CDCs were grandfathered in to the 504 loan program; however, all new CDCs must be nonprofit corporations. Additional criteria for CDC eligibility are provided by statute and regulation, and will be discussed in more detail later in this report.

[11]CDCs operate within a defined area of operations covering a specific geographic area. The area of operations for a CDC must include the entire state in which it is incorporated. 13 C.F.R. § 120.810(b).

[12]As part of the loan application process, the CDC must determine whether the small business applicant is unable to obtain a loan on reasonable terms without a federal government guarantee and that some or the entire loan is not available from the resources of the applicant or its business partners. To make this determination, the CDC applies SBA's "credit elsewhere test," which includes substantiating the factors that prevent the financing being undertaken without SBA support.

[13]*See* Pub. L. No. 103-403, tit. II, §§ 212, 217 (1994) (codified as amended at 15 U.S.C. §§ 697d, 697e).

may designate a CDC as having ALP authority if the CDC meets certain statutory and regulatory requirements. The ALP designation is for 2 years and can be renewed. CDCs with ALP authority assume responsibility for thorough borrower credit and loan eligibility analysis on initial 504 loan applications, which we discuss in more detail later in this report.

For a typical 504 loan project, the financing is provided by three parties: a third-party lender, a CDC, and a small business borrower. A third-party lender, typically a commercial bank, provides financing totaling at least as much as the 504 loan, generally 50 percent or more of the total 504 project financing. A CDC provides up to 40 percent of the financing through a loan (the “504 loan”) that is backed by a debenture that is fully guaranteed by SBA.[14] The maximum amount a CDC can loan a small business borrower is $5,000,000 or $5,500,000, depending on the circumstances.[15] Finally, the small business borrower must contribute at least 10 percent of the project financing. Exposure to default risk is tiered in the 504 loan program. The third-party lender’s loan is collateralized by a first lien on the project property. The CDC’s 504 loan is subordinate to the bank’s first position on the debt.

A 504 loan is approved but not funded by the sale of the debenture until project-related construction is completed. Prior to the sale of the debenture and funding of the 504 loan, the borrower may obtain interim financing from a third-party lender, usually the same lender that provided the loan covering 50 percent of the total 504 project financing. After project-related construction is completed, the 504 loan is closed, and the debenture is sold by SBA’s central servicing agent. The central servicing agent distributes the appropriate funds to the small business borrower on behalf of SBA and the CDC.

[14]SBA may authorize, for good cause shown, an increase in the 504 loan of up to 50 percent of total project costs. A debenture is an obligation issued by a CDC and guaranteed 100 percent by SBA, the proceeds of which are used to fund a 504 loan. Debentures are packaged together and sold to underwriters. Investors then purchase interests in debenture pools.

[15]The lending limit for 504 loans issued by CDCs is $5,500,000 if the small business borrower is a small manufacturer, the project reduces the borrower’s energy consumption by at least 10 percent, or the project generates renewable energy or renewable fuels. For all other 504 loans, the lending limit is $5,000,000.

SBA's Office of Capital Access (OCA) is responsible for overseeing the 504 loan program and CDCs. The Office of Financial Assistance (OFA) is an office within OCA that is responsible for the implementation of the 504 loan program. OFA's primary responsibilities include structuring the 504 loan application process and making necessary adjustments to application criteria based on feedback from program participants and data analysis. OFA also monitors and oversees the requirements and program protocols that determine SBA's ability to extend capital to small businesses. The Office of Performance and Systems Management, also within OCA, analyzes relevant data to inform final 504 policy decisions and provides system oversight for the central servicing agent, among other responsibilities. The Office of Credit Risk Management (OCRM), another office within OCA, is responsible for managing all activities regarding lender and CDC oversight. Its duties include assigning risk ratings to CDCs, conducting reviews, and preparing written reports addressing CDC oversight. Finally, OCA's Office of Financial Program Operations is responsible for the execution of the 504 program through loan processing and servicing and through liquidation of 504 loans and management of the loan portfolio.

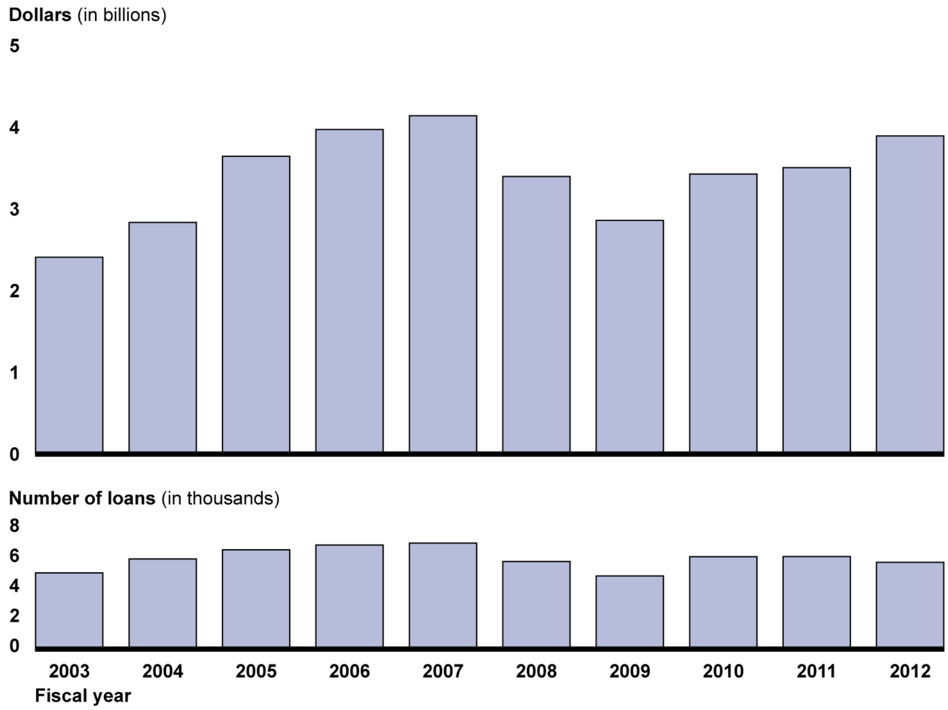
SBA also has district offices and processing and servicing centers that have a role in the 504 program. Staff in SBA's 68 district offices provide local assistance to participating CDCs and occasionally offer 504 program training courses to lenders and CDCs. They also conduct annual reviews of CDCs' annual reports. In addition, district office counsel review 504 loan closing documentation, among other things. The Sacramento Loan Processing Center (SLPC) evaluates and issues loan guarantee commitments to eligible and creditworthy 504 loan applicants. In addition, there are two servicing centers, located in Little Rock, Arkansas, and Fresno, California, that serve CDCs based on the CDC's location. These two servicing centers collectively handle the entirety of SBA's commercial loan servicing activities, including the liquidation of 504 loans. The Office of Financial Program Operations is responsible for managing SLPC and the two servicing centers.

We analyzed 504 loan program data for fiscal years 2003 through 2013 (as of Mar. 31, 2013) to identify loans approved and disbursed.[16] Based on our analysis of this subset of loans, SBA approved loans totaling the largest amounts in fiscal years 2006 and 2007 (see fig. 1). In fiscal years 2008 and 2009, the total number of 504 loans approved and disbursed declined slightly. Section 504 of the American Recovery and Reinvestment Act of 2009 and Section 1122 of the Small Business Jobs Act of 2010 (Jobs Act) expanded the 504 program to allow debt refinancing under certain circumstances, which could account for some of the increase after 2009.[17] The temporary debt refinancing program authorized by the Jobs Act expired at the end of fiscal year 2012.

[16]As noted previously, we limited our analysis of data provided by SBA to loans that had been approved as of March 2013 and disbursed. We did this to facilitate our analysis of default rates, which is presented later in this report. SBA officials noted that, based solely on the total number of loans approved, fiscal year 2012 had the most loans approved of all the years, not fiscal year 2007. SBA officials also stated that due to the time lag between approval and disbursement (which can be up to 4 years, but is usually 1 to 2 years) the number of loans approved in fiscal years 2011 and 2012 and disbursed will continue to increase as more loans are disbursed.

[17]American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 504, 123 Stat. 115, 155 (2009); Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 1122, 124 Stat. 2504, 2510 (2010).

Figure 1: Number and Dollar Amount of 504 Loans Approved and Disbursed, Fiscal Years 2003-2012



Source: GAO analysis of SBA data.

Note: The SBA data we analyzed were as of March 31, 2013. Our analysis excluded loans that were (1) approved in fiscal years 2003 through 2012 but not disbursed as of March 2013 and (2) made using Premier Certified Lender Program authority. SBA officials stated that due to the time lag between approval and disbursement (which can be up to 4 years, but is usually 1 to 2 years) the number of loans approved in fiscal years 2011 and 2012 and disbursed will continue to increase as more loans are disbursed.

Based on our analysis, the top four types of small businesses funded by 504 loans were hotels, restaurants, doctors' offices, and dentists' offices. Respectively, these business types made up 12 percent, 5 percent, 4 percent, and 3 percent of all approved 504 loan dollars from fiscal year 2003 through 2012. Also, 85 percent of approved loans and dollars went to existing small businesses, and 15 percent went to new small businesses.

SBA Has Established Lending Standards and Measured Performance, but Lacks Guidance on Determining Jobs Supported

SBA has established lending standards and guidance that address program requirements and protect against default risk. However, the agency has not provided CDCs with specific guidance on compiling and supporting data on jobs created or retained as a result of 504 loans, which is a key economic development goal of the 504 loan program. SBA also has established performance indicators for the 504 program and analyzed 504 program data to measure loan performance.

SBA Lending Standards Address 504 Requirements and Default Risk, but SBA Lacks Guidance on Determining Jobs Supported

SBA has established lending standards and guidance for CDCs that address 504 program requirements and protect against default risk. Table 1 contains some of the key requirements of the 504 program.

Table 1: Selected Requirements of the 504 Loan Program

Requirement	Description
Economic development goals	A project must create or retain one job for every $65,000 guaranteed by SBA (one job for every $100,000 for projects assisting small manufacturers), or, if the CDC's overall loan portfolio has already met the jobs creation and retention requirement, • the project must improve the economy of the locality, such as by stimulating other business development in the community, bringing new income into the area, or assisting the community in diversifying and stabilizing its economy, or • the project must meet one of other enumerated public policy goals.[a]
Lending limits	The 504 lending limit is $5,000,000-$5,500,000 per loan, depending on the type of project being funded by the loan, and a 504 loan generally may not exceed 40 percent of the project's cost (and in certain cases, for good cause shown, up to 50 percent).
Funding portion from the small business borrower	The borrower funds 15% of the project cost if the small business has been in operation 2 years or less or if the project involves the construction of a limited- or single-purpose building or structure; 20% if both above conditions apply; and 10% in all other circumstances, at the discretion of the CDC.
Third-party lender financing	A third-party lender must contribute not less than 50 percent of total project costs if the borrower has operated for 2 years or less or if the project is for the acquisition, construction, conversion, or expansion of a limited- or single-purpose asset. For all loans, the third-party loan must total at least as much as the 504 loan.

Requirement	Description
Collateral	The CDC usually takes a second lien position on the project property to secure the 504 loan. Additional collateral shall be required only if SBA determines, on a case-by-case basis, that additional security is necessary to protect the interest of the government.

Source: 15 U.S.C. §§ 695-697g; 13 C.F.R. pt. 120.

[a]The public policy goals for the 504 loan program are business district revitalization; expansion of exports; expansion of minority business development or women-owned business development; rural development; expansion of small business concerns owned and controlled by veterans; enhanced economic competition; changes necessitated by federal budget cutbacks; business restructuring arising from federally mandated standards or policies affecting the environment or the safety and health of employees; reduction of energy consumption by at least 10 percent; increased use of sustainable design; plant, equipment, or process upgrades of renewable energy sources; and reduction of rates of unemployed in labor surplus areas.

SBA has issued regulations implementing the program as well as SOPs that address program requirements and provide additional guidance to CDCs on how to implement the program.[18] SOP 50 10 Subpart C addresses the 504 loan program. In addition to the noneconomic development-related requirements listed in table 1, SBA officials said that credit underwriting standards and reviews of borrowers' character and credit history, required by regulation and discussed in the SOP, are important requirements that protect against default risk. The SOP lays out the credit underwriting standards that CDCs must comply with as part of the 504 loan approval process. It specifies that CDCs must analyze each loan application in a manner consistent with prudent lending standards and that the cash flow of the small business is the primary source of repayment. In addition, the SOP discusses the types of financial analyses CDCs must perform as part of determining the viability of the project. SBA officials added that the third-party lender also performs its own credit underwriting of the 504 project, which provides additional review of the project and also helps protect against default risk. The majority of CDCs (7 of 10) we spoke with thought SBA 504 lending standards were sufficient in addressing default risk.[19] Three of the 10 CDCs noted that it is the CDC's responsibility to make sure it is underwriting good loans. SBA also requires reviews of borrowers' character and credit history. Specifically, SBA requires that any person with 20 percent or more

[18]13 C.F.R. pt. 120; U.S. Small Business Administration Office of Financial Assistance, SOP 50 10 5 (F): Lender and Development Company Loan Programs (Jan. 1, 2014); and U.S. Small Business Administration Office of Capital Access, SOP 50 55: 504 Loan Servicing and Liquidation (Oct. 1, 2013).

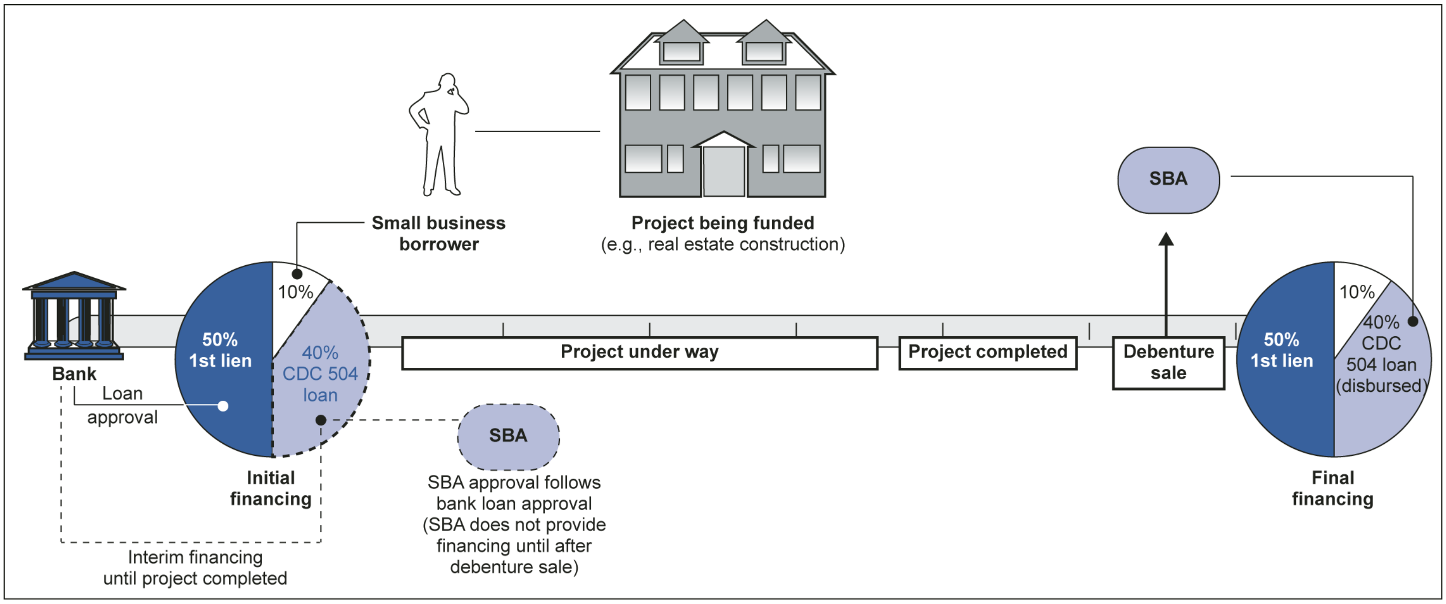
[19]Two of the 10 CDCs we spoke with did not directly comment on the sufficiency of SBA's lending standards to protect against default risk, and one CDC commented that they thought SBA's standards were too broad.

ownership interest in the small business applying for the loan be of good character.[20]

SBA officials said that they consider the 504 financing structure to be another protection against default risk. As previously discussed, 504 loan applications are initially approved but are not funded until after project-related construction has been completed (see fig. 2). A third-party lender—typically, the bank that provides 50 percent of the 504 project cost—provides interim financing to cover the 504 loan portion of the project (typically 40 percent) prior to construction being completed. As no SBA-guaranteed funds are disbursed until key aspects of the project have been completed, this mitigates the risk of default due to problems with construction or other issues that may arise prior to project completion. SBA officials told us that the time between approval and closing varies depending on the extent of construction. The debenture must be sold to fund the 504 loan within at least 4 years of the initial approval of the 504 loan. After the project is completed, the 504 loan is closed in accordance with SBA processes (discussed later in this report) and the debenture is sold. SBA officials told us that it is rare for loans that were initially approved not to eventually be funded by the sale of a debenture. However, as discussed previously, the third-party lender typically holds a first-lien position on collateral provided under the 504 loan financing agreement, exposing SBA to potentially higher losses in the event of a default.

[20]These individuals are required to complete a Statement of Personal History (SBA Form 912), which includes questions on criminal history.

Figure 2: Typical 504 Project Structure



Source: GAO (analysis); Art Explosion (images).

Note: As discussed previously, in certain cases the small business borrower must contribute more than 10 percent. For example, a business that has been in operation less than 2 years must contribute 15 percent of total project costs.

SBA's commercial loan servicing centers review and approve certain servicing actions that are not delegated to CDCs. For all CDCs, SBA must approve certain servicing requests, such as exceptions to policy, compromise of the principal loan balance, increase in a loan amount, litigation plans, acquisition of title to any property in SBA's name, or any other loan action for which SBA's prior written consent is required by another loan program requirement.[21] For regular CDCs and CDCs with ALP authority, SBA must approve servicing requests such as liquidation plans, substantial alterations of the terms or conditions of any loan document, and the compromise of any portion of the loan balance.[22] Otherwise, regular and ALP CDCs generally have unilateral authority (meaning they can take action without prior SBA approval) to take all

[21]SOP 50 55, Chapter 3, Para.D.3.a. (effective date Oct. 1, 2013) contains a list of servicing requests that SBA must approve for all CDCs.

[22]SOP 50 55, Chapter 3, Para. D.3.b. (effective date Oct. 1, 2013) contains a list of servicing requests that SBA must approve for regular CDCs and CDCs with ALP authority.

necessary action to service and liquidate the 504 loans for which they are responsible, subject to SBA's right to take over the servicing or liquidation of any loan.[23] CDCs must provide the appropriate commercial loan servicing center with written notice of each substantive unilateral loan action taken on a 504 loan.[24] SBA's central servicing agent collects loan payments and reports delinquencies on its secure website.[25] However, CDCs are responsible for pulling reports and reporting 60-day delinquencies to SBA. SBA can also pull reports for the 504 program from the central servicing agent's website. In October 2013, SBA created SOP 50 55, which consolidated servicing and liquidation guidance specific to the 504 loan program. SBA officials told us that they did this in order to make the 504 servicing guidance more user-friendly.

While SBA guidance addresses many of the program's key requirements and default risk, SBA has not provided specific guidance to CDCs on how to compile and support data they report on jobs created or retained due to 504 lending. When applicable, SOP 50 10 requires that CDCs provide an estimate of jobs to be created or retained in the loan application and update the estimate 2 years after a loan is disbursed.[26] The SOP also states that a job opportunity does not have to be at the project facility, but 75 percent of the jobs must be in the community where the project is located. In addition, it states that job retention may be used if the CDC can reasonably show how jobs would be lost to the community if the project was not done. However, the SOP does not provide any explicit guidance on which jobs within the community may count towards jobs supported, nor does it explain how CDCs should reasonably show that jobs would be lost without a 504-supported project.[27] The SOP also does not discuss the types of supporting documentation that CDCs should collect as part of compiling jobs supported information. In the past, we

[23]SOP 50 55, Chapter 3, Para. D.1. (effective date Oct. 1, 2013).

[24]SOP 50 55, Chapter 3, Para. D.2. (effective date Oct. 1, 2013).

[25]The central servicing agent receives and disburses funds among the various parties involved with 504 loan financing under a master servicing agent agreement with SBA.

[26]As noted previously, if the CDC's overall loan portfolio meets the jobs requirement, the CDC can approve projects that meet other economic development goals.

[27]SBA provides additional guidance on calculating jobs created and retained in its 504 loan application (Form 1244) and CDC Annual Report Guide (Form 1253), but this guidance is less specific than that in the SOP.

have commented that reporting on jobs created and retained can be problematic without clear guidance.[28] Federal internal control standards emphasize the need for federal agencies to have control activities in place to help ensure that program participants report information accurately.[29] Control activities are policies, procedures, and methods (such as guidance) that enforce management directives. Without clear and specific guidance on compiling jobs supported data, SBA cannot ensure that CDCs are compiling and supporting this information consistently and in accordance with SBA's expectations.

SBA Has Established Indicators to Measure Program Performance

SBA has established indicators to track program performance, including a measure to track a key economic development requirement (number of jobs created or retained). As shown in table 2, these indicators are loans approved, small businesses assisted, small businesses assisted in underserved markets, jobs supported, active lending partners, cost per small business assisted, and approved applications originated electronically.[30] SBA's indicators are consistent with our standards, which

[28]We found weaknesses in recipient reporting on jobs created and retained during our work on the American Recovery and Reinvestment Act. For example, in November 2009 we reported data inconsistencies and recommended, among other things, that the Office of Management and Budget (1) clarify the definition and standardize the period of measurement for full-time equivalents and (2) consider being more explicit that "jobs created or retained" are to be reported as hours worked and paid for with Recovery Act funds. See GAO, *Recovery Act: Recipient Reported Jobs Data Provide Some Insight into Use of Recovery Act Funding, but Data Quality and Reporting Issues Need Attention*, GAO-10-223 (Washington, D.C.: Nov. 19, 2009); *Recovery Act: One Year Later, States' and Localities' Uses of Funds and Opportunities to Strengthen Accountability*, GAO-10-437 (Washington, D.C.: Mar. 3, 2010); and *Recovery Act: States' and Localities' Uses of Funds and Actions Needed to Address Implementation Challenges and Bolster Accountability*, GAO-10-604 (Washington, D.C.: May 26, 2010).

[29]GAO/AIMD-00-21.3.1.

[30]SBA defines underserved markets as underserved populations and underserved places. Underserved populations include veteran-owned, women-owned, and minority-owned small businesses. Underserved places include small businesses that are located within geographic areas listed as Historically Underutilized Business Zones (HUBZone), low- and moderate-income areas, and Empowerment Zones and Enterprise Communities. HUBZone is a federal program that helps small businesses in urban and rural communities gain preferential access to federal procurement opportunities. Low- and moderate-income areas are determined by the Department of Housing and Urban Development based on census data. The Empowerment Zones and Enterprise Communities program encourages comprehensive planning and investment aimed at the economic, physical, and social development of the neediest urban and rural areas in the United States.

recommend the establishment of performance measures that include key output measures as well as cost information, such as the unit cost per output.[31] In fiscal year 2012, SBA met or exceeded its targets for six of its seven performance indicators, which is an improvement from fiscal year 2011, during which SBA met only one of its targets.

Table 2: Performance Indicators for the 504 Loan Program, Fiscal Years 2010-2012

Performance indicator	Type of indicator	2010 target	2010 actual	2011 target	2011 actual	2012 target	2012 actual
Loans approved ($)	Output	$4,000,100,000	$4,433,308,000	$4,750,000,000	$4,845,119,000	$4,100,000,000	$6,711,656,000
Number of small businesses assisted	Output	5,600	7,664	8,100	**7,752**	6,800	9,038
Number of small businesses assisted in underserved markets	Output	3,500	4,384	4,800	**4,548**	4,000	5,379
Number of jobs supported	Outcome	133,000	**82,543**	88,800	**87,337**	75,900	116,569
Number of active lending partners	Output	267	267	267	**249**	267	**256**
Cost per small business assisted ($)	Efficiency	$15,191	$4,728	$4,979	**$5,017**	$5,839	$4,383
Approved applications originated electronically (%)	Efficiency	N/A[a]	N/A[a]	N/A[a]	50%	62%	65%

Source: SBA's FY 2010, FY 2011, and FY 2012 Annual Performance Reports.

Note: Numbers in bold indicate targets not met.

[a]SBA first introduced this performance indicator in fiscal year 2011 and began setting targets for this indicator in fiscal year 2012.

[31]GAO/GGD-96-118. Outputs represent the quantity of goods or services produced by a program. Inputs are the amount of resources (in terms of money, material, personnel, etc.) that are put into a program.

In most cases, SBA has a process in place to collect and validate the data used to report on its performance indicators. Data for several indicators—loans approved, small businesses assisted, and active lending partners—are captured using SBA's loan application and accounting systems. With respect to the underserved markets indicator, there are two components. Data on underserved populations are captured in SBA's loan application and accounting systems. Loans are also geographically coded based on their business address in SBA's loan accounting system, from which SBA can determine if the borrower's project is in an underserved place. According to SBA, both its loan application and loan accounting systems are subject to periodic audits of their completeness and accuracy, and these audits provide validation of the collected data. According to SBA officials, the agency uses a separate technique for calculating the cost per small business assisted by compiling employee-reported information from annual activity surveys on which SBA staff indicate what portion of their overall time is spent working on the 504 program. SBA officials stated that supervisors review each survey for accuracy and completeness prior to submission. SBA validates the percentage of applications originated electronically by verifying that the information in its data sets coincides with what is shown in the loan application system and other data from its loan processing centers.

However, SBA does not have a process for validating the jobs supported indicator, which is based on data reported by CDCs. According to SBA guidance, CDCs are to estimate the number of jobs supported at the time of the loan application and determine the actual number 2 years after a 504 loan is disbursed, as previously discussed. When compiling data for this indicator, SBA states that it uses the data captured in SBA's loan application system at the time of loan approval. SBA officials who are responsible for reporting on the performance indicators have stated that no process currently exists for reviewing jobs supported information that SBA receives from CDCs. SBA's lack of a process for reviewing jobs supported information received from CDCs will be discussed in greater detail later in this report.

SBA Analyzes Program Performance, and Default Rates Have Followed U.S. Economic Trends

SBA staff analyze 504 loan data on a weekly, monthly, quarterly, and annual basis and prepare reports at each of these intervals. These reports analyze various aspects of 504 program performance, including loan activity (amount of dollars approved), loan status (current, stressed, delinquent), and cash flows.[32] SBA officials said that they have been issuing these reports in some form since 2002 and that senior management, including the Assistant Administrator and managers in OFA and OCRM, review these reports. They noted that the purposes of these reports include aiding senior officials in tracking program performance and identifying potential issues that may have an impact upon the program's performance. For example, a report may show a decrease in 504 loan applications, which may indicate a need for increased education about the 504 loan program to the small business community. SBA officials will then be able to determine whether or not to further promote the program to the lending community. SBA officials also noted that these reports have helped OCRM make changes to its lender oversight policies. For example, based on their reviews of some of these reports, OCRM has begun to stratify and compartmentalize its measurement of lenders' compliance based on delegated authority (ALP or regular), risk, and size.

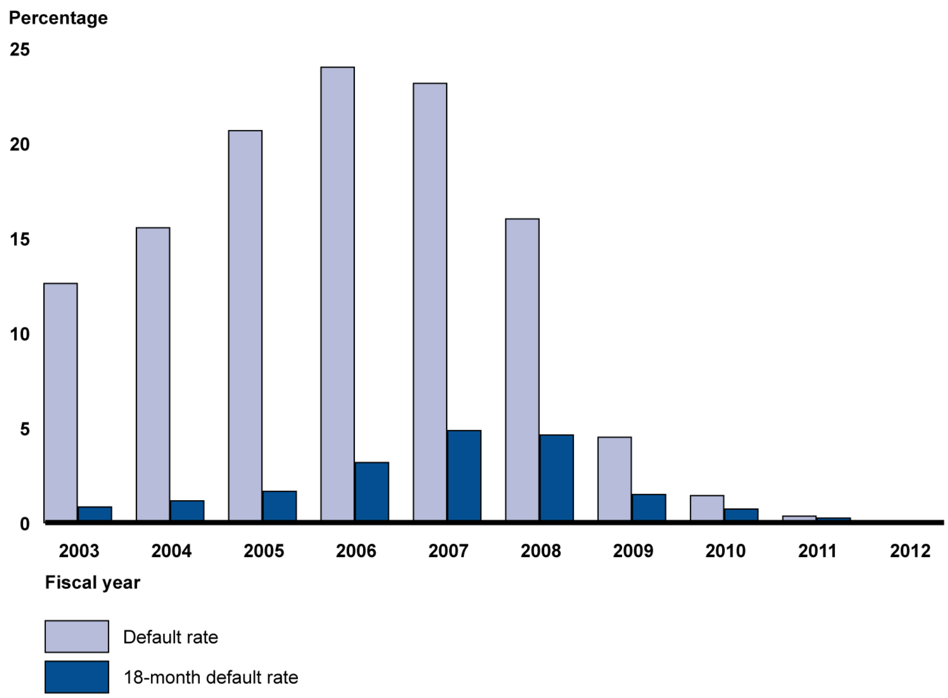
We analyzed SBA data on 504 loans approved from fiscal year 2003 through fiscal year 2013 (as of Mar. 31, 2013) and found that 504 loans followed trends in the U.S. economy.[33] Of the loans we analyzed, 10.8 percent were paid in full, 72.9 percent were current, 4.0 percent were stressed, and 12.3 percent had their debentures purchased (i.e., defaulted loans). As seen in figure 3, 504 loans (loans issued by CDCs and backed by SBA's 100 percent guarantee) approved during the economic expansion period from 2005 through 2007 experienced higher default rates than any other year during the period from 2003 through 2012. Specifically, 504 loans approved from fiscal year 2005 through fiscal year 2007 had the highest default rates, and loans approved from fiscal year 2006 through fiscal year 2008 had the highest 18-month

[32]SBA defines stressed loans as any loans in deferred, past due, delinquent, or catch-up status. SBA defines delinquent loans as loans that are 60 or more days past due.

[33]We analyzed loan-level data from SBA on 504 loans—those issued by CDCs and backed by SBA's 100 percent guarantee. This analysis does not include the third-party lender portion of a 504 project's financing.

default rates.[34] The default rate (the number of 504 loans whose debentures were purchased divided by the total loans approved in that fiscal year) for loans approved in fiscal year 2006 was 24.0 percent, the highest default rate for the observed period. Loans approved in fiscal year 2007 experienced the highest 18-month default rate at 4.9 percent. According to SBA officials, the 18-month default rate is an indicator of default primarily due to poor underwriting.

Figure 3: Default Rates by Cohort Year (Year 504 Loan Approved), Fiscal Years 2003-2012



Source: GAO analysis of SBA data.

Note: The SBA data we analyzed were as of March 31, 2013. Our analysis excluded loans that were (1) approved in fiscal years 2003 through 2012 but not disbursed as of March 2013 and (2) made

[34] In our analysis, we determined that a 504 loan had defaulted if SBA had purchased the loan's associated debenture. SBA guidance states that a good faith effort should be made to help delinquent borrowers bring their loans current. But, when a payment default cannot be cured, the loan should be classified as in liquidation and the CDC should immediately request that SBA purchase the loan's associated debenture. The default rate is the total number of loans that had defaulted divided by the total number of loans approved in a given fiscal year. The 18-month default rate is the number of loans that defaulted within 18 months of disbursal divided by the total number of loans approved in a given fiscal year.

using Premier Certified Lender Program authority. The default rate is the total number of loans that had defaulted divided by the total number of loans approved in a given fiscal year. The 18-month default rate is the number of loans that defaulted within 18 months of disbursal divided by the total number of loans approved in a given fiscal year.

The 504 default rates followed trends in the U.S. economy during this period. A study on the U.S. financial crisis stated that the crisis was triggered by a dramatic weakening of underwriting for U.S. subprime mortgages, beginning in late 2004 and extending into early 2007, which was "symptomatic of a much broader erosion of market discipline on the standards and terms of loans to households and businesses."[35] Further, SBA officials told us that the 504 loan program—which primarily finances commercial real estate—was negatively impacted by declining commercial real estate values beginning in 2008. According to data from Moody's/REAL Commercial Property Price Index for 2002 through 2010, commercial real estate values increased by more than 85 percent from 2002 to the market's peak in October 2007, at which point these values steadily declined, leveling off around 2010. SBA officials noted that this rapid decline in real estate prices was associated with increased 504 loan defaults. Declining prices can make refinancing difficult for borrowers and thus lead to a higher rate of commercial real estate loan defaults. However, because this period also overlapped with a general economic recession, some of the defaults may have also been due to a lack of general business revenue.

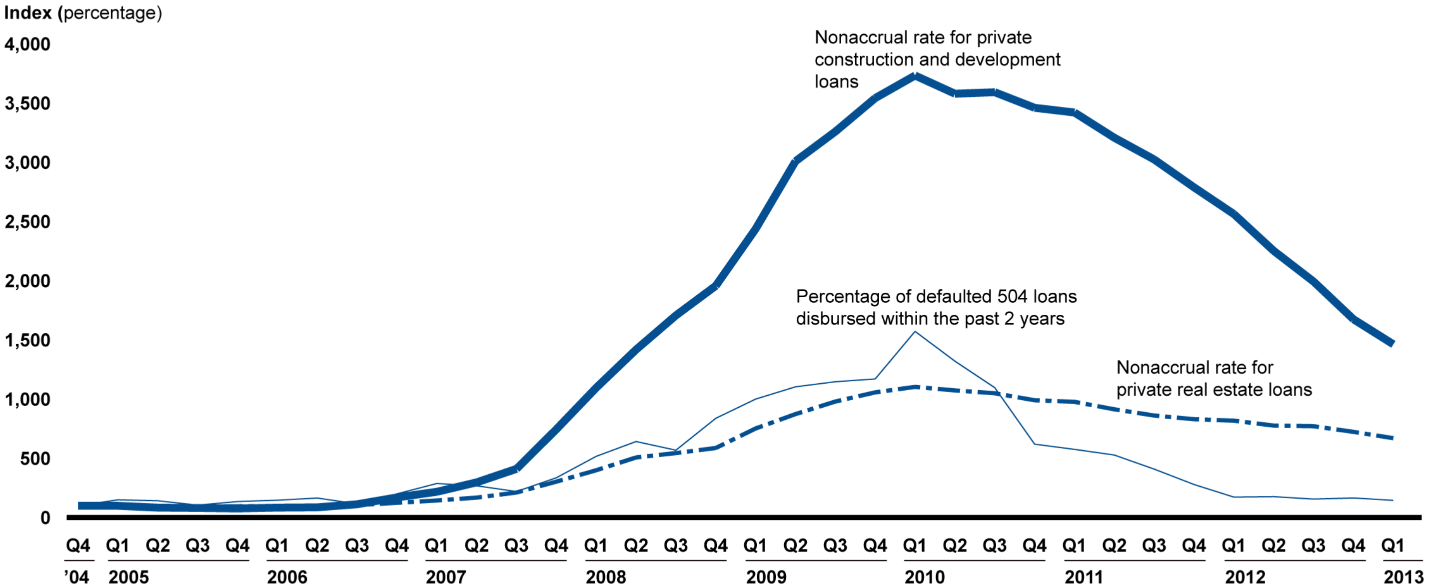
We compared 504 loan data to the Federal Deposit Insurance Corporation's quarterly analysis of Federal Financial Institutions Examination Council call report data on the performance of loans issued by U.S.-chartered commercial banks and found similar patterns.[36] We analyzed call report data on construction and development loans and real estate loans ("commercial loans"). As shown in figure 4, the percentage of defaulted 504 loans that were disbursed within the 2 previous years and the nonaccrual rates for commercial loans both peaked in the first quarter of 2010. (Loans in nonaccrual status are nonperforming loans on which

[35]President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments* (March 2008).

[36]A "call report" is a report that must be filed by all insured depository institutions in the United States on a quarterly basis and contains financial information about the institutions. The report is officially known as the Report of Condition and Income.

payments are at least 90 days overdue.[37] We used nonaccrual status as a trend comparison because it was the weakest category of loans and most similar to purchases made by SBA. However, while trends may be compared, levels of nonaccrual rates and SBA default rates may not be compared, as SBA data represent early defaults only and the call report data represent nonaccruals for total outstanding loans.) Since then, both of these rates have experienced steady declines.

Figure 4: Comparison of Trends in Nonaccrual Rates for 504 Loans and Private Sector Commercial Loans, Calendar Years 2004-2013



Source: GAO analysis of SBA data and FDIC call report data.

Note: The SBA data we analyzed were as of March 31, 2013. Our analysis excluded loans that were (1) approved in fiscal years 2005 through 2013 (as of Mar. 31, 2013) but not disbursed as of March 2013 and (2) made using Premier Certified Lender Program authority. While trends may be compared, levels of nonaccrual rates may not be compared to SBA default rates because SBA data represent early defaults only and the call report data represent nonaccruals for total outstanding loans. This figure shows the value of the three rates over time, expressed as a percentage of that rate in the fourth quarter of 2004. For example, the nonaccrual rate for construction loans was 0.40 percent in the fourth quarter of 2004. At its peak in the first quarter of 2010, it was 15 percent.

[37] We calculated the nonaccrual rate for commercial loans as the percentage of loan dollars in nonaccrual status (principal or interest has been in default for at least 90 days, and payment in full is not expected) out of the total amount of outstanding loan dollars for the quarter of that calendar year. In order to compare 504 loan data with this rate, we calculated the percentage of defaulted 504 loans that were disbursed within the past 2 years for each quarter of the calendar.

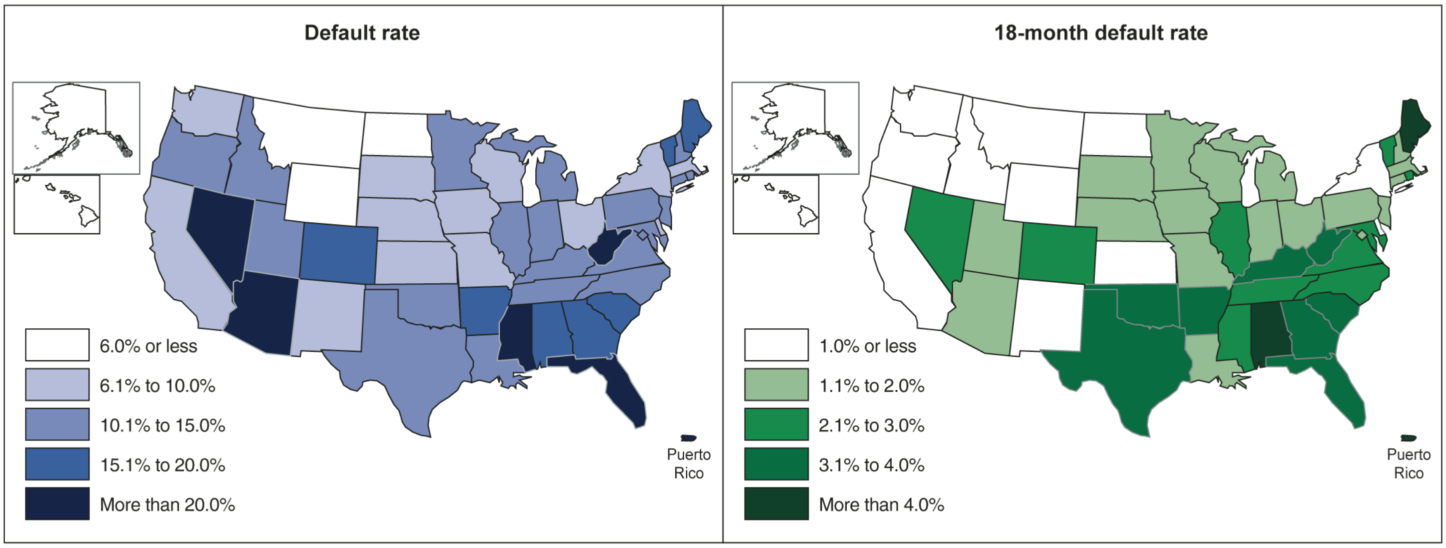
Therefore, for the fourth quarter of 2004 the index has a value of 100 percent and for the first quarter of 2010 the index has a value of 3,500 percent, which is 37 times its original value.

We also compared the performance of different types of 504 loans approved in fiscal years 2003 through fiscal year 2013 (as of Mar. 31, 2013). Certain aspects of the 504 program performed better than others with respect to defaults. ALP loans, for example, had a default rate of 11.0 percent, compared to a default rate of 14.9 percent for regular 504 loans. Further, the 18-month default rate for regular 504 loans was 2.5 percent, while the same rate for ALP loans was lower at 1.6 percent. We also compared default rates for 504 loans made to new small business borrowers versus those made to existing small businesses. We found that existing small businesses experienced a default rate of 10.9 percent and a 1.6 percent 18-month default rate, while new businesses experienced a higher default rate of 19.8 percent and a 4.0 percent 18-month default rate.

In addition, we analyzed 504 loan performance based on the location of the CDCs making the loans. Figure 5 illustrates default rates and 18-month default rates by state.[38] Mississippi, Puerto Rico, Nevada, West Virginia, Arizona, and Florida had the highest rates of total defaulted loans. Puerto Rico, Alabama, Maine, Kentucky, West Virginia, and Florida had the highest 18-month default rates.

[38]This analysis covers all states with CDCs, the District of Columbia, and Puerto Rico. (There is no CDC located in Alaska.)

Figure 5: Default Rates by State, as of March 2013



Source: GAO analysis of SBA data; Map Resources (map).

Note: The SBA data we analyzed were as of March 31, 2013. Our analysis excluded loans that were (1) approved in fiscal years 2003 through 2013 (as of Mar. 31, 2013) but not disbursed as of March 2013 and (2) made using Premier Certified Lender Program authority. We analyzed 504 loan performance based on the state in which the CDC was located. All 50 states (except Alaska), the District of Columbia, and Puerto Rico had CDCs.

According to SBA analysis, 504 loan program cash flows have consistently been negative since 2008. In fiscal year 2012, SBA purchased $871.9 million in defaulted 504 loan debentures, resulting in an overall net cash flow of negative $555.3 million for the year. Costs of 504 loan defaults are offset by collected fees and any recoveries.[39] Net cash flow is equal to the sum of all fees and recoveries minus purchases. In fiscal year 2011, SBA purchased $1.3 billion in defaulted 504 loan debentures, and the program had a negative cash flow of $1.1 billion. In fiscal year 2010, the program experienced an even greater negative cash flow with a deficit of $1.4 billion after purchasing $1.6 billion in defaulted 504 loan debentures that fiscal year. According to SBA, the effects of the economic recession and the 504 loan program fee reductions that went into place under the American Recovery and Reinvestment Act and the

[39]SBA is authorized to assess and collect certain fees, such as loan origination and servicing fees, and is authorized to use the proceeds of such fees to offset the cost of making guarantees in the 504 loan program. 15 U.S.C. § 697(b)(7).

Small Business Jobs Act of 2010 played a large role in the substantial cash flow deficit for fiscal years 2010 through 2012.[40]

From fiscal year 2008 through fiscal year 2013 (as of April 2013), SBA charged off 6,888 504 loans for a total of $3.4 billion in charged-off dollars. Charged-off dollars are the remaining balance of the loan, after all recoveries (the amount of funding recovered from defaulted loans) are made, that SBA charges off its balance sheet. During this period, SBA recovered $353.5 million from defaulted loans and calculated a recovery rate of 9.3 percent. SBA officials stated that the 504 loan program has a low recovery rate due in part to the fact that the third-party lenders (which generally provide at least 50 percent of the financing on the 504 project) typically have the first lien on the assets funded by the 504 loan and receive any recoveries before SBA. SBA's guarantee of the debenture lessens the risk exposure associated with bank lending compared with a conventional commercial loan; SBA's second lien position further transfers risk to SBA.[41] By taking on this risk, SBA's guarantee and lien position can facilitate lending and economic development that may not occur otherwise.

SBA Reviews CDC Eligibility and Loan Applications, but Does Not Confirm Compliance with Some Requirements

SBA has processes to review CDCs' eligibility to participate in the 504 loan program but, as previously mentioned, does not require or examine support for CDC-reported data on jobs created or retained. SBA also does not require SBA staff to review CDC compliance with the retained-earnings requirement when reviewing CDC eligibility. SBA has multiple processes for reviewing 504 loan applications; however, SBA does not verify certifications made by CDCs with ALP authority at loan closing that the small business borrower has not suffered any adverse financial changes since the 504 loan was initially approved.

[40]American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009); Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2504 (2010).

[41]We define a conventional commercial loan as financing of fixed assets without an SBA guarantee. Due to data limitations and differences in loan structure, we were not able to compare the recovery rates for 504 loans to those of conventional commercial loans.

SBA Reviews CDC Eligibility, but Does Not Confirm Compliance with Jobs-Supported and Retained-Earnings Requirements

SBA has established a process for approving CDCs to participate in the 504 loan program, which includes a probationary period. Institutions that are interested in participating in the 504 loan program must first apply and receive approval from SBA to become a CDC. To be eligible, an institution must, among other things, (1) be a nonprofit corporation, (2) be in good standing with, and in compliance with all laws in, the state in which the CDC is incorporated and in any other state in which the CDC conducts business, and (3) have at least 25 members who actively support economic development in the proposed area of operations.[42] A CDC applicant must apply to the SBA district office serving the applicant's proposed area of operations for certification. The applicant is required to submit several documents, including evidence of its nonprofit status and an operating budget. District office staff make their recommendation and send the application to headquarters for final approval. If their initial application is approved, CDCs are then on probation for 2 years, meaning they do not yet have permanent status as a CDC. At the end of the 2-year probation, the CDC must petition SBA for permanent CDC status or a year-long extension of probation.[43] SBA will decide whether to give a CDC permanent status based, in part, on comments received from the applicable servicing center, the CDC's compliance with 504 requirements, and the performance of the CDC's 504 loan portfolio.[44]

SBA annually reviews current CDCs' continuing eligibility to participate in the 504 loan program. A CDC must submit an annual report to its SBA district office within 180 days after the end of its fiscal year and include audited or reviewed financial statements, as applicable, and such interim

[42]Members must be from one of the following groups: (1) government organizations responsible for economic development, (2) financial institutions that provide commercial long-term fixed-asset financing (lenders), (3) community organizations dedicated to economic development (e.g., chambers of commerce, foundations, colleges), and (4) businesses located within the CDC's area of operations.

[43]SBA considers failure to file a petition before the end of the probationary period as a withdrawal from the 504 program. If a CDC elects to withdraw, it must transfer all funded and approved loans to another CDC, SBA, or another servicer approved by SBA.

[44]According to SBA regulations, the CDC must have satisfactory performance, as determined by SBA. The CDC's risk rating will be considered in determining satisfactory performance. Other factors considered may include examination assessments, historical performance measures (e.g., default rate, purchase rate, and loss rate), and loan volume (to the extent it impacts performance measures). 13 C.F.R. § 120.812(c).

reports as SBA may require.[45] In its annual report, a CDC must also indicate the job opportunities actually or estimated to be provided by each project. In addition to an annual report, CDCs must also submit to SBA a statement of personal history for each new associate and staff, reports of involvement in any legal proceedings, changes in organizational status, changes in any condition that affects its eligibility to continue to participate in the 504 program, quarterly service reports on each loan in its portfolio which is 60 days or more past due, and other reports as required by SBA. District office staff use an annual report review template to review CDCs' annual reports before forwarding the reports to SBA staff in headquarters. The CDC annual report review template covers the CDCs' 504 activity (e.g., number of loans approved and closed and delinquencies), organization (e.g., staff changes), and financial capacity (e.g., consistency in revenues and expenses). SBA officials stated that they use a monthly management report to track the status of CDCs' annual report submissions.

The annual report review template does not require SBA staff to confirm CDC compliance with certain key 504 requirements. For example, while the template requires SBA staff to review the number of jobs created or retained included in the annual report, it does not require staff to request and review supporting documentation for the figures reported. As discussed previously, each CDC is required to create or retain one job in its community for every $65,000 of 504 loan funds (every $100,000 if the project involves a small manufacturer). This requirement is a key requirement of the 504 loan program that promotes economic development within CDCs' communities. SBA officials we spoke with acknowledged that they do not regularly request and examine supporting documentation to review the data on jobs supported in CDCs' annual reports. However, SBA officials stated they may request supporting documentation if information appears to be unrealistic based on their experience. All 10 CDCs we spoke with stated that SBA had not requested supporting documentation for the jobs-supported information that they reported in their annual reports. As discussed previously, SBA also uses CDC-reported jobs data to report on the status of the jobs-

[45]This annual report includes submission of financial statements audited by an independent certified public accountant for CDCs with 504 loan portfolio balances of $20 million or more or, at a minimum, a review by an independent certified public accountant or independent accountant in accordance with generally accepted accounting principles for CDCs with 504 loan portfolio balances of less than $20 million. 13 C.F.R. § 120.826(c).

supported performance indicator. Federal internal control standards emphasize the need for federal agencies to have control activities in place to help ensure that program participants report information accurately.[46] Control activities are the policies, procedures, and methods that enforce management directives. In addition, our guidance on data reliability recommends tracing a sample of data records to source documents to determine whether the data accurately and completely reflect the source documents.[47] Finally, our guidance on performance measurement states that data used to report on performance indicators should be sufficiently complete, accurate, and consistent.[48] Because SBA does not request and review at least some supporting documentation during its reviews of CDCs' annual reports, it lacks assurance that jobs data are supported and that CDCs are meeting a key economic development goal. It also lacks assurance that data it uses to report on the jobs-supported performance indicator are supported.

The annual report review template also does not require an assessment of whether CDCs are complying with the retained-earnings requirement, which is intended to help ensure that earnings are used to fund additional economic development activities. SBA 504 loan program regulations require that any funds generated from 504 loan activity remaining after payment of staff and overhead expenses be retained by the CDC as a reserve for future operations or for investment in other local economic development activity.[49] SBA officials stated that they review whether CDCs are complying with this requirement as part of their review of the financial statements in CDCs' annual reports. However, the annual report review template does not list an item requiring an assessment of compliance with this requirement. In February 2013, SBA published a proposed rule that would require, among other things, a CDC's Board of Directors to approve all investments over $2,500 and the CDC manager to approve investments of $2,500 or less to help ensure that the investments constitute appropriate economic development activity and do

[46]GAO/AIMD-00-21.3.1.

[47]GAO, *Assessing the Reliability of Computer-Processed Data*, GAO-09-680G (Washington, D.C.: July 2009).

[48]GAO/GGD-96-118.

[49]13 C.F.R. § 120.825.

not compromise the adequacy of the reserves.[50] However, the proposed rule does not include a description of plans for SBA's review of the Board of Directors and CDC manager's approvals of these investments. As of December 2013, SBA had drafted a final rule and submitted it to the Office of Management and Budget for review. Federal internal control standards indicate that federal agencies should have the information necessary to determine compliance with laws and regulations.[51] Because the annual report template does not require a review of compliance with the retained-earnings requirement, SBA cannot be assured that district office or other staff are consistently reviewing CDCs' annual reports for this requirement or that CDCs are compliant with this requirement.

SBA has an additional eligibility review process for CDCs with ALP authority. According to SOP 50 10, these CDCs are accountable for thorough credit and eligibility analysis on loan applications and on servicing actions. SBA relies on the CDC's credit analyses in making the decision to guarantee the debenture and complete the documentation in a reduced time frame. CDCs with the ALP designation have increased authority to process and close 504 loans. For example, 504 loan applications from CDCs with ALP authority are to be processed within 3 business days (versus 6 business days for regular loans). To be eligible for ALP authority, a CDC must, among other things, (1) have permanent CDC status, (2) attain priority status (with a Designated Attorney and SBA-required insurance), (3) have at least 20 504 loan applications approved by SBA within the most recent 3 years, and (4) have a portfolio of at least 30 active 504 loans.[52] The CDC also must have a record of complying with SBA's 504 policies and procedures and of satisfactorily underwriting, closing, and servicing 504 loans.

A CDC applies for ALP authority first through its SBA district office. As part of its application, the CDC must provide, among other things, information on the experience and qualifications of its staff, the size and

[50] 504 and 7(a) Loan Programs Updates, 78 Fed. Reg. 12,633 (Feb. 25, 2013).

[51] GAO/AIMD-00-21.3.1.

[52] To attain priority status, a CDC must have at least one 504 loan closing Designated Attorney, adequate experience and expertise in closing 504 loans, a history of presenting complete and accurate closing packages, satisfactory SBA performance, a qualified and knowledgeable staff, a satisfactory working relationship with its lead SBA office, and directors and officers liability insurance with limits of at least $1 million.

performance of its 504 loan portfolio, and compliance with 504 requirements. The CDC reviews by SBA must be current (within the past 2 years, if applicable), and the CDC must have received an assessment of “Acceptable” or “Acceptable with Corrective Actions Required.”[53] The district office reviews the ALP application and forwards its recommendation to SBA headquarters staff for their final determination. In fiscal year 2013, 83 CDCs had ALP authority. ALP status is generally provided to CDCs for a period of 2 years, and according to SBA officials, renewals usually occur every 1 to 2 years. Ninety days prior to the end of its ALP term, a CDC should apply for renewal of its status and submit certain information to SBA.[54]

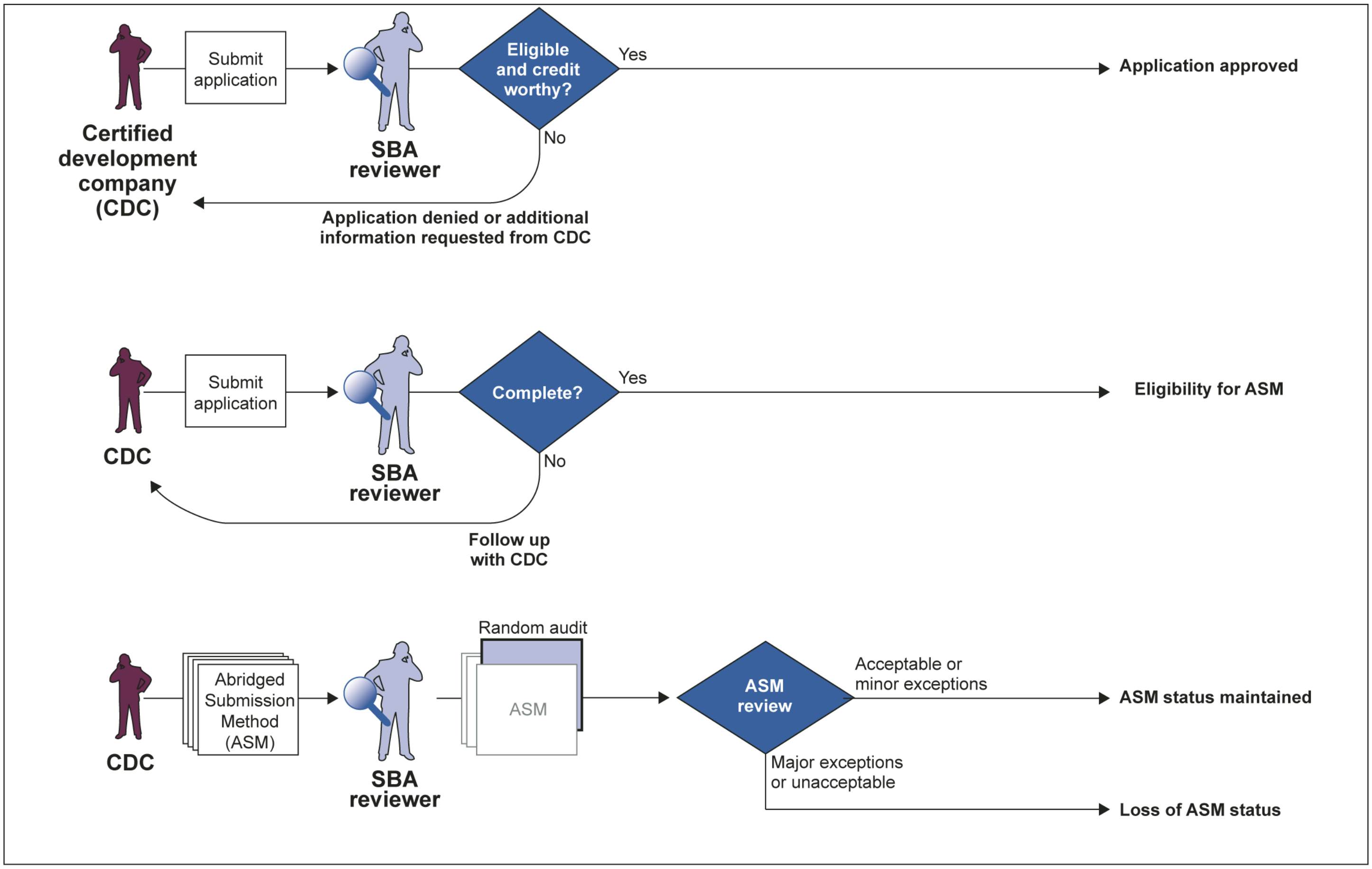
SBA Has Multiple Processes for Reviewing 504 Loan Applications

As shown in figure 6, SBA performs multiple reviews of 504 loan application packages to assess whether loan applications comply with program requirements. First, SBA’s Sacramento Loan Processing Center (SLPC) reviews all loan application packages to determine whether borrowers meet the program’s eligibility and creditworthiness requirements. Second, it also reviews all application packages to assess their completeness. Third, SLPC conducts periodic reviews of loan applications submitted under its streamlined processing guidelines—called the Abridged Submission Method (ASM)—to help ensure that a CDC’s abbreviated application submitted to SLPC is consistent with the complete loan application maintained by the CDC.

[53]Based on the results of its risk-based reviews, SBA assigns CDCs a rating (e.g., “Acceptable,” “Acceptable with Corrective Actions Required,” “Less than Acceptable”). These reviews and ratings are discussed in more detail later in this report.

[54]The information a CDC with ALP authority must submit as part of the renewal process includes a summary of the experience of the CDC’s staff, including the Designated Attorney.

Figure 6: 504 Loan Application Reviews



Source: GAO analysis of SBA information.

At the time of application, the small business must meet SBA's eligibility requirements and with the exception of size, must continue to meet these requirements through the closing and disbursement of the loan. The applicant must be an operating business; be organized for profit; be located in the United States; be small; and demonstrate a need for the desired credit. CDCs must certify that credit is not available elsewhere on reasonable terms, and the applicant must show that funds are not available from alternative sources, including personal resources of the principals.

CDCs must submit all 504 loan application packages to SLPC for processing. The loan application covers key 504 requirements, including the borrower's capital injection and economic development goals (jobs-created and public policy goals), as well as financial summary information, analysis of debt to net worth ratio, and cash flow information. CDCs must submit certain documents with the loan application, including eligibility information, a credit memorandum, a personal history statement for each officer and director and individuals with 20 percent or more ownership of the small business, a personal financial statement that is current within 90 days for individuals with 20 percent or more ownership, a participating lender commitment letter, a balance sheet and income statement, and a cash flow analysis. According to SBA's guidance, the credit memorandum should provide a clear representation of the loan proposal and a complete analysis of the business, including an analysis of management's ability and the business's financial capacity. The memorandum should also explain why the transaction completely satisfies SBA's credit standards. This memorandum, along with the other documents, demonstrates the CDC's basis for the applicant's ability to repay the loan. For example, SBA requires that a CDC perform a financial analysis of the applicant's repayment ability based on historical income statements, tax returns, and projections. The CDC must also analyze cash flow because cash flow of the small business applicant is the primary source of repayment, not the liquidation of collateral.

According to SBA officials, two SLPC loan officers review all 504 loan application packages to determine whether applicants meet SBA's eligibility and creditworthiness requirements. During these reviews, the loan officers analyze financial data to determine if the loan satisfies SBA's credit standards and use a checklist to determine whether the project fulfills SBA's eligibility requirements, such as loan eligibility, jobs created and retained, and economic development goals. Upon completion of its review, SLPC issues an authorization to the CDC if the applicant meets the eligibility requirements and is creditworthy.[55] Staff may screen out applications if information is missing or they have questions about the application.[56] In effect, screen outs are similar to declines if the CDC fails to respond with additional information to resolve the issue. SBA must decline a loan request if, for example, a CDC's financial analysis demonstrates that the small business applicant lacks reasonable

[55]The authorization is SBA's written agreement between the agency and the CDC providing the terms and conditions under which SBA will guarantee a CDC debenture.

[56]Screen outs are exceptions that may require follow up and could later be approved or declined.

assurance of repayment in a timely manner from the cash flow of the business. See table 3 for information on the number of loans SBA approved, screened out, and declined in recent years. As the table shows, the largest number of loans approved in the past 4 fiscal years was in 2012. SBA officials told us that most of the screen outs and declines stemmed primarily from failure to meet eligibility standards, poor credit quality, or incomplete application packages. The officials also told us that the agency experienced an increase in loan applications in fiscal year 2012 because of the debt refinancing program authorized by the Small Business Jobs Act, which expired in September 2012.

Table 3: Loans Approved, Screened Out, or Declined, Fiscal Years 2010-2013

Fiscal year	Loans approved	Loans screened out	Loans declined
2010	7,935	284	102
2011	7,720	152	145
2012	9,405	578	265
2013	7,118	208	245

Source: SBA.

Note: Not all of the loans approved in each fiscal year were disbursed during that year, or at all. Our analysis of 504 loan data showed that approximately 72 percent of loans approved during fiscal years 2003-2013 had been disbursed as of March 2013.

During the processing of each 504 loan application, SLPC staff also evaluate the completeness of the package and assign a letter grade to each application package. This letter grade is later converted to a numeric calculation to derive a CDC's loan package score based on the 25 most recent loans submitted to SLPC. According to SBA officials, the grading is not an indication of the credit quality of the applicant but is simply a measure of how complete the application is.[57] The grades range from "A" to "E," with "A" being the highest possible rating. SBA converts these grades to numeric scores ranging from "1" to "5," with "1" corresponding to "A," so that a lower score indicates a better rating. SLPC determines the rating by evaluating whether the CDC (1) submitted all necessary documents and data, (2) completely and accurately analyzed the eligibility of the transactions, and (3) produced a complete and thorough credit analysis.

[57]SBA does not track and analyze trends in the application scores because they do not pertain to credit quality.

SBA uses the loan package score, among other things, to determine a CDC's eligibility to participate in ASM, a streamlined loan application processing procedure. Under this process, eligible CDCs can submit fewer documents in order to expedite the application process but must collect and maintain all required documentation in their files. According to SBA officials, while it generally takes about 6 business days to process an application package submitted by a regular CDC, the application package processing time for a loan submitted under ASM is about 3 business days. The ASM process facilitates a faster review of application packages because loan officers have fewer documents to review. To participate in ASM, CDCs must have ALP or Premier Certified Lender Program authority or have submitted 10 complete loan packages during the preceding 12 months and earned a numeric equivalent average loan package score of no more than "2.0" among the 25 most recent loan applications submitted to SLPC. While SBA officials told us that they do not keep historical records of CDCs that have ASM status, they said 128 CDCs had this status as of September 2013.

In addition to evaluating all application packages, SBA's policy requires that SLPC conduct periodic reviews of loan applications submitted under the ASM processing guidelines. According to SOP 50 10, SBA is to review 1 out of every 10 loan applications annually for each CDC. Each CDC will have at least 1 but no more than 12 loans reviewed during a 12-month period. To accomplish this, SLPC randomly selects ASM files to review. The primary purpose of these ASM audits is to help ensure that the abridged application is consistent with the complete loan application file that is maintained by the CDCs and to monitor CDCs' continued eligibility to use ASM. Using a checklist, SLPC staff review the files selected for the audit to determine, among other things, whether all documents that the CDC collected were appropriately signed and dated, the project costs were consistent with the cost stated on the abbreviated application, financial analysis such as cash flow was correctly determined, and the size analysis was correct.

We reviewed the results of five ASM audits conducted between January 2011 and August 2013 (1,047 files were reviewed) to determine whether SLPC was performing these audits as required and what the results showed. We found that SBA graded the 1,047 files and reported that the one major exception of concern identified during the first four audits was resolved satisfactorily.[58] SBA reported that the fiscal year 2013 audit identified some exceptions, which resulted in a 1-year suspension of two CDCs' ASM status. According to SBA officials, when CDCs lose their ASM status, they generally do so because they cannot provide all loan application documentation they should retain in their files, or the documentation they submitted to SBA is not properly signed. According to SBA's policy, a CDC will also lose its ASM status if its average loan package score for the most recent 25 applications submitted to SLPC exceeds 2.0. In addition, the SLPC center director or a designee may approve or remove ASM status at any time for good cause including, but not limited to, misrepresentation, quality of post approval actions, and findings of internal or external audits of the CDC.

SBA Does Not Verify Certifications Made by Certain CDCs Prior to Closing but Does Conduct Some Other Reviews

As noted previously, significant time (as much as 4 years) can pass between approval of the initial 504 loan application and loan closing. Therefore, CDCs must issue an opinion, prior to closing, that there has been no adverse change in the borrower's ability to repay the loan prior to closing. Prior to closing, a CDC must issue a certification that to the best of its knowledge there has been no unremedied substantial adverse change in the borrower's ability to repay the 504 loan since its submission of the loan application to SBA. Regular CDCs must provide their finding to SLPC along with copies of financial statements that are current within 120 days supporting the finding of no adverse change.[59] If SBA disagrees with a CDC's determination of no adverse change, the debenture will not close until SBA has been satisfied that any adverse change has been remedied. CDCs with ALP authority are required to conduct a review to determine no adverse change but are not required to submit the results of this review to SBA. Instead, CDCs with ALP authority retain in their files the finding and copies of the financial statements on which they relied. According to SBA officials, if a CDC with ALP authority is in good standing, SLPC accepts certification that there has been no adverse change and does not perform an additional check. If a CDC with ALP

[58]Loans reviewed during ASM audits are graded using the following four categories: acceptable, minor exceptions, major exceptions, and unacceptable.

[59]Unlike the requirement that financial statements submitted with the initial application must be current within 90 days, financial statements provided to support no adverse change must be current within 120 days.

authority is not in good standing, SBA officials stated that the loan file would not be approved.

According to SBA officials, SBA reviews CDCs' ALP authority for renewal every 1 to 2 years. We found that the assessment form SBA uses when determining whether to renew ALP authority does not include a step verifying that CDCs with ALP authority can support their certification that there was no adverse change in a borrower's ability to repay the loan after initial submission of the loan application. SBA officials confirmed that they have not reviewed CDCs with ALP authority for compliance with this requirement. They stated that CDCs were closely scrutinized before SBA granted them ALP authority and that any problems with certifying that there were no adverse changes would show up in loan performance data or in OCRM reviews of the CDC. However, federal internal control standards require that federal agencies have control activities in place, such as verification, to ensure compliance with key program requirements.[60] Furthermore, annually since 2005, more 504 funds have been loaned using ALP authority than regular authority. In fiscal years 2010 through 2012, the dollar amount of 504 loans made with ALP authority was about twice the dollar amount of regular 504 loans.[61] Without incorporating a step in its renewal process to assess compliance with this requirement, SBA cannot be assured that CDCs with ALP authority are meeting the requirement.

SBA district office counsel conduct other reviews in conjunction with loan closing. CDCs and their attorneys are responsible for the 504 loan closing, including compliance with all SBA loan program requirements. The SBA district office counsel reviews the closing documents submitted by the CDC for legal sufficiency and issues a legal opinion on whether SBA may guarantee the debenture. The SBA officials we spoke with told us that the counsel also reviews SBA's authorization and all modifications transmitted by SLPC. If the counsel determines that a loan was not closed properly, he or she notifies the CDC of the deficiencies in the package as well as changes needed to address the concern. If the CDC

[60] GAO/AIMD-00-21.3.1.

[61] In fiscal years 2010 and 2011, loans made with ALP authority totaled $3.05 billion and $3.07 billion, respectively, and $1.36 billion and $1.56 billion for regular loans, respectively. In fiscal year 2012, loans made with ALP authority totaled $3.03 billion versus $1.47 billion for regular loans.

is unable to provide the information or otherwise alleviate the concern, the counsel will not submit the debenture for sale. According to SBA officials, SBA rarely declines to close a debenture. Usually, declines occur early in the loan approval process.

SBA Is Implementing a New Approach to Monitoring CDC Compliance but Has Not Yet Documented Key Processes

SBA has made several changes to its processes used to monitor CDC compliance with 504 program requirements, including revising the areas to be reviewed and the types of reviews to be conducted. However, the processes have not been finalized, and review of certain key requirements is not yet documented. Further, SBA is updating its corrective action process to improve review of actions taken.

SBA's New Review Process Covers Five Areas of CDC Operations and Tailors the Level of Review Based on Risk

According to the OCRM Director, SBA is finalizing a new process for monitoring CDCs and developing its first risk plan for 2014. According to SBA officials, the plan will be used to monitor CDC performance and enforce 504 program requirements. They noted that it will include the OCRM Director's objectives for the year ahead; lender and loan portfolio stratifications; a description of the types of lender reviews OCRM will be undertaking; a proposed list of planned reviews; proposed supervisory and enforcement actions; and a section on matters internal to OCRM (e.g., policy updates, training, and staffing). OCRM expects to finalize this plan by March 31, 2014.

As a part of its new process, OCRM is incorporating risk as a criterion for selecting CDCs for review. Based on data in its Loan and Lender Monitoring System, SBA assigns all CDCs a quarterly risk rating of 1 to 5.[62] A rating of "1" reflects lower risk to SBA, and "5" reflects greater risk.[63] In a November 2009 report, we recommended that SBA use its risk ratings to select CDCs for review.[64] At that time, the agency targeted

[62]The Loan and Lender Monitoring System is the system SBA uses to monitor the individual risk that each loan poses to the agency in order to identify lenders whose SBA loan operations and portfolios may require additional monitoring or other actions.

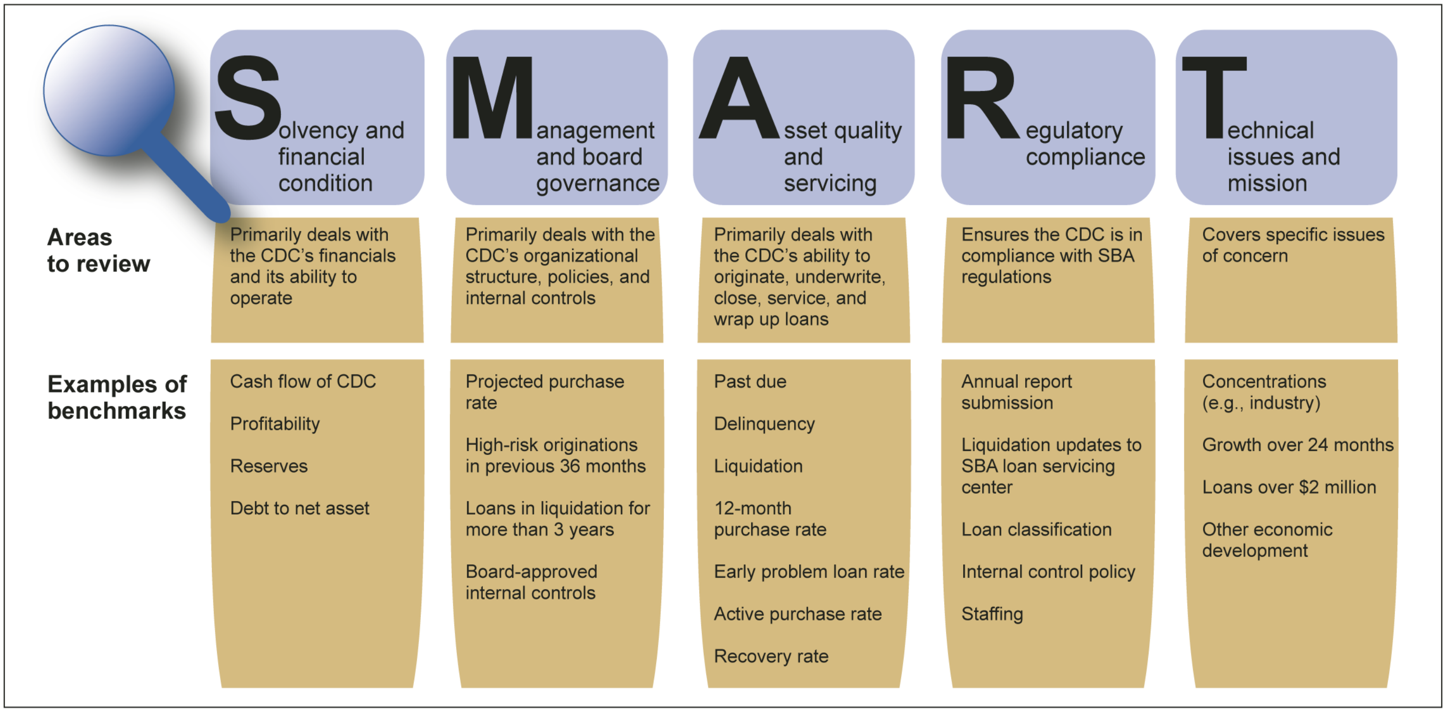
[63]Of the 267 active CDCs as of September 30, 2013, 66 were rated "1"; 126 were rated "2"; 58 were rated "3"; 13 were rated "4"; and 4 were rated "5."

[64]GAO-10-53.

CDCs for review based on the size of their portfolios, focusing on CDCs with balances of at least $30 million. In fiscal year 2012, OCRM began incorporating risk ratings into its CDC selection criteria. OCRM placed emphasis on CDCs that were rated “4” or “5” (higher risk). In fiscal year 2013, SBA selected a number of CDCs for review and prioritized them based on risk ratings and other factors, such as portfolio size, time elapsed since last review, and last review assessment.

The OCRM Director also told us that the agency is developing a new process for assessing CDCs that have been selected for review, but this process is not yet finalized. Draft guidance on this new process, known as SMART, shows that SBA has developed preliminary benchmarks to assess each CDC’s performance and compliance under five areas: Solvency and financial condition, Management and board governance, Asset quality and servicing, Regulatory compliance, and Technical issues and mission. Figure 7 illustrates the SMART components and examples of preliminary benchmarks that are to be used to assess CDCs’ activities. In February 2014, the OCRM Director told us that the agency expects to finalize these benchmarks by March 31, 2014.

Figure 7: Description of the Proposed SMART Process, as of January 2014



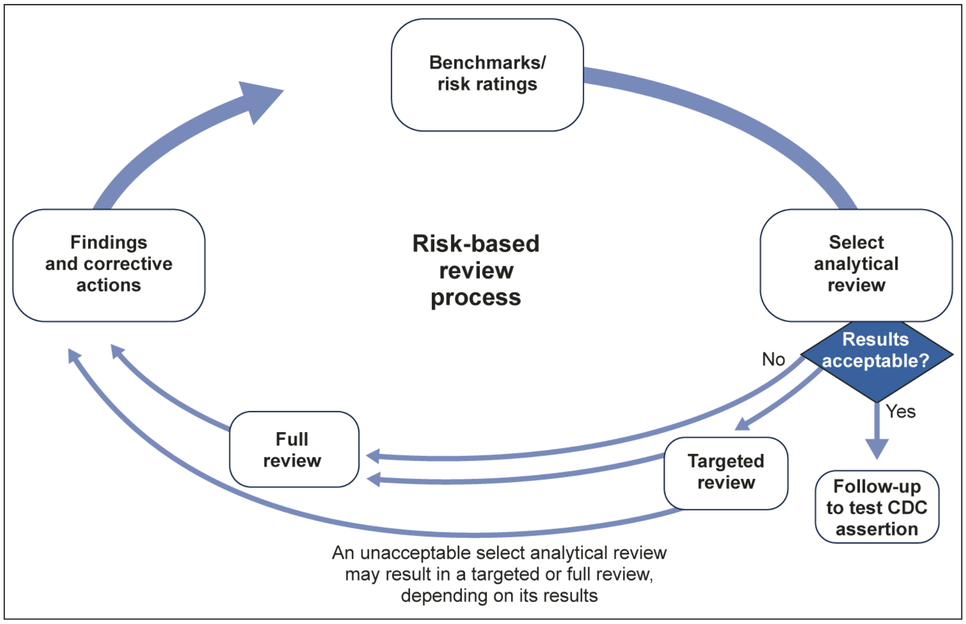
Source: GAO analysis of SBA information.

In general, once CDCs have been selected for review, the benchmarks and CDC risk ratings are to be used to determine the level of review. Under the new review process, SBA plans to conduct three types of risk-based reviews—select analytical reviews, targeted reviews, and full reviews (see fig. 8). A select analytical review will be OCRM's initial review of a CDC's operations and performance. A targeted review will examine specific components of SMART in more detail, and a full review will examine all components of SMART in more detail. Targeted and full reviews are only to be performed if the select analytical review indicates that they are warranted.[65] For each CDC selected, OCRM plans to notify the CDC of the planned select analytical review and request documents such as a current organizational chart, interim financial statements, and

[65]SBA officials stated that OCRM may, from time to time, select lenders for full on-site reviews even if their ratings or benchmarks are "good." For example, SBA officials stated that they may occasionally review lenders with very large portfolios on-site.

credit policy manual. In addition, based on its draft guidance, OCRM plans to use a questionnaire to inquire about, among other things, any significant changes regarding delegations, responsibilities, and structure since the CDC's last risk-based review or submission of its last annual report. The OCRM Director said OCRM also intends to solicit information about the CDC from SLPC, the commercial loan servicing center that works with the CDC, and SBA's district office counsel. According to SBA officials, OCRM does not initially plan to request loan files in connection with select analytical reviews. However, they stated that OCRM could decide to review loan files in the future. To perform a select analytical review, OCRM plans to use a CDC profile assessment template to analyze and document review of a CDC's activities aligned with each of the SMART components. Further, OCRM intends to summarize the findings of the review as well as the review assessment on a report summary template.

Figure 8: Proposed Risk-Based Review Process



Source: GAO analysis of SBA information.

Based on our review of draft guidance, each component of SMART is to receive one of three assessment scores—Preferred, Acceptable, or Less than Acceptable with Corrective Actions. In addition, CDCs are to receive one of four overall review assessments after their review is completed—Acceptable, Acceptable with Corrective Actions Required, Marginally

Acceptable with Corrective Actions Required, or Less than Acceptable with Corrective Actions Required. Select analytical reviews are to be conducted remotely, and the results will determine whether a targeted or full review is necessary. They also are to be used to assess CDCs for renewal of their ALP authority. OCRM plans to align risk-based reviews with ALP renewals because during its risk-based reviews OCRM analyzes information similar to that reviewed during ALP renewals. In addition, OCRM has expanded the scope of the ALP renewal analysis to include a review of issues such as the structure of the organization, board-approved internal control policy, and industry concentrations. In fiscal year 2013, 83 CDCs had ALP authority. Of those CDCs with ALP authority, 65 were due for renewal in fiscal year 2013. SBA reported that they completed 15 of those renewals in fiscal year 2013. SBA officials commented that they are addressing the backlog by dividing the process by risk rating. They explained that most of the CDCs with a 4 or 5 risk rating are undergoing a SMART select analytical review before a longer-term ALP renewal is considered. OCRM provided lenders with risk ratings of 1, 2, and 3 with temporary extensions of their ALP status. SBA officials also noted that OCRM has devoted additional staff to reviewing and processing ALP renewals beginning in calendar year 2014.

According to SBA's draft guidance, if a select analytical review identifies risks, OCRM is to perform a targeted or full review. In a targeted review, OCRM would focus on the aspects of the CDC and its operations that warrant further attention, based on the SMART components. For example, the OCRM Director told us that OCRM may target areas such as loan originations, loan authorizations that may not have been funded, or financial statement matters. SBA officials told us that in deciding to conduct a targeted review, OCRM plans to consider a CDC's risk rating and loan purchases and apply some judgment in addition to the results of the select analytical review. OCRM plans to conduct a full review when the select analytical review identifies issues that are critical or crucial in nature. A full review would involve examining all components of SMART. A targeted or full review may be conducted remotely or on-site. An on-site review is to be used if CDCs do not have technological capabilities for remote reviews or if OCRM needs to observe an activity as it is being performed.

In 2013, OCRM initiated 20 select analytical reviews and 5 on-site reviews using the SMART protocol. According to the OCRM Director, the purpose of these reviews was to continue developing the new compliance processes, as well as providing oversight of CDCs. There were more total reviews in fiscal year 2013 than in previous years but fewer on-site reviews. In fiscal year 2011 and fiscal year 2012, SBA conducted 21 and 19 on-site risk-based reviews, respectively. Staff from various SBA offices and contractor staff hired to conduct risk-based reviews participated in the fiscal year 2013 reviews and will continue to do so. Previously, only contractors, not SBA staff, conducted on-site reviews.

SBA officials told us that as part of SBA's targeted and full risk-based reviews, OCRM has begun to request two samples of loan files—origination loan files and servicing loan files.[66] OCRM currently uses two checklists to review individual loan files. One checklist primarily includes questions about loan origination and routine servicing such as whether the business was organized for profit, whether there was written evidence documenting that credit was not available elsewhere without the guarantee provided by SBA, and whether monitoring of continued creditworthiness is considered sufficient and describes the evidence in the file. The other checklist includes questions for defaulted loans in liquidation status on loan closing and servicing, such as whether evidence shows that all closing documents were legally sufficient and that the CDC engaged in intensive servicing activities when a loan became 60 days past due. OCRM plans to eventually merge the checklists as it refines the new process. According to SBA officials, prior to 2012 OCRM did not routinely examine a sample of servicing files. Instead, it performed reviews of CDCs' servicing files on an ad hoc basis. SBA officials told us that servicing issues emerged in 2012 because there was a lag effect for real estate loans after the economic downturn.

Many aspects of the new SMART process have not been finalized. For instance, the OCRM Director told us that the agency is assessing the results of a benchmark study, which will be used to finalize the benchmarks used to rate CDCs on the various SMART components. Also, OCRM has not yet finalized the assessment templates used for select analytical reviews or the checklist used for targeted and full reviews. According to the OCRM Director, these forms are evolving with OCRM's review processes. In addition, OCRM is considering creating a composite CDC risk grade, similar to a bank's CAMELS rating, to assess

[66]OCRM intends to request samples of loan files on targeted reviews when the scope of the review includes matters that can only be assessed through the review of loan files.

the overall condition of a CDC.[67] These grades would help communicate to CDCs how they are doing with respect to the overall quality of their operations, compliance, and portfolio risks. According to the OCRM Director, SBA expects to fully implement SMART by June 1, 2014.

SBA's Review of Key Requirements Is Not Yet Documented

As noted previously, OCRM currently uses two checklists to review loan files as a part of its risk-based reviews. One checklist primarily focuses on origination and routine servicing, while the other focuses on loan closing and servicing of problem loans. However, OCRM's current compliance file review checklists do not require a review of documentation supporting the numbers reported by CDCs for jobs created or supported. SBA officials told us that in the past OCRM did not examine documentation supporting jobs data, but that such a review would be included under the SMART process. Based on our review of SBA's draft SMART protocols, under the Asset quality and servicing component OCRM staff are expected to determine whether 504 projects meet specified economic development goals and job opportunity criteria. Furthermore, under the Technical issues and mission component, staff are expected to determine whether a CDC's loan portfolio meets the required minimum job opportunity average. While some oversight has been built into the SMART guidance, the guidance does not call for a review of documentation supporting the jobs numbers.

OCRM's current compliance file review checklists also do not require the review of whether retained earnings were used in compliance with CDC eligibility requirements. SBA staff told us that in the past OCRM did not examine CDCs' compliance with the requirement that CDCs retain excess funds generated from the 504 loan program as a reserve for future operations or for investment in other local economic development activity, but that assessing compliance with this requirement would be included under SMART. Based on our review of SBA's draft SMART protocol, under the Solvency and financial condition component OCRM is expected to analyze whether the CDC has sufficient cash flow to support ongoing operations and the reserve requirement. However, there is no specific

[67] CAMELS is a supervisory rating system used to classify a bank's overall condition. Institutions are judged on six different components under the acronym C-A-M-E-L-S: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risks. Banks receive a score of 1 to 5 for each component, and a final CAMELS score in that same range represents the composite total of the components.

mention of verifying compliance with the retained-earnings requirement concerning how the reserves can be used. According to federal internal control standards, federal agencies should have control activities in place to help ensure compliance with key requirements.[68] Without documenting in its examiner checklists or guidance that key requirements—such as the jobs-supported and retained-earnings requirements—should be reviewed, SBA cannot be assured that SBA and contractor staff are reviewing compliance.

SBA Is Revising Its Corrective Action Process to Improve Review of Actions Taken

SBA is revising its corrective action process. According to the OCRM Director, if SBA identifies weaknesses in a CDC's operations during its reviews, it may request that the CDC take corrective actions to address the deficiencies. For instance, if SBA determines that a CDC's credit analysis is deficient, the CDC may be required to modify its process for performing credit analyses. OCRM documents its review findings in a report and notifies the CDC in writing if there is a need for corrective actions. In its September 2012 report, SBA's Inspector General reported that SBA had closed out corrective actions related to the 7(a) program without verifying their implementation and effectiveness.[69] The Inspector General recommended that SBA develop and implement a corrective action follow-up process to require analysts to monitor lender progress in implementing corrective actions and obtain and verify evidence from lenders to ensure corrective actions have been effectively implemented prior to close-out. While the Inspector General's review pertained to the 7(a) loan program, the process in use at the time also was used for the 504 loan program. SBA officials told us they are in the process of developing a new corrective action process to capture more specific findings from reviews and to determine whether testing of a CDC's corrective responses is needed prior to the CDC's next review. See table 4 for information on the number of reviews that required corrective actions in recent years.

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[68] GAO/AIMD-00-21.3.1.

[69] SBA, Office of Inspector General, *Addressing Performance Problems of High-Risk Lenders Remains a Challenge for the Small Business Administration*, Report no. 12-20R (Washington, D.C.: Sept. 28, 2012).

Table 4: Number and Results of Risk-Based Reviews, Fiscal Years 2007-2012

	Acceptable	Acceptable with corrective actions	Marginally acceptable with corrective actions	Less than acceptable with corrective actions	Total number of reviews
2007	1	43	0	1	45
2008	6	56	1	0	63
2009	11	42	0	4	57
2010	0	21	0	2	23
2011	2	10	0	9	21
2012	1	6	2	10	19
Total	**21**	**178**	**3**	**26**	**228**

Source: SBA.

From October 1, 2010, through March 31, 2012, SBA identified some frequently occurring findings, including inadequate verification of the borrower's contribution prior to closing, failure to meet Internal Revenue Service tax transcript requirements prior to closing, and failure to assess creditworthiness periodically. According to the OCRM Director, SBA expects to complete the new processes for resolving corrective actions by March 31, 2014.

Conclusions

SBA is developing new processes for monitoring 504 loan performance and CDCs' compliance with 504 requirements. However, SBA's current processes and planned improvements do not sufficiently address all program requirements. Creating and retaining jobs is a key economic development goal of the 504 program. While SBA has provided general guidance to CDCs and its staff on compliance with this requirement, it has not provided CDCs with specific guidance needed to consistently and accurately compile and support jobs information. Further, SBA's current annual report review and risk-based review guidance do not require SBA staff to request and review supporting documentation for CDC-reported data on jobs supported or assess compliance with the requirement that CDCs invest retained earnings in local economic development. Federal internal control standards require agencies to establish control activities to ensure that program participants report information accurately and comply with requirements.[70] Without developing guidance for CDCs and

[70]GAO/AIMD-00-21.3.1.

reviewing at least some documentation on jobs data and compliance with the retained-earnings requirement, SBA cannot be assured that self-reported information on jobs supported is consistent and accurate and that CDCs are following program requirements.

In addition, while SBA has established multiple reviews for 504 loan applications, the agency does not verify certifications made by CDCs with ALP authority that borrowers are still able to repay a 504 loan at loan closing, which can take place years after the loan was initially approved. Again, federal internal control standards require agencies to have control activities in place, such as verifying compliance with key requirements.[71] Annually since 2005, more 504 loans have been made using ALP authority than regular authority, making the need for some review of these certifications all the more important. Without verifying self-certifications made prior to loan closings, SBA lacks assurance these CDCs are in compliance with SBA credit analysis requirements established to help protect against default risk.

Recommendations for Executive Action

To help ensure that CDCs are meeting the 504 loan program's jobs-supported requirement, we recommend that the SBA Administrator take the following actions:

- Develop specific guidance on how CDCs should compile information on jobs created or retained and on the documentation CDCs should maintain to support these data.
- When reviewing CDCs' annual reports, implement a process to assess the supporting documentation for a sample of the jobs data that CDCs report.
- When finalizing the agency's risk-based review procedures, include in the checklists or guidance for examiners a requirement to review supporting documentation on the number of jobs created or retained by 504 loan projects.

[71] GAO/AIMD-00-21.3.1.

To help ensure that CDCs are meeting the 504 loan program's requirement that CDCs invest retained earnings in local economic development, we recommend that the SBA Administrator take the following actions:

- When reviewing CDCs' annual reports, add an item to its annual report review template requiring SBA staff to assess compliance with this requirement.
- When finalizing the agency's risk-based review procedures, include in the checklists or guidance for examiners a requirement to review compliance with the retained-earnings requirement.

To help ensure that CDCs with ALP authority are taking the necessary steps to determine whether there has been no adverse change to borrowers' financial condition prior to loan closing, we recommend that the SBA Administrator include oversight of CDCs' compliance with this requirement in the agency's process for renewing ALP authority.

Agency Comments and Our Evaluation

We requested comments from SBA on a draft of this report, and the agency provided written comments that are presented in appendix II. SBA generally agreed with our recommendations and outlined steps it plans to take to address them. In response to our recommendations regarding the 504 loan program's jobs-supported requirement, SBA stated that it will (1) work to provide guidance on the compilation of job creation and retention information and document maintenance requirements and (2) consider ways to phase in the implementation of jobs data sampling and review of supporting documentation in its annual report and risk-based reviews. In regard to our recommendations concerning the 504 loan program's retained-earnings requirement, SBA stated that a final rule discussing 504 loan program updates (not yet finalized at the time of SBA's comment letter) will require that a CDC's annual report include a written report on the CDC's investments in local economic development. SBA stated that after publication of the final rule, it plans to work to provide additional guidance on the retained-earnings requirement and consider ways to review compliance with this requirement in its annual report and risk-based reviews. In response to our recommendation regarding CDCs with ALP authority, SBA stated that it will consider ways to review compliance with the requirement to determine whether there has been an adverse change to borrowers' financial condition prior to loan closing during SBA's ALP renewal processes and risk-based reviews. As noted in the report, a 504 loan is not closed until after project-related construction is complete, which can be up to 4 years after initial approval. Given that a borrower's financial condition can change over time, we reiterate the importance of assessing CDCs' compliance with this requirement.

SBA also provided several technical comments, which we incorporated as appropriate. In one technical comment regarding our discussion of the need for SBA to review some supporting documentation for jobs data during its review of CDCs' annual reports, SBA's Associate Administrator of the Office of Capital Access stated that validating job creation and retention data can only occur following loan disbursement and is a separate issue from the indicator on jobs supported that SBA includes in its performance report. As we discuss in the report, SBA uses the data captured in SBA's loan application system at the time of loan approval (which are estimates) when compiling the jobs supported indicator. CDCs' annual reports contain both estimated and actual jobs data for 504 loan projects. Therefore, adding reviews of supporting documentation for a sample of jobs data—both actual and estimated—during the annual report review process could also inform CDCs' processes for compiling estimates for jobs created or retained in their loan applications, and provide better assurance that the data used for the jobs supported indicator are supported.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to SBA and interested congressional committees. The report also will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact William B. Shear at (202) 512-8678 or shearw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

William B. Shear

William B. Shear
Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objectives were to examine (1) the lending standards and performance indicators that the Small Business Administration (SBA) has established to help ensure that loans meet key requirements, as well as 504 loan program performance, (2) the extent to which SBA has implemented procedures to help ensure that certified development companies (CDC) are eligible to participate in the program and that loan applications comply with program requirements, and (3) the extent to which SBA has implemented procedures to monitor CDC compliance with program requirements.

To address these objectives, we reviewed relevant laws and regulations; GAO and SBA Inspector General reports; SBA guidance for the 504 loan program, including Standard Operating Procedures (SOP), the form used to apply for 504 loans, and checklists for different SBA processes; and internal SBA guidance for its staff and examiners. We interviewed relevant staff at SBA, the National Association of Development Companies (the trade association for the 504 loan program), and staff from 10 CDCs. We selected these CDCs to ensure a range of CDCs based on factors such as size and geographic location. Specifically, we selected one CDC from each of SBA's 10 regions based on loan portfolio size. We used the five peer groups that SBA uses for monitoring purposes to establish which CDCs were large versus small.[1] To ensure a mix of large and small CDCs and geographic locations, we selected 7 large CDCs from the regions with the largest 504 loan portfolios and 3 small CDCs from the regions with the smallest 504 loan portfolios. As a secondary measure, we considered the default rates, as calculated by GAO, of the selected CDCs to ensure that we selected CDCs that had a mix of default rates.[2] Five of the 10 CDCs had default rates below 10 percent, and 5 had default rates of 12 percent or higher. Due to ongoing litigation related to a subset of CDCs known as Premier Certified Lenders,

[1]The peer groups, as defined by outstanding dollars of SBA debentures, are CDCs with (1) $100 million or more; (2) $30 million to $99,999,999; (3) $10 million to $29,999,999; (4) $5 million to $9,999,999; and (5) $0 to $4,999,999.

[2]In our analysis, we determined that a 504 loan had defaulted if SBA had purchased the loan's associated debenture. SBA guidance states that a good faith effort should be made to help delinquent borrowers bring their loans current. But, when a payment default cannot be cured, the loan should be classified as in liquidation and the CDC should immediately request that SBA purchase the loan's associated debenture. The default rate is the total number of loans that had defaulted divided by the total number of loans approved in a given fiscal year.

we did not assess loans made using the specific additional authority that SBA may provide to these lenders.[3]

To respond to our first objective, we reviewed relevant laws, regulations, and SOPs to identify SBA's lending standards and servicing policies. We then compared SBA's guidance on compiling data on jobs created and retained with 504 loan funds to federal internal control standards.[4] We also reviewed SBA's annual performance reports for fiscal years 2010 through 2012 to identify SBA's performance measures for the 504 loan program and assessed whether they addressed the program's economic development goals and were consistent with GAO standards for performance measurement.[5] In addition, we reviewed documentation on SBA's processes for reviewing and validating its performance indicators.

We also analyzed 504 loan data for fiscal years 2003 through 2013 (as of Mar. 31, 2013) to determine the composition and performance of the current 504 loan portfolio.[6] For example, we analyzed default rates (the number of 504 loans whose debentures were purchased divided by the total loans approved in that fiscal year) and 18-month default rates for loans approved in fiscal years 2003 through 2012.[7] We only analyzed

[3]*See United States ex rel. U.S. Small Bus. Admin. v. EDF Res. Capital, Inc.*, No. 2:13-cv-01158 (E.D. Cal.). The litigation is an enforcement action by SBA against EDF for, among other things, EDF's alleged failure to pay amounts owed as a Premier Certified Lender to SBA. Under GAO's policy to avoid addressing disputed factual or legal matters pending in litigation, we did not evaluate these matters, including the liquidation of defaulted loans, enforcement actions, or any loans made using Premier Certified Lender legal authority.

[4]GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

[5]GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1996).

[6]Data as of March 2013 were the most recent available data at the time of our request. The 504 data set analyzed does not include any data on loans issued by CDCs using Premier Certified Lender Program authority or any non-Premier Certified Lender Program loans issued by the CDC with Premier Certified Lender Program authority that is involved in the pending litigation. The amount excluded totaled 9,233 loans and approximately $5.9 billion. The data set provided by SBA included 80,080 loans totaling approximately $47 billion. However, based on conversations with SBA, we limited the analysis to loans that had been disbursed—61,171 loans totaling about $34 billion.

[7]The 18-month default rate is the number of loans that defaulted within 18 months of disbursal divided by the total number of loans approved in a given fiscal year.

loans that were approved as of March 2013 and had been disbursed.[8] According to SBA, the 18-month default rate is an indicator of default primarily due to poor underwriting. We also calculated default rates weighted by the approved values of loans and found the rates comparable to the rates discussed above.

For context, we reviewed Moody's/REAL Commercial Property Price Index data for 2002 through 2010 on commercial real estate values. We also compared 504 loan data to Federal Deposit Insurance Corporation quarterly analysis of Federal Financial Institutions Examination Council call report data on nonaccrual rates for commercial loans, specifically construction and development loans and real estate loans.[9] We calculated the nonaccrual rate for commercial loans as the percentage of loan dollars in nonaccrual status. Loans in nonaccrual status are generally loans that are maintained on a cash basis because of the deterioration in the financial condition of the borrower and for which principal or interest has been in default for at least 90 days (unless the loan is in "the process of collection" and "well secured") or payment in full is not expected. We divided the dollar value of loans in nonaccrual status by the total amount of outstanding loan dollars for the quarter of that calendar year. We used nonaccrual status as a trend comparison because it was the weakest category of loans and most similar to purchases made by SBA. In order to compare 504 loan data with this rate, we calculated the percentage of defaulted 504 loans that were disbursed within the past 2 years for each quarter of the calendar year. However, while trends may be compared, levels of nonaccrual rates and SBA default rates may not be compared as SBA data represent early defaults only and the call report data represent nonaccruals for total outstanding loans. We also compared 504 loan default rates and 18-month default rates by geographic location by analyzing these rates for loans based on the location of CDCs making the loans.[10] This analysis

[8] As discussed previously in this report, the disbursement of 504 loans does not occur at the time of approval, but can occur, at a maximum, up to 4 years later. About 28 percent of the loans in the data set SBA provided had not been disbursed as of March 2013.

[9] A "call report" is a report that must be filed by all insured depository institutions in the United States on a quarterly basis and contains financial information about the institutions. The report is officially known as the Report of Condition and Income.

[10] The majority of CDCs serve the state in which they are headquartered, which is their "area of operations." A few CDCs have received permission to serve contiguous communities located across multiple states.

covers all states with CDCs, the District of Columbia, and Puerto Rico. (There is no CDC located in Alaska.) To assess the reliability of the SBA loan-level data, we interviewed SBA representatives from the Office of Performance and Systems Management about how they collected the data and helped ensure data integrity. We also reviewed documentation about the sources of the data and performed electronic testing to detect errors in completeness and reasonableness. We determined that the data were sufficiently reliable for the purpose of reporting on portfolio composition and performance. To assess the reliability of the Moody's/REAL Commercial Property Price Index and Federal Deposit Insurance Corporation quarterly analysis of call report data we used, we reviewed prior GAO assessments of the reliability of this data. We determined the data were sufficiently reliable for the purpose of comparing trends in related private sector loan program performance and SBA 504 loan program performance.

To respond to our second objective, we identified SBA's compliance processes for overseeing CDC eligibility and loan approval. To determine whether SBA had implemented compliance procedures to help ensure that CDCs are eligible and that loan applications comply with program requirements, we reviewed (1) checklists SBA uses to review CDCs' eligibility and renew CDCs' Accredited Lenders Program (ALP) authority, (2) the template used to review CDCs' annual reports, (3) checklists used to review applicant eligibility and creditworthiness, and (4) checklists used to conduct Abridged Submission Method (ASM) audits. We also reviewed the data on these processes, including the results of SBA's loan application review processes for fiscal years 2010 through 2013 and results of ASM audits performed between January 2011 and August 2013 to determine whether SBA was performing these audits as required and review their results. We assessed the reliability of the data on these processes by interviewing officials knowledgeable about the data and determined that they were sufficiently reliable for the purpose of discussing the results of SBA's compliance processes. We also reviewed 504 loan data on the amounts of loans made with ALP authority versus regular authority from fiscal years 2003 through 2012. These data came from the same SBA data system as the set of 504 loan data discussed previously, which we found reliable for the purposes of this report. Finally, we assessed whether the above processes were consistent with federal internal control standards.[11]

To respond to our third objective, we assessed SBA's monitoring of CDCs' compliance with program requirements. To determine whether SBA implemented compliance procedures to monitor CDC compliance, we reviewed documentation on SBA's (1) CDC risk-rating processes; (2) previous compliance processes as represented in relevant SOPs and other guidance; and (3) new preliminary "SMART" approach to monitoring CDCs, including risk-based review checklists, draft protocols, preliminary benchmarks, and CDC profile assessment templates. We also reviewed the data on these processes, including data on lender risk ratings as of September 2013 and the results of SBA's risk-based reviews from fiscal years 2007 through 2012, to assess the extent to which SBA was implementing its compliance processes. We assessed the reliability of these data by interviewing officials knowledgeable about the data and, in some cases, reviewing documentation about the sources of the data. We determined that they were sufficiently reliable for the purpose of discussing the results of SBA's compliance processes. Finally, we compared SBA compliance processes to federal internal control standards.[12]

We conducted this performance audit from January 2013 to March 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[11]GAO/AIMD-00-21.3.1.

[12]GAO/AIMD-00-21.3.1.

Appendix II: Comments from the Small Business Administration

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

February 21, 2014

Mr. William B. Shear
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Shear:

Thank you for the opportunity to comment on the U.S. Government Accountability Office (GAO) draft report titled "Actions Needed to Ensure Planned Improvements Address Key Requirements of the Development Company (504) Loan Program" (GAO-14-233).

The 504 Program is a key component of the Agency's mission to deliver assistance to small business owners by providing needed long-term capital not otherwise available in order to encourage economic development within a community. SBA works to establish clear guidelines and standards that ensure documented lender compliance without creating overly burdensome paperwork. We are pleased that your report demonstrates that we are achieving this balance through innovations such as the Abridged Submission Method (ASM), while enhancing Certified Development Company (CDC) oversight through a soon to be published final rule and improvements in our credit risk management processes.

We have reviewed the draft report and GAO's three Recommendations for Executive Action. Our response to each recommendation is set forth below:

GAO RECOMMENDATION 1:

To help ensure that CDCs are meeting the 504 loan program's jobs-supported requirement, we recommend that the SBA Administrator take the following actions:

- Develop specific guidance on how CDCs should compile information on jobs created or retained and on the documentation CDCs should maintain to support these data.
- When reviewing CDCs' annual reports, implement a process to assess the supporting documentation for a sample of the jobs data that CDCs report.
- When finalizing the agency's risk-based review procedures, include in the checklists or guidance for examiners a requirement to review supporting documentation on the number of jobs created or retained by 504 loan projects.

SBA RESPONSE:

SBA generally agrees with GAO's recommendation. SBA will work to provide guidance on the compilation of job creation and retention information and document maintenance requirements in a way that balances the need for CDC compliance without imposing an undue burden. SBA will also consider ways to phase in the implementation of jobs data sampling and review of supporting documentation in annual report reviews and during risk-based reviews.

GAO RECOMMENDATION 2:

To help ensure that CDCs are meeting the 504 loan program's requirement that CDCs invest retained earnings in local economic development, we recommend that the SBA Administrator take the following actions:

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- When reviewing CDCs' annual reports, add an item to its annual report review template requiring SBA staff to assess compliance with this requirement.
- When finalizing the agency's risk-based review procedures, include in the checklists or guidance for examiners a requirement to review compliance with the retained-earnings requirement.

SBA RESPONSE:

SBA generally agrees with GAO's recommendation. SBA's new final rule will require CDC Board of Directors accountability regarding the use of retained earnings. Additionally, the final rule will require that a CDC's annual report include a written report on the CDC's investments in local economic development in each state in which the CDC has an outstanding 504 loan. After publication of the final rule, SBA will work to provide additional guidance regarding the retained earnings requirement. SBA will also consider ways to implement review of compliance with this requirement in annual report reviews and during risk-based reviews.

GAO RECOMMENDATION 3:

> To help ensure that CDCs with ALP authority are taking the necessary steps to determine whether there has been no adverse change to borrowers' financial condition prior to loan closing, we recommend that the SBA Administrator include oversight of CDCs' compliance with this requirement in the agency's process for renewing ALP authority.

SBA RESPONSE:

SBA generally agrees with GAO's recommendation. SBA will consider ways to implement review of compliance with this requirement during ALP renewals as well as the general risk-based review process.

We are attaching additional technical correction comments to this letter.

The SBA is committed to strengthening oversight of CDCs to achieve the goals of the 504 Program. We appreciate the opportunity to provide these comments to you, and we look forward to answering any questions you may have. If you require additional information, please contact Shawn McKeehan, SBA GAO Liaison, at (202) 205-7729.

Sincerely,

Ann Marie Mehlum
Associate Administrator
Office of Capital Access

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Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

William B. Shear, (202) 512-8678 or shearw@gao.gov

Staff Acknowledgments

In addition to the contact above, Andrea (Paige) Smith (Assistant Director), Allison Abrams, Benjamin Bolitzer, Pamela Davidson, Rachel DeMarcus, Yola Lewis, Daniel McKenna, Marc Molino, Patricia Moye, and Jennifer Schwartz made key contributions to this report.

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