Management Advisory
Report No. 16-23

DATE: September 30, 2016

TO: Maria Contreras-Sweet
Administrator

Ann Marie Mehlum
Associate Administrator, Office of Capital Access

FROM: Troy M. Meyer /s/
Assistant Inspector General for Audit

SUBJECT: *Audit of SBA's 504 Loan Liquidation Process*

This management advisory presents the results of our audit of the Small Business Administration's (SBA) 504 loan liquidation process. The objectives of our audit were to determine the extent to which SBA (1) effectively managed and monitored the 504 liquidation portfolio and (2) maximized recovery when liquidating 504 loans. We previously furnished copies of the draft advisory and requested written comments on the recommendations. SBA management's comments are appended and were considered in finalizing the advisory.

The report contains two recommendations that SBA agreed to implement. Please provide us within 90 days your progress in implementing the recommendations.

Background

The Small Business Administration (SBA) is authorized under Title V of the Small Business Investment Act of 1958 to provide financial assistance to small businesses in the form of Government-guaranteed loans. SBA's 504 Certified Development Company (CDC) Loan Program provides small businesses with long-term, fixed-rate financing for the purchase of land, buildings, machinery, and other fixed assets. Economic development organizations, approved by SBA, are known as CDCs. CDCs package, close, and service these loans, which are funded through a variety of funds from private sector lenders, proceeds from selling SBA-guaranteed debentures, and borrower equity investment. Of the total project costs, a third-party lender must provide at least 50 percent of the financing, while the CDC provides up to 40 percent of the financing through a 100 percent SBA-guaranteed debenture, and the applicant provides at least 10 percent of the financing. In fiscal year (FY) 2015, SBA guaranteed approximately $4.3 billion in 504 loan approvals.

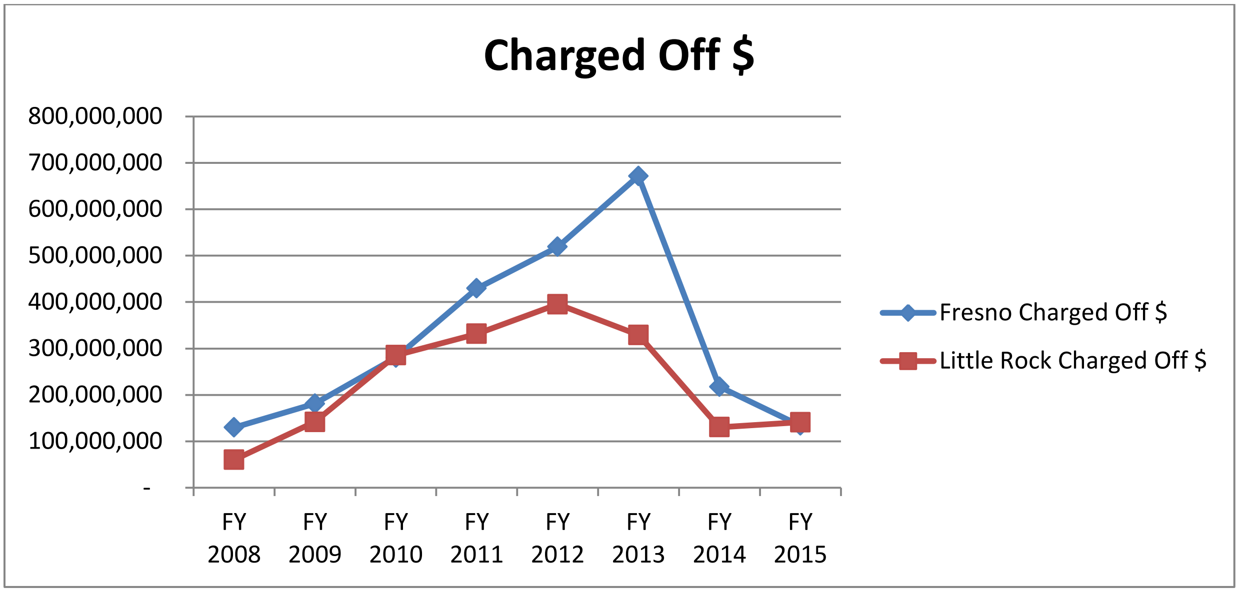
SBA approves the majority of 504 loans; therefore, SBA is responsible for conducting the liquidation for the loans in the event of default.[1] SBA's Fresno and Little Rock Commercial Loan Service Centers (CLSC) are responsible for managing 504 loan liquidation operations.[2] Some of the primary liquidation actions taken by SBA include (1) liquidation plan review, (2) approving or actively conducting the sale or release of collateral, (3) approving offers in compromise, (4) evaluating the expenses associated to the care and preservation of collateral (CPC), (5) evaluating protective bids, (6) reviewing wrap up reports (preparation for charge off), and (7) charge off/referral to the Department of the Treasury.[3,4]

A loan is placed into liquidation status when an adverse event occurs that could materially affect the borrower's ability to repay the loan or result in dissipation or deterioration of collateral. In some cases, SBA delegates to CDCs the authority to liquidate the assets securing 504 loans. For authorized CDC liquidators (ACL) and liquidations serviced by the Premier Certified Lender Program (PCLP), the CDC is responsible for preparing and sending a "wrap-up" report to SBA for review. The wrap-up report usually recommends charging off the loan balance, includes a statement on whether SBA should refer the loan to the Department of the Treasury for any further collection, and details any final actions the CDC is planning to take such as placing a lien on guarantor-encumbered assets.[5] SBA loan centers are primarily responsible for liquidating the 504 loans that do not fall under the liquidation authority of PCLP CDCs and ACLs.

Delinquency rates for all SBA business loan programs reached their peaks in the latter part of 2009, coinciding with the economic downturn. Delinquency rates, resulting from borrowers who are late on their payments, are a leading indicator of the Agency's charge-off rate. From 2008 to 2013, annual charge-offs of 504 loans significantly increased from $200 million to more than $1 billion dollars. Given the significant increase, there were concerns that if SBA was not properly or efficiently liquidating 504 loans, the Agency may be at a higher risk of loss due to insufficient recoveries. Although there was a significant increase in charged-off dollars between 2008 and 2013, there has been a sharp decline in charge-offs at the Fresno and Little Rock CLSCs in recent years. Specifically, in FY 2013, charge-offs completed at both centers exceeded $1 billion. In FY 2014 charge-offs completed at both centers had been reduced to $347 million, representing a 65 percent decrease. (See Figure 1 for a representation of the decline in charge-offs between FY 2013 and FY 2015.)

[1] Liquidation is the conversion of the assets of a firm into cash, often just before the firm goes out of business. The result of the liquidation process is settling the affairs of a business by disposing of its assets and liabilities.
[2] In February 2007, SBA consolidated the responsibility for managing 504 loan liquidation from its district offices to its Fresno and Little Rock CLSC. This transfer of responsibility to the CLSC's was intended to reduce staffing and unit costs to liquidate the loans and to ensure nationwide consistency in applying SBA's liquidation policies and procedures.
[3] A protective bid is an offer made by a secured creditor to pay a designated price for property at a foreclosure sale to protect the secured creditor's interest in the property that might otherwise be eliminated by the foreclosure sale.
[4] An offer in compromise is an offer made by an obligor to pay less than what is owed in full settlement of the debt obligation on a loan.
[5] Charge-off is an SBA administrative action whereby a loan is moved from liquidation status to charged-off status. It has no impact on the obligors' liability for the loan balance.

Figure 1: Charged-Off 504 Loan Volume FY2008-FY2015



Source: OIG analysis of SBA charge-off data

Prior Work

In our report, *SBA Serviced Liquidation of Certified Development Company Loans* (OIG Report No. 9-11, March 30, 2009), we examined 95 loans that were purchased on or before July 29, 2007. We determined that SBA did not maximize opportunities to recover $12.7 million in outstanding loan balances on 30 out of 95 loans we reviewed. Additionally, SBA missed collection opportunities because it did not fully execute actions in all key areas of the liquidation process, most notably protective bid analysis, compromises, and charge-offs. Our report also noted that 10 out of 95 loans reviewed had been in liquidation for over 18 months. Additionally, our report underscored the continued need for SBA to ensure its liquidation actions are conducted in a timely manner, as assets are subject to dissipation, devaluation, or diversion the longer they are allowed to sit in inventory. In response to our audit SBA performed a quality review of the 504 liquidation process and determined that process improvements had been implemented.

Another 2009 OIG audit, *Audit of the Liquidation Process at the National Guaranty Purchase Center* (OIG Report No. 9-08, January 30, 2009), found that when purchase or charge-off deficiencies were noted, the center did not always take appropriate action to mitigate its losses. Additionally, the report stated that loans in liquidation status were not properly managed because the center focused most of its resources on purchase activities, as it was insufficiently staffed and under pressure by lenders to expediently pay guarantees. The report detailed the types of deficiencies noted, including (1) unsupported sales of collateral, (2) inappropriate repair decisions regarding collateral, (3) unsupported care and preservation of collateral (CPC) expenses, and (4) acceptance of inadequate offers in compromise. An additional concern was raised about the effectiveness of SBA's controls to ensure outstanding money from liquidation owed to SBA on older loans that lenders had not remitted. In response to our audit, SBA completed a planned reorganization of the Office of Capital Access and implemented a Center Quality Program. Further, SBA pursued recovery from lenders of approximately $2.7 million in questioned costs we identified. SBA also clarified Standard Operating Procedures (SOPs) over SBA loan liquidation, enhanced its loan portfolio management systems and began performing routine liquidation status reviews of defaulted loans.

Objectives

Our objectives were to determine the extent to which SBA (1) effectively managed and monitored the 504 liquidation portfolio and (2) maximized recovery when liquidating 504 loans. (See Appendix I for additional information regarding our scope and methodology.)

Results

As 504 loan liquidation activity had largely stabilized in recent years, we focused our audit on FYs 2015 and 2016 to assess the effectiveness of current operations. We performed a series of audit tests to evaluate the current 504 loan liquidation control environment, including assessing procedural guidance, interviewing SBA officials, examining SBA data and reports, and reviewing a judgmental sample of 14 high risk 504 loan liquidations. Based on our results, we believe management and monitoring of the 504 liquidation portfolio at the CLSCs during FYs 2015 and 2016 was effective. Additionally, SBA CLSCs generally maximized recovery when liquidating the 504 loans we reviewed. While SBA had established effective policies and procedures and had experienced staff managing its current 504 loan liquidation operations, we provide two recommendations that if implemented, would improve SBA's internal controls over servicing and liquidating 504 loans.

Training Plans at the Commercial Loan Servicing Centers

The Fresno CLSC had not developed a formal training plan for staff in accordance with established goals and procedures. Specifically, 1 month after our request for its FY 2016 training plan, Fresno CLSC management emailed center team leads a list of training that would be provided during FY 2016. Although center management recognized the importance of a formal training program, this correspondence supported that a training plan for FY2016 had not been established prior to our request. Further, the provided training schedule established six scheduled sessions of training, with one session designated for 504 loan liquidation "hot topics." The specific topics to be covered were not included, and Fresno CLSC management noted that materials for the planned training had not been prepared at the time of our request. In contrast, the Little Rock CLSC's FY 2016 training plan included training courses specific to 504 loan liquidation areas including offers in compromise, administrative wage garnishments, and protective bids.

We also confirmed that the Fresno CLSC had not developed a FY 2015 staff training plan. Based on interviews with SBA officials, a formalized training plan was not developed due to the conflicting priorities of center management and the loss of key staff. While a formal training plan had not been developed, a series of trainings occurred during the fourth quarter of FY 2015. Center management also noted that while a significant portion of their 504 liquidation team was eligible for retirement, they had procedures in place that would at least diminish the impact of retiring employees, such as the rotation of team leads and the cross-training of center employees.

We surveyed all 21 of the CLSC 504 liquidation team employees in part to determine their perspective on both the quantity and quality of the training provided at the centers.[6] Based on the results of this survey, 39 percent of the respondents did not feel the centers provided adequate training. Specifically, 7 of the 18 respondents stated that they either "disagreed" or "strongly disagreed" that training was sufficient. We note that this represented one of the highest unfavorable response rates of all surveyed topics.

[6] The internal control survey included questions on training, ethics, integrity, competency, resources, communication, and the organizational structure at the CLSCs.

The CLSC directors, according to their position descriptions, must develop a comprehensive training program for the entire CLSC staff to assure career development of assigned personnel. Further, while the FY 2016 CLSC strategic plan included specific training goals, objectives, measures, and initiatives it did not appear that these objectives had been achieved. (See Table 1 below.)

Table 1: CLSC Strategic Plan

Goals (Overall or Performance)	Objectives	Measures	Initiatives
Fully Engaged and Trained Employees	Develop training calendar based on staff input, supervisor needs assessment, and HQ directives.	Training calendar	Training assigned through Talent Management Center. Training programs presented by the Center
Quality Products and Services	Implement updated SOPs center wide to promote staff knowledge.	SOP training	Staff engaged in SOP rewrites.

Source: CLSC FY 2016 Strategic Plan

Internal control standards for Government agencies also state management should ensure that skill needs are continually assessed and that the organization is able to obtain a workforce that has the required skills that match those necessary to achieve organizational goals.[7] Training should be aimed at developing and retaining employee skill levels to meet changing organizational needs.

SBA has established clear standards that managers should follow regarding the provision of adequate training to their employees. However, the Fresno CLSC was not providing adequate training to its 504 loan liquidation personnel to ensure they maintained required skills. In the face of likely turnover due to a large number of retirement eligible employees, the lack of a formalized training program could represent a significant barrier for new or inexperienced employees to effectively liquidate 504 loans, maximize recoveries and reduce loan losses.

Commercial Loan Servicing Center Systems and Procedures

Components of the information systems used by each center were developed independently and were not utilized uniformly. For example, the Little Rock CLSC developed the Service Center Electronic Process Tracking and Reporting (SCEPTAR) interface, which is used to provide electronic process flow tracking and reporting tools to center management and staff. The Fresno CLSC chose not to implement the SCEPTAR interface. Additionally, we noted that the Fresno CLSC developed a portfolio management tool and loan follow-up and reminder system called Pegasus, which was not implemented by the Little Rock CLSC.

[7] GAO Publication AIMD-00-21.3.1, Standards for Internal Control in the Federal Government, (November 1999).

We also determined that the internal policies and procedures for liquidating 504 loans were unique to and applied inconsistently at the centers. Specifically, each center had developed its own manual to guide workforce operations. For example, the Little Rock CLSC's operations manual required that three payments be made after a loan payment workout had been agreed to before returning the loan to regular servicing; however, the Fresno CLSC's manual did not have this requirement.[8]

In addition, when documenting the procedures for processing a short sale, the Fresno operations manual contained significantly more detail regarding the information that the reviewer should consider before approval.[9] The Fresno CLSC documentation directed reviewers to verify what was being sold, the proposed sales price, and determine whether the sale price is reasonable based on the fair market value. In contrast, the Little Rock CLSC documentation only noted that a reviewer should obtain a copy of the signed short sale agreement without providing direction on how to analyze the agreement.

When discussing these inconsistencies with CLSC officials, they noted that both centers had unique processes. Additionally, they stated their belief that aligning the process at both centers would result in less creative solutions. According to Agency documents, however, the reason 504 loan liquidation operations were consolidated to its Fresno and Little Rock CLSC was to streamline and simplify policies and procedures to ensure efficiency and nationwide consistency. Further, we determined that the centers' overall structure was the reason for the inconsistencies of operations. These centers operated independently, under the direction of separate management, without responsibility to report to each other or regularly coordinate. Without consistent implementation and application of policies and procedures over the 504 loan liquidation process, the CLSCs' effectiveness in liquidating 504 loans could result in loss to the Agency. Further, in the event of significant turnover or workload fluctuation at a given center, differences in operations could impact the Agency's ability to effectively reallocate resources to meet demand.

Recommendations

We recommend that the Office of Financial Program Operations (OFPO):

1. Develop and implement a comprehensive training plan that ensures continuity of expertise and maximized recoveries for SBA 504 loan liquidation activities.

2. Conduct a review of CLSC internal guidance, systems, and practices to ensure that 504 loans are liquidated consistently nationwide.

Summary of Actions Necessary to Close the Report

SBA management provided formal comments that are included in their entirety in Appendix II. The following provides the status of each recommendation and the necessary actions to close the report.

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[8] The term "workout" refers to the debt collection and negotiation process as well as the final plan agreed upon by a creditor and a debtor with regard to how the debtor's delinquent obligation to the creditor can be "worked out" (i.e., resolved).

[9] A short sale is a sale of real property by the owner in which the proceeds from the sale of the property fall short of the balance of the debts secured by liens against the property. Because the owner cannot afford to repay the full amount of the secured debt, the secured creditors agree to release their liens on the real property for less than the total amount due.

1. **Resolved.** OFPO concurred with our recommendation and plans to develop and implement a comprehensive training plan for the CLSCs. This recommendation can be closed upon OFPO providing evidence that the training plan has been developed and implemented.

2. **Resolved.** OFPO concurred with our recommendation and plans to conduct a review of CLSC internal guidance, systems, and practices to ensure 504 loans are liquidated consistently by our CLSCs. This recommendation can be closed when OFPO demonstrates that its CLSC internal guidance, systems, and practices are aligned to ensure that 504 loans are liquidated consistently nationwide.

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Please contact us if you would like to discuss this memorandum or any related issues.

cc: Nicolas Maduros, Chief of Staff
Melvin F. Williams, Jr., General Counsel
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Tami Perriello, Associate Administrator for Performance Management and Chief Financial Officer
LaNae Twite, Director, Office of Internal Controls

Appendix I: Scope and Methodology

Our objectives were to determine the extent to which SBA (1) effectively managed and monitored the 504 liquidation portfolio and (2) maximized recovery when liquidating 504 loans.

To answer our objectives, we reviewed the Small Business Investment Act of 1958 and CFR Title 13. In addition, we reviewed SBA's SOPs including SOP 50 55 and SOP 50 51 3. We also reviewed internal guidance, strategic plans, management reports, and other documentation to gain an understanding of the SBA 504 Loan Program. Further, we obtained and reviewed SBA data on loans charged off from October 1, 2007 through September 31, 2015. We also conducted trend analysis on the charge-off data provided by the Agency to determine whether 504 liquidation volume, recovery rates, and liquidation timeframes had significantly changed over the last 5 years. Based on our analyses, we focused our audit test work on FYs 2015 and 2016 liquidation activity.

We interviewed Agency officials to gain an understanding of SBA's 504 loan liquidation process and internal controls used in that process. Additionally, we developed, distributed, and subsequently analyzed responses from an internal control questionnaire given to employees involved in the 504 loan liquidation process. We reviewed training plans at the CLSCs to determine if training adequately provided the necessary skills for employees reviewing 504 loan liquidation actions. We evaluated CLSC quality control reports to identify liquidation actions that had a higher risk for error. We also reviewed a judgmental sample of high risk loan liquidation actions on 14 loans that were charged off in FY 2015 to determine their appropriateness.

We conducted this performance audit 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.

Use of Computer-Processed Data

We relied on 504 loan servicing and performance information provided by SBA's Office of Portfolio Systems Management. This information is used by SBA's Office of Capital Access to evaluate SBA's 504 Loan Program performance. We also relied on 504 portfolio information provided from each of the CLSCs. We conducted reliability tests on the data provided by SBA officials. For example, we verified that the data was within the scope of our requests and did not include critical data errors such as incorrect loan numbers. In addition, we compared SBA program office data to that of the CLSCs' for completeness and did not identify any significant differences. We tested the data provided by SBA against source documents for a judgmental set of loans and found no errors. As a result, we believe the information was generally reliable, as presented in this audit report.

Review of Internal Controls

SBA's internal control systems SOP provides guidance on implementing and maintaining effective internal control systems, as required by OMB Circular A-123.[10] OMB Circular A-123 provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls.[11]

To assess internal controls during the audit, we assessed the control environment in which SBA managed the liquidation of 504 loans. To perform our assessment, we interviewed CLSC management and officials responsible for liquidating 504 loans. Additionally, we administered an internal control survey to CLSC employees responsible for liquidating 504 loans. We also assessed internal controls by reviewing SBA internal guidance, policies and procedures, and through reviewing liquidation actions on 504 loans. Overall, we found that internal controls were operating effectively. However, we identified two areas that if improved, would strengthen the control environment.

Nature of Limited or Omitted Information

No information was omitted due to confidentiality or sensitivity, nor were there limitations to information on this audit.

[10] SOP 00 02, *Internal Control Systems* (January 1986).
[11] OMB Circular A-123, Management's Responsibility for Internal Control (December 21, 2004).

Appendix II: Agency Response

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

MEMORANDUM
September 23, 2016

To: Troy M Meyer
Assistant Inspector General for Auditing

From: Jihoon Kim
Acting Director, Office of Financial Program Operations

Subject: Response to Draft Report 15014 Audit of SBA's 504 Loan Liquidation Process

We appreciate the role the Office of Inspector General (OIG) plays in working with management in ensuring that our programs are effectively managed, and for the feedback provided in this draft report.

The Small Business Administration (SBA) strives to ensure proper liquidation processes consistent with SBA's regulations and policies. The Office of Financial Program Operations (OFPO) takes great pride in its continuous improvement efforts at the Fresno and Little Rock Commercial Loan Service Centers (CLSC) and is always looking for ways to improve the effectiveness of the 504 loan liquidation process. SBA also recognizes the importance training plays in ensuring its employees possess the knowledge and skills required to properly liquidate 504 loans and works diligently to ensure it provides quality training for their continued improvement.

The OIG references an audit which they conducted in 2009. It should be noted for this audit over half of the loans reviewed were purchased prior to centralization of 504 liquidation. Before the centralization, 504 loans were liquidated in 74 district offices. Both Fresno and Little Rock have made great strides in standardization and consistency since we centralized the process in 2006.

OFPO takes training very seriously and agrees with OIG's recommendation to develop and implement a comprehensive training plan. It is also important to note that OFPO utilized numerous methods to maximize the skills of our loan specialists during this audit period. Training sessions conducted during this time include: 504 SOP 50 55 training, Servicing and all topics associated with 504 loan liquidation and maximization of recovery. The Center Directors for both Fresno and Little Rock ensure that the training needs of employees are met.

Management's responses to the recommendations in the draft report are noted below:

1. ***Develop and implement a comprehensive training plan that ensures continuity of expertise and maximized recoveries for SBA 504 liquidation activities.***

   OFPO agrees to develop and implement a comprehensive training plan for our CLSCs. We will provide follow-up documentation of our findings.

2. ***Conduct a review of CLSC internal guidance, systems, and practices, to ensure 504 loans are liquidated consistently nationwide.***

   OFPO agrees to conduct a review of CLSC internal guidance, systems, and practices, to ensure 504 loans are liquidated consistently by our CLSCs. We will provide OIG with our review results.