AUDIT REPORT

AUDIT OF SBA'S CONTROLS OVER 7(A) LOANS SOLD ON THE SECONDARY MARKET

MARCH 14, 2019 REPORT NUMBER 19-07

EXECUTIVE SUMMARY

AUDIT OF SBA'S CONTROLS OVER 7(A) LOANS SOLD ON THE SECONDARY MARKET

Report No. 19-07

March 14, 2019

What OIG Reviewed

This report presents the results of our audit of the Small Business Administration's (SBA's) controls over loans sold on the secondary market. The SBA secondary market program allows lenders to sell the guaranteed portions of their SBA 7(a) loans to private investors at a premium to provide expanded availability to capital for small businesses. The fiscal transfer agent (FTA) for 7(a) loans that is contracted by SBA facilitates the sale process and is responsible for various other functions regarding the secondary market. Between fiscal years 2013 and 2017, approximately 59,000 7(a) loans were approved, disbursed, and sold on the secondary market, totaling $45 billion.

Our objectives were to determine the effectiveness of SBA's (1) controls to ensure that quality loans were sold into the secondary market and (2) review process to determine lender compliance with program requirements on loans purchased off the secondary market.

To answer our objectives, we interviewed SBA and FTA officials to gain an understanding of the secondary market and their specific roles and responsibilities. Through those interviews and reviews of randomly selected loans, we also gained an understanding of the controls implemented to mitigate the risk of noncompliant loans being sold on the secondary market and to ensure that lenders complied with SBA loan program requirements for defaulted loans purchased off the secondary market.

Our overall scope of work covered fiscal years 2013 through 2017. However, based on our analysis and controls recently implemented by SBA, we limited our sample selections to specific periods within that scope. Specifically, our random samples included 7(a) loans covering a period between August 2015 and December 2017.

What OIG Found

We determined that internal controls related to the sale of loans into the secondary market and SBA's reviews for lender compliance on defaulted loans were generally effective. However, opportunities exist to strengthen controls to further mitigate the risk of loss for loans sold on the secondary market. Specifically, we found that the Office of Credit Risk Management (OCRM) did not communicate the results of their secondary market loan sale reviews to the National Guaranty Purchase Center and the Commercial Loan Servicing Centers. Also, SBA did not always provide statutory reports to Congress timely, and SBA's lender guidance for the secondary market was outdated. Lastly, SBA did not properly determine lender compliance with loan program requirements for one of the loans reviewed.

As a result, there is a risk that SBA could improperly purchase secondary market loans that OCRM identified as having material noncompliance with SBA requirements. Additionally, Congress may not have the necessary information to make informed decisions regarding SBA's secondary market operations, and new lenders may not have consistent and updated guidance to ensure compliance with SBA requirements. Finally, by charging off an ineligible loan, SBA incurred a loss of $130,173.

OIG Recommendations

We made five recommendations that, if implemented, will strengthen SBA's internal controls, enhance external communication, and seek recovery of funds on an ineligible loan that was charged off.

Agency Response

Management agreed with the report findings and all recommendations. Management stated they will communicate material loan deficiencies to the appropriate loan centers via the loan system, for both previously identified and future issues. Management also stated they established a process to ensure timely submission of secondary market annual reports, and they are currently updating the Secondary Market Program Guide. Finally, regarding the ineligible loan, management stated they will work with the lender to bring the loan into compliance; if the issues are not overcome, SBA will seek recovery.

U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

Final Report Transmittal
Report Number: 19-07

DATE: March 14, 2019

TO: Linda E. McMahon
Administrator

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: Audit of SBA's Controls Over 7(a) Loans Sold on the Secondary Market

This report presents the results of our audit of the Small Business Administration's (SBA's) controls over 7(a) loans sold on the secondary market. Our objectives were to determine the effectiveness of SBA's (1) controls to ensure that quality loans were sold into the secondary market and (2) review process to determine lender compliance with program requirements on loans purchased off the secondary market.

We considered management's comments on the draft of this report when preparing the final report. Management agreed with the findings and all recommendations.

We appreciate the courtesies and cooperation extended to us during this audit. If you have any questions, please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616.

cc: Pradeep Belur, Chief of Staff
Christopher M. Pilkerton, General Counsel
William Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Dianna Seaborn, Director, Office of Financial Assistance
Jihoon Kim, Director, Office of Financial Program Operations
Susan Streich, Director, Office of Credit Risk Management
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Timothy E. Gribben, Chief Financial Officer and Associate Administrator for Performance Management
LaNae Twite, Director, Office of Internal Controls

Table of Contents

Introduction

The Secondary Market for Small Business Administration 7(a) Loans

The Small Business Administration's (SBA's) 7(a) loan program provides small businesses access to capital. SBA guarantees up to 90 percent for loans up to $5 million on private lender loans to eligible small businesses. In the event that a borrower defaults, SBA will honor its guaranty if it determines that the lender originated, closed, serviced, and liquidated the loan in accordance with SBA's loan program requirements.

The secondary market was established to provide greater liquidity to lenders, and thereby expand the availability of commercial credit for small businesses. Lenders are allowed to sell the guaranteed portions of their loans in the secondary market. The lender receives cash equal to the amount of the guaranteed portion sold plus a market driven premium, while the investor gets an interest earning security that is backed by the full faith and credit of the U.S. government. In fiscal year (FY) 2016, approximately 64 percent of guaranteed loan dollars on the secondary market were sold at a premium of at least 10 percent over par.

If a lender chooses to sell a loan on the secondary market, it enters into an agreement with the fiscal transfer agent (FTA), the investor, and SBA. Once the sale has been finalized, the lender maintains responsibility for servicing the loan in accordance with SBA loan program requirements. The FTA is responsible for facilitating the sale of the loan to the investor, accounting for borrower payments, and assisting with guaranty purchase if the loan defaults.

Secondary Market Portfolio Characteristics

Between FY 2013 and FY 2017, approximately 59,000 7(a) loans were approved, disbursed, and sold on the secondary market, totaling $45 billion, which represented 48 percent of the total $93 billion in disbursed 7(a) loans. The average loan amount for loans sold on the secondary market exceeded $760,000, which was nearly three times the average amount of $270,000 for non-secondary market loans.

The total dollar outlays for secondary market purchases were 134 percent higher than non-secondary market purchases between FY 2013 and FY 2017. Specifically, total dollar outlays for defaulted loans purchased on the secondary market from FY 2013 through FY 2017 totaled approximately $552 million. For the same period, defaulted loans not sold on the secondary market totaled approximately $236 million.

The average loan amount and total dollar outlays for secondary market purchases exceed those of non-secondary market loans. Based on the size, on a per loan basis, loans sold on the secondary market would generally present greater risk to taxpayers.

SBA Controls Over Loans Prior to Sale on the Secondary Market

Before a loan can be sold on the secondary market, the lender must submit the loan to the FTA for approval. SBA has established a risk-based review process to determine whether loans are eligible to be sold. Loans submitted for sale approval are reviewed by the FTA via the SBA Form 1086.[1] On the form, the lender is required to certify that, among other things, it

1. underwrote, closed, and serviced the loan in a prudent manner and in accordance with all SBA loan program requirements;
2. will not share any premium it received from the sale with a lender service provider, packager, or other loan referral source;
3. fully disbursed the loan;
4. did not issue a revolving loan or line of credit; and
5. has no knowledge of a default or likelihood of a default by Borrower.

Once received from the lender, the FTA reviews the SBA Form 1086, note, and other documentation to ensure information contained in the loan package is consistent with SBA's loan origination information. This limited review ensures the loan meets the requirements to be sold on the secondary market.

For lenders under regulatory, state, or federal orders, SBA maintains a watch list. Lenders on this watch list may request for a loan to be sold on the secondary market through the FTA. However, due to the risk associated with these lenders, SBA's Office of Credit Risk Management (OCRM) conducts a detailed review of each loan to determine whether it complied with SBA requirements and is eligible for sale.

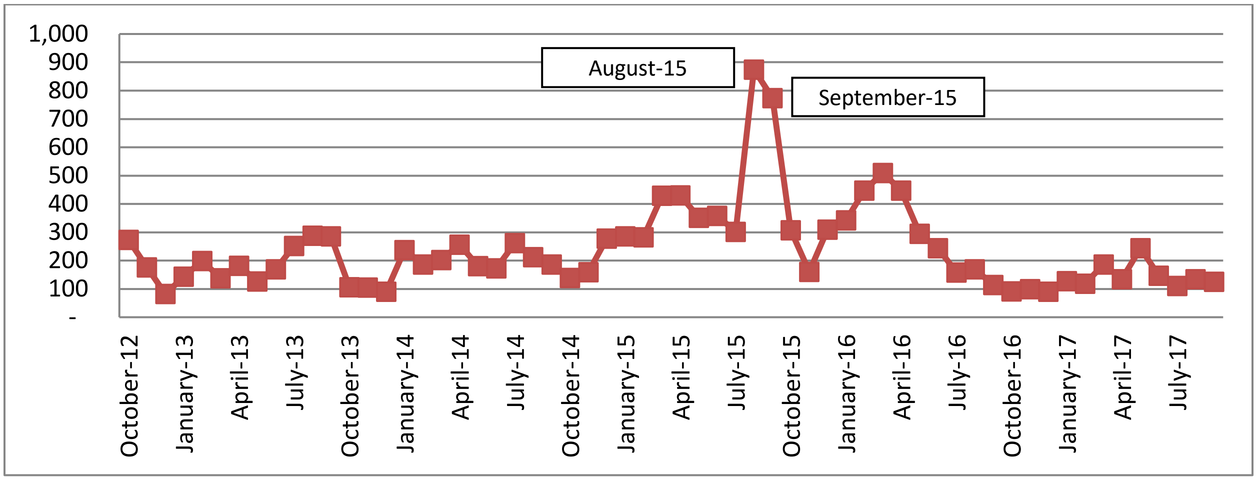
SBA's Role in Defaulted 7(a) Loans Sold on the Secondary Market

In the event that a borrower defaults, the lender may buy back the loan from the secondary market investor. If the lender does not buy back the loan, SBA will purchase the loan from the secondary market investor upon receipt of the required loan balance documentation. After SBA purchases a loan from the secondary market, SBA must conduct a purchase review to determine whether the lender complied with SBA loan program requirements. Once liquidation is complete, the lender is required to submit a final report to indicate that the loan is ready for charge-off and potential referral to the Treasury. Upon receipt of this documentation, SBA conducts the charge-off review to determine whether all avenues of recovery were exhausted.

In response to an increasing number of outstanding purchase and charge-off reviews in FY 2014, SBA initiated an inventory reduction project to reduce the outstanding number of purchase and charge-off reviews. Specifically, SBA's analysis indicated that the beginning inventory level was approximately 16,000 outstanding charge-offs. SBA anticipated that the inventory reduction project would decrease the inventory level by approximately 5,000 charge-offs within 18 months. SBA data showed that more than 1,600 loans were charged off in a 2-month period (between August and September 2015). See the figure below for a representation of the 2-month anomaly.

[1] SBA Form 1086 is a legally binding document, which includes the terms and conditions that govern the sale and all subsequent servicing of the loan sold, which must be executed by the lender, registered holder (or investor), FTA, and SBA.

Figure: Secondary Market Charge-Offs by Month (FY 2013–FY 2017)



Source: SBA mainframe data.

Prior Work

A 2017 OIG report on SBA's 2017 financial statements identified a significant deficiency related to prepaid principal that was to be distributed to pool investors by the FTA.[2] The audit found that the Secondary Market Guaranty program was not being executed in accordance with Federal Register changes from 2004. Specifically, the changes implemented in 2004 required the FTA to disburse any partial prepayments to the pool holders with the next scheduled payment. Previously, the FTA would have held the partial prepayment in the Master Reserve Fund and distribute the prepayment over the remaining life of the pool. OIG made and management agreed to the following two recommendations:

1. Enhance SBA's complementary controls regarding the Secondary Market Guaranty program and relevant processes at the FTA.

2. Monitor and perform procedures over service organization's attestation report regarding user control considerations.

Recommendation 1 has been closed; however, recommendation two remains open with a management action due date of September 2019.

Objectives

Our objectives were to determine the effectiveness of SBA's (1) controls to ensure that quality loans were sold into the secondary market and (2) review process to determine lender compliance with program requirements on loans purchased off the secondary market.

[2] OIG Report 18-03, Independent Auditors' Report on SBA's FY 2017 Financial Statements (November 14, 2017). The report defined a significant deficiency as a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Finding 1: Communication With SBA Loan Purchase Centers Could Prevent Improper Guaranty Purchases

Based on our testing, we determined that OCRM's review of loans sold on the secondary market was generally effective. Specifically, OCRM developed an extensive checklist and completed detailed reviews to determine whether loans were eligible for sale on the secondary market. Further, OCRM denied 13 secondary market loan sale requests as a result of their reviews from May 2017 to February 2018. Three of the denied loan sale requests were resubmitted with additional information and subsequently approved. Eight of the remaining 10 loans had deficiencies related to eligibility and closing. We believe these deficiencies represent issues that would warrant loan guaranty denial consideration, should the loan default. However, OCRM officials did not communicate their loan review results to the SBA loan centers responsible for guaranty purchases.

The Office of Management and Budget (OMB) establishes policies and procedures for justifying, designing, and managing federal credit programs. It also establishes principles for designing and improving program efficiency and effectiveness.[3] The Circular reads, "Departments and agencies shall manage credit programs… in accordance with their statutory authorities and the provisions of this Circular to protect the government's assets and to minimize losses in relation to social benefits provided." Additionally, the Circular reads that to achieve those objectives, agencies shall "[e]mploy robust diagnostic and reporting frameworks, including dashboards and watch lists, so that all levels of the organization receive appropriate information to inform proactive portfolio management."

OCRM's mission is to maximize the efficiency of SBA's lender programs by effectively managing program credit risk. As part of its mission, OCRM maintains a secondary market watch list for lenders that participate in SBA programs that are under a federal or state regulatory order. Once the lender is placed on the watch list, the FTA is notified. When a lender that is on the watch list requests for a loan to be sold on the secondary market, the FTA notifies OCRM. Subsequently, OCRM requests and reviews loan documents to ensure the loan was originated and closed in accordance with SBA loan program requirements.

Although OCRM established a watch list, and conducted secondary market loan sale reviews, they did not communicate the results of the reviews to the National Guaranty Purchase Center and Commercial Loan Servicing Centers to inform proactive portfolio management. This occurred because OCRM did not believe they needed to communicate the results, and they didn't have an established process for doing so. As a result, there is risk that loan centers could improperly purchase the guaranties on these loans.

During our followup discussions with OCRM officials, they indicated that they recently decided to implement a process to note OCRM review results in the Centralized Loan Chron System.[4] However, our subsequent review of the system determined that the deficiencies for the 10 denied loan sale requests we reviewed were not recorded in the system. Therefore, we do not consider the process implemented.

[3] OMB Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables (January 2013).
[4] The Centralized Loan Chron System provides a centralized repository for viewing and entering loan chron information.

Recommendations

We recommend that the Administrator direct the Director of the Office of Credit Risk Management to:

1. Communicate material loan deficiencies previously identified by OCRM secondary market loan sale reviews to the appropriate SBA loan purchase centers to mitigate the risk of improper guaranty purchases in the event of default.

2. Establish a process to ensure that pertinent review results from future OCRM secondary market loan reviews are communicated to the appropriate SBA loan centers.

Finding 2: Providing Timely Congressional Reports is Essential to Ensure Congress Has Vital Information for Its Decision Making

SBA did not provide the 2016 and 2017 congressionally mandated secondary market reports to Congress in a timely manner. Specifically, the responsible Office of Financial Assistance official stated they provided the 2016 and 2017 reports to congressional staff during the fall of 2017 and September 28, 2018, respectively. We noted that the 2017 report was provided approximately 6 months after the required due date. We could not determine the extent of the delay for the 2016 report because SBA did not provide the exact date they delivered the report to Congress. In addition, SBA did not provide the reports to Congress for calendar years 2013, 2014, and 2015, as required.

The Small Business Act requires SBA officials to submit a report on the secondary market operations for the preceding year to the Committees on Small Business of the Senate and House of Representatives by March 31 of each year.[5] The report must include the following:

1. number and the total dollar amount of loans sold into the secondary market and the distribution of such loans by size of loan, size of lender, geographic location of lender, interest rate, maturity, lender servicing fees, whether the rate is fixed or variable, and premium paid;
2. number and dollar amount of loans resold in the secondary market with a distribution by size of loan, interest rate, and premiums;
3. number and total dollar amount of pools formed;
4. number and total dollar amount of loans in each pool;
5. dollar amount, interest rate, and terms on each loan in each pool, and whether the rate is fixed or variable;
6. number, face value, interest rate, and terms of the trust certificates issued for each pool;
7. use by the lender of the proceeds of sales of loans in the secondary market for additional lending to small business concerns (to the maximum extent possible); and
8. analysis of the information reported in (1) through (7) to assess small businesses' access to capital at reasonable rates and terms as a result of secondary market operations.

The SBA official stated the reports were not prepared and provided due to staffing issues. The secondary market annual reports provide Congress vital information needed to establish baseline statistics for the secondary market. SBA's noncompliance in providing these reports as required could negatively affect Congress' ability to make informed decisions regarding SBA's secondary market, such as whether any changes are necessary to the established cap for secondary market loan sales.

Recommendation

We recommend that the Administrator direct the Director of the Office of Financial Assistance to:

3. Establish and implement controls to ensure secondary market annual reports are provided to Congress in a timely manner, as required.

[5] 15 U.S.C 639(h), Small Business Act.

Finding 3: Consistent Program Guidance Could Safeguard Program Integrity

SBA standard operating procedure provides high-level information on the secondary market and directs lenders that need additional program guidance, such as those new to selling on the secondary market, to visit the FTA website. The FTA website includes the SBA Form 1086, bid sheets, and prepayment certifications. One of the key documents provided to lenders to detail the secondary market loan sale process is the Secondary Market Program Guide. However, SBA has not updated this guide since it was created in August 1985. While SBA made a number of necessary changes to standard operating procedures and lender notices since the guide was issued, program management indicated that the recent changes need to be incorporated into the guide. SBA management indicated that they anticipated completing and releasing an updated guide in FY 2019.

Internal control serves as the first line of defense in safeguarding assets and helps an entity run its operations efficiently and effectively. Internal controls also help an entity comply with applicable laws and regulations. Effective internal controls include management communicating necessary quality information to achieve the entity's objectives both internally and externally.[6]

SBA did not prioritize updating the guide to ensure consistency with the updated requirements. Without communicating consistent and updated information, SBA cannot ensure that its newer lending partners have clear information to consistently comply with appropriate laws and regulations.

Recommendation

We recommend that the Administrator direct the Director of the Office of Financial Assistance to:

4. Update secondary market guidance to ensure that it aligns with current secondary market requirements.

[6] Standards for Internal Control in the Federal Government (September 2014).

Finding 4: SBA's Improper Review of a Loan Resulted in a Loss of $130,173

After SBA purchases a loan from the secondary market, SBA must conduct a purchase review to determine whether the lender complied with SBA loan program requirements. Once liquidation is complete, the lender is required to submit a final wrapup report to indicate that the loan is ready for charge-off and potential referral to the Treasury. Upon receipt of this documentation, SBA conducts the charge-off review to determine whether all avenues of recovery were exhausted. Our analysis of SBA data showed that more than 1,600 loans were charged off in a 2-month period (between August and September 2015). Because of this anomaly, we selected a random sample of 20 loans that SBA completed charge-off reviews for during this timeframe.

Based on our reviews, we determined that SBA personnel adequately conducted charge-off reviews for 19 of 20 loans. Specifically, the reviews contained documentation to support that SBA completed the reviews, as required, and any identified issues were adequately resolved prior to charge-off. However, SBA did not resolve an eligibility issue prior to charging off the remaining loan. The loan was approved for $410,000. SBA honored the guaranty on the loan for $275,736, and SBA subsequently charged off $130,173, which was a reduced amount due to other recoveries.

The initial legal reviewer identified that the loan had an eligibility deficiency. Due to the identified deficiency, the loan was required to have a secondary legal review; however, the legal reviewer did not address the eligibility deficiency. The approver documented that the initial legal reviewer identified the eligibility deficiency but still closed the review. The charge-off reviewers did not identify any outstanding issues and subsequently charged off the loan. In subsequent correspondence, SBA officials indicated that they had determined the loan was ineligible, and they planned to act accordingly.

An SBA official stated that the issue was not properly addressed because the legal reviewer completed the wrong section of the purchase review, which resulted in an improper interpretation of the legal reviewer's decision by the approving official. Because SBA did not properly determine lender compliance with loan program requirements, SBA incurred a loss of $130,173 on the loan guaranty.

Recommendation

We recommend that the Administrator direct the Director of the Office of Financial Program Operations to:

5. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $130,173 on the guaranty paid by SBA.

Analysis of Agency Response

Management agreed with the findings and all recommendations. Regarding recommendations 1 and 2, management stated they will communicate material loan deficiencies to the appropriate loan centers via the loan system, for both previously identified and future issues. They also will establish a process to ensure the future issues are communicated. In subsequent correspondence, management stated they implemented these actions on February 28, 2019.

Management also stated it established a process to ensure timely submission of the secondary market annual reports to Congress by March 31, 2019. They are currently updating the Secondary Market Program Guide, which will be completed by December 31, 2019. Lastly, management is working with the lender to bring the ineligible loan into compliance. If the issues are not overcome, SBA will seek recovery. In subsequent correspondence, management stated they will implement this action by January 31, 2020.

The Agency's response is included in its entirety in appendix III.

Summary of Actions Necessary to Close the Recommendations

The following provides the status of the recommendations and necessary actions to close them.

1. **Resolved.** SBA management agreed with our recommendation and plans to communicate material loan deficiencies previously identified in the secondary market loan sale reviews to the SBA loan purchase centers via comments in the loan system. This recommendation can be closed when management provides evidence that the identified material loan deficiencies are documented in the loan system.

2. **Resolved.** SBA management agreed with our recommendation and plans to establish a process to ensure that pertinent results from future secondary market loan reviews are communicated via comments in the loan system to the appropriate loan centers. This recommendation can be closed when management provides evidence that the process is established and the results are communicated to the appropriate loan centers.

3. **Resolved.** SBA management agreed with our recommendation and stated they established a process to ensure timely submission of secondary market annual reports to Congress. In subsequent correspondence, management stated they will implement this action by March 31, 2019. This recommendation can be closed when management provides evidence that the process is established and the reports are submitted timely, as required.

4. **Resolved.** SBA management agreed with our recommendation and plans to update the Secondary Market Program Guide by December 31, 2019. This recommendation can be closed when management provides a copy of the updated guide and evidence that the guide is available to appropriate SBA personnel and lenders.

5. **Resolved.** SBA management agreed with our recommendation and plans to work with the lender to bring the loan into compliance. If the issues are not overcome, SBA will seek recovery by January 31, 2020.

Appendix I: Objective, Scope, and Methodology

This report presents the results of our audit of SBA's controls over loans sold on the secondary market. Our objectives were to determine the effectiveness of SBA's (1) controls to ensure that quality loans were sold into the secondary market and (2) review process to determine lender compliance with program requirements on loans purchased off the secondary market.

To accomplish our objectives, we reviewed Section 7(a) of the Small Business Act, CFR Title 13, and OMB Circular A-129.[7] In addition, we reviewed various versions of SBA's standard operating procedures, informational notices, and procedural notices for policies and procedures related to the secondary market. Additionally, we reviewed secondary market guidance and documentation to gain an understanding of the internal controls in place. Further, we met with SBA officials to gain an understanding of SBA's role in the secondary market. We interviewed officials from the FTA to gain an understanding of the FTA's role in the secondary market, and we conducted numerous analyses related to loans sold on the secondary market. Our scope of work covered fiscal years 2013 through 2017.

SBA data showed that more than 1,600 loans were charged off in a 2-month period (between August and September 2015). Based on this anomaly, we selected and reviewed a random sample of 20 loans that were charged off in this timeframe. We did not perform extensive OIG loan file reviews; instead, we reviewed the charge-offs to determine whether SBA completed reviews, as required, and whether identified issues were resolved prior to charge-off. We also selected and reviewed a random sample of 10 OCRM secondary market loan sale reviews completed on loans submitted for secondary market sale between March and December 2017. We reviewed these loans to determine whether OCRM followed the appropriate process in determining whether the loans were eligible to be sold on the secondary market. Finally, we selected and reviewed a random sample of 10 FTA loan sale documentation packages for loans sold between October 2016 and September 2017 to determine whether the FTA followed the appropriate process and the loans were eligible to be sold on the secondary market.

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 information from SBA's Mainframe Loan Accounting System and data from the National Guaranty Purchase Center to conduct our analyses. Previous OIG engagements have verified that the information maintained in Mainframe Loan Accounting System is reasonably reliable. In addition, we conducted reliability tests by comparing the supplemental loan level data provided by the National Guaranty Purchase Center to source documentation and determined it was reasonably reliable. As a result, we believe the information obtained and used for the purposes of this audit is reliable.

[7] OMB Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables (January 2013).

Review of Internal Controls

SBA's internal control systems standard operating procedure provides guidance on implementing and maintaining effective internal control systems, as required by OMB Circular A-123.[8] 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.[9] To assess internal controls during the audit, we assessed the control environment in which SBA reviewed and evaluated loans that were sold on the secondary market. We interviewed SBA officials with the responsibility over the secondary market and SBA officials involved with various aspects such as oversight and the purchase of defaulted loans from the secondary market. We found that internal controls related to our audit objectives were generally effective in mitigating risk in the secondary market.

In 2017, SBA self-reported a deficiency regarding prepaid principal that was to be distributed to pool investors by the FTA. OIG Report 18-03 identified this as a significant deficiency and made two recommendations to strengthen SBA's controls over the secondary market.[10] However, the deficient controls were not within the scope of this audit. Further, one of recommendations has been closed.

[8] SOP 00 02, Internal Control Systems (January 1986).
[9] OMB Circular A-123, Management's Responsibility for Enterprise Risk Management and Internal Control (July 15, 2016).
[10] OIG Report 18-03, Independent Auditors' Report on SBA's FY 2017 Financial Statements (November 14, 2017).

Appendix II: Questioned Costs

Questioned Costs for Secondary Market Charge-Off Sample

Sample	Approval Amount	Purchase Amount	OIG Questioned Costs
1	$410,000	$275,736	$130,173
Totals	**$410,000**	**$275,736**	**$130,173**

Source: Generated from audit results.

Appendix III: Agency Comments

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

TO: Hannibal M. Ware, Inspector General
Office of Inspector General (OIG)

FROM: Susan Streich
Director, Office of Credit Risk Management (OCRM)

Dianna Seaborn
Director, Office of Financial Assistance (OFA)

Jihoon Kim
Director, Office of Financial Program Operations (OFPO)

SUBJECT: Responses to Draft Report on SBA's Controls Over Loans Sold on the Secondary Market

DATE: February 12, 2019

The Office of Capital Access (OCA) Management appreciates the role of 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.

This draft report presents the results of OIG's audit of the Small Business Administration's (SBA's) controls over loans sold on the secondary market.

OIG determined that internal controls related to the sale of loans into the secondary market and SBA's reviews for lender compliance on defaulted loans were generally effective. However, OIG stated that opportunities exist to strengthen controls to further mitigate the risk of loss for loans sold on the secondary market, therefore:

OIG made the following five recommendations and Management's responses to the recommendations in the draft report are noted as follows:

1. Communicate material loan deficiencies previously identified by OCRM secondary market loan sale reviews to the appropriate SBA loan purchase centers to mitigate the risk of improper guaranty purchases in the event of default.

Management substantially concurs with the report and recommendations.

OCRM will communicate material loan deficiencies identified in the secondary market loan sale reviews to the SBA loan purchase centers via comments in the loan system.

2. Establish a process to ensure that pertinent review results from future OCRM secondary market loan reviews are communicated to the appropriate SBA loan centers.

   Management substantially concurs with the report and recommendations.

   OCRM will establish a process to ensure that pertinent results from future secondary market loan reviews are communicated via comments in the loan system to the appropriate loan centers.

3. Establish and implement controls to ensure secondary market annual reports are provided to Congress in a timely manner, as required.

   Management substantially concurs with the report and recommendations.

   OFA has established a process to ensure timely submission of secondary market annual report (March 31) as required by Statute.

4. Update secondary market guidance to ensure that it aligns with current secondary market requirements.

   Management substantially concurs with the report and recommendations.

   OFA is in the process of updating the Secondary Market Program Guide. The Guide will be completed no later than December 31, 2019.

5. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $130,173 on the guaranty paid by SBA.

   Management substantially concurs with the report and recommendations.

   After conducting a preliminary review, and absent additional information from the lender, deficiencies appear to exist. OFPO will notify the lender and work with the lender to obtain documentation to bring the loan into compliance. If the issues are not overcome, SBA will seek recovery from the lender.