Audit Report

OIG-16-017

SMALL BUSINESS LENDING FUND

Corrective Action Verification: Treasury Effectively Monitored Small Business Lending Fund Participants' Compliance with Program Requirements

November 25, 2015

Office of Inspector General

Department of the Treasury

Contents

Appendices

Abbreviations and Acronyms

Act	Small Business Jobs Act of 2010
JAMES	Joint Audit Management Enterprise System
OIG	Office of Inspector General
SBLF	Small Business Lending Fund
Treasury	Department of the Treasury

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November 25, 2015

Jessica Milano
Deputy Assistant Secretary for Small Business, Community Development, and Housing

This report presents the results of our audit of the corrective actions taken by the Department of the Treasury (Treasury) management in response to our December 2014 report on Treasury's compliance monitoring of institutions' annual certification and dividend payment requirements for the Small Business Lending Fund (SBLF).[1] The objective of this corrective action verification was to determine whether management has taken corrective actions that were responsive to our recommendations. Appendix 1 provides more detail of our audit objective, scope, and methodology.

In our December 2014 report, we concluded that Treasury was reasonable and fair in denying dividend rate adjustments when banks did not comply with their annual certification requirements, and overall, was effectively monitoring participants' SBLF dividend, interest, and incentive fee payments. However, at the time of that report, one institution had missed five dividend payments in 2013 and 2014. We also reported that Treasury had no policy to address the disposition of participants that do not fully repay their SBLF principal after dividend and interest rate increases take effect.[2]

Accordingly, we recommended that management (1) name an observer or observers to the board of directors of banks that have missed five or more dividend payments; and (2) develop a plan to prepare and assist institutions that plan to redeem prior to the

[1] *SMALL BUSINESS LENDING FUND: Treasury Effectively Monitored Small Business Lending Fund Participants' Compliance with Program Requirements* (OIG-SBLF-15-002; issued December 23, 2014)
[2] Participants must pay dividends or interest to Treasury at rates ranging from 1 to 9 percent, which automatically increase as high as 13.8 percent after 4.5-years in the SBLF program.

dividend and interest rates increase at the participants' 4.5-year anniversary; and, evaluate the remaining portfolio after the rate increases take effect. According to the Joint Audit Management Enterprise System (JAMES), management implemented and closed all planned corrective actions on March 4, 2015.

In brief, Treasury management addressed each recommendation. In October 2014, Treasury named an observer to the board of directors of the bank that missed five dividend payments in 2013 and 2014. To prepare for redemptions prior to participants' 4.5-year anniversary, Treasury reminded all remaining institutions of the rate increases that will take place and provided other information about the increases and redemption procedures. Also, Treasury developed a credit model to monitor the health of its investment portfolio, before and after the rate increases take effect late 2015/early 2016. As such, we make no new recommendations in this report.

Going forward, we plan to focus on the role and Treasury's expectations of the bank observer, as well as the actions, if any, that should be taken when banks miss dividend payments. We also plan to evaluate the impact of the mandatory dividend rate increases on banks, including determining how many institutions have repaid the SBLF principal and whether Treasury is collecting the additional dividends from institutions remaining in the SBLF program. Also as contemplated by the Small Business Jobs Act of 2010 (Act),[3] we plan to gain an understanding of how Treasury will determine when the SBLF program will end.

In a written response, management acknowledged the conclusions of this corrective action verification and had no comments. Management's response, in its entirety, is included as appendix 2 to this report.

Background

According to Office of Management and Budget Circular No. A-50, audit follow-up is an integral part of good management and a shared responsibility of management and auditors. Each agency

[3] Pub. L. 111-240 124 Stat. 2590, Sec. 4103, (d)(5)(H) (September 27, 2010).

should establish an audit follow-up system to assure the prompt and proper resolution and implementation of audit recommendations.[4] Treasury Directive 40-03, *Treasury Audit Resolution, Follow-Up, and Closure*, requires bureau staff to ensure that (1) audit recommendations are resolved on a timely basis, (2) resolved audit recommendations (i.e., those agreed to by bureau management) are promptly acted upon and that progress with respect to proposed and ongoing corrective actions is adequately monitored, and (3) statistical information and other data are appropriately reported pursuant to all statutory and regulatory requirements.

The status of audit recommendations is tracked in JAMES, an interactive system accessible to both the Treasury Office of Inspector General (OIG) and management. JAMES contains tracking information on audit reports from their issuance through completion of all actions related to findings and recommendations.

Personnel within the Office of the Deputy Chief Financial Officer's-Risk and Control Group, request corrective action status updates from the office responsible for implementing the action. SBLF management was responsible for implementing the recommendations in our December 2014 report. The SBLF program office provided the status reports and notified the Risk and Control Group that both recommendations in the report had been addressed. Accordingly, the Risk and Control Group closed the recommendations in JAMES.

Status of Corrective Actions Taken by Management

In our December 2014 report, the audit objectives were to (1) determine whether Treasury was reasonable and fair in denying dividend rate adjustments for noncompliance with annual certification requirements, and (2) evaluate the effectiveness of Treasury's efforts to monitor interest, dividend, and incentive fee payments.

[4] Office of Management and Budget Circular No. A-50 Revised, "Audit Followup" [*sic*]

Overall, we found that Treasury was reasonable and fair in denying dividend rate adjustments in cases of noncompliance and effectively monitored SBLF payments. However, we noted matters needing management's attention regarding missed dividend payments and developing a plan for participants' exit from the program.

Missed Dividend Payments

In the case of the missed dividend payments, we reported that one bank, a C corporation,[5] had missed five dividend payments in 2013 and 2014. Of the five missed payments, two were paid late and the remaining three totaling $122,062 were never paid to Treasury. According to the securities purchase agreement signed by C corporations, Treasury may name an observer to the board of directors of an institution that misses a dividend payment in five or more dividend periods. Accordingly, in our December 2014 report, we made the following recommendation to management to address this finding, which the Risk and Control Group closed in JAMES on March 4, 2015:

Name an observer or observers to the board of directors of banks that have missed five or more dividend payments.

On October 22, 2014, Treasury named an observer to the board of directors of the bank that missed its dividend payments. The observer attended four board meetings starting with the December 2014 meeting. Subsequent to this action, the bank missed four more dividend payments resulting in Treasury foregoing a total of $463,838 of dividend revenue. The securities purchase agreement does not provide for Treasury to take further action on missed payments. Nonetheless, the SBLF program office continues to monitor the health of the institution. Also, as of September 30, 2015, no other bank had missed any dividend or interest payments.

Treasury's actions met the intent of our recommendation.

[5] A C corporation is a legal entity operating under state law whose profit is taxed to the corporation when earned, and taxed to the shareholders when distributed as dividends.

SBLF Program Exit

We also noted in our December 2014 report that to encourage banks' timely repayment of all SBLF principal, the Act required a dividend and interest rate increase after 4.5 years in the SBLF program. Accordingly, starting in 2016, for those banks that entered the program in the third quarter of 2011, the rate paid will rise to 9 percent for all C corporations and 13.8 percent for S corporations and Mutual Institutions.[6]

According to the SBLF program office, over 80 percent of SBLF bank participants expect to repay the SBLF principal and exit the program before the rate increases take effect. However, Treasury did not have a policy to address the disposition of participants that do not fully repay their SBLF principal after the rate increases. Therefore, we made the following recommendation to address this finding, which the Risk and Control Group closed in JAMES on March 4, 2015:

Develop a plan to prepare and assist institutions that plan to redeem prior to the dividend and interest rate increase at the participant's 4.5-year anniversary; and, evaluate the remaining portfolio after the rate increase takes effect.

To address our recommendation, Treasury sent an email to all remaining participants in December 2014 reminding them of the rate increases that will take place on their 4.5-year anniversary and provided various sources of information on Treasury's website about the rate increases and redemption procedures. In addition, Treasury met with institutions' Federal banking regulators to discuss the large volume of participants that are expected to redeem their securities during the first quarter of 2016, as those participants will have to obtain prior approval from their Federal regulator.

[6] An S corporation is an entity, as allowed by the Internal Revenue Code, where income, losses, deductions, and credits are passed through to their shareholders for Federal tax purposes. In so doing, the corporation avoids double taxation on corporate income. A Mutual Institution has no stockholders and, thus, is owned by its depositors or policyholders and are generally thrifts and savings and loan associations.

Additionally, Treasury developed a credit model to monitor and assess the health of participant banks throughout the life of the SBLF program. The model evaluates and scores an institution's capital, assets, earnings, and liquidity. While it is encouraged, there is no requirement for banks to exit the program at the 4.5-year anniversary when the rate increases take effect. As such, Treasury plans to continue using this model to monitor the remaining SBLF portfolio after the rates increase.[7]

Treasury's actions have met the intent of our recommendation.

* * * * *

We would like to extend our appreciation for the cooperation and courtesies extended to our staff during the audit. Major contributors to this report are listed in appendix 3. A distribution list for this report is provided as appendix 4. If you have any questions, please contact me at (202) 927-1011 or John Gauthier, Audit Manager, at (202) 927-5373.

/s/

Theresa A. Cameron
Director, Office of Small Business Lending Fund Program Oversight

[7] As of September 30, 2015, of the original 332 institutions, 244 remained in the program with an outstanding balance of $2.36 billion, which included 47 Community Development Loan Funds with a balance of $98.6 million that do not have a rate increase at their 4.5-year anniversary.

Pursuant to Section 4107 of the *Small Business Jobs Act of 2010*, we initiated an audit of the corrective actions (i.e. corrective action verification) taken by Department of the Treasury (Treasury) management in response to the recommendations presented in our audit report titled, *SMALL BUSINESS LENDING FUND: Treasury Effectively Monitored Small Business Lending Fund Participants' Compliance with Program Requirements* (OIG-SBLF-15-002; issued December 23, 2014). The objective of this corrective action verification was to determine whether management has taken corrective actions that are responsive to our recommendations.

To accomplish our objective, we conducted fieldwork at the Treasury Office of Inspector General (OIG) office and Small Business Lending Fund (SBLF) Headquarters in Washington, D.C., between September 2015 and October 2015, which comprised the following steps.

- We reviewed the following documents:
    - OIG audit report, *SMALL BUSINESS LENDING FUND: Treasury Effectively Monitored Small Business Lending Fund Participants' Compliance with Program Requirements* (OIG-SBLF-15-002; issued December 23, 2014) for the original findings and recommendations;
    - Joint Audit Management Enterprise System report for the status of the prior report's recommendations and corrective actions;
    - Office of Management and Budget Circular No. A-50, *Audit Followup*;
    - Treasury Directive 40-03, *Treasury Audit Resolution, Follow-Up, and Closure*;
    - Executed Securities Purchase Agreements;
    - SBLF Third Annual Lending Survey (August 6, 2015);
    - SBLF Monthly Transaction Reports;
    - SBLF Term Sheets for C Corporations, S Corporations, and Mutual Institutions;
    - SBLF Frequently Asked Questions; and
    - SBLF Fact Sheet.

- We interviewed key officials at SBLF responsible for implementing the recommendations, including:

- Director;
- Risk and Control Officer;
- Investment Manager (Board observer);
- Operations Manager;
- Communications Manager; and
- Counsel.

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.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

November 20, 2015

Theresa Cameron
Director
Office of Small Business Lending Fund Program Oversight
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Cameron:

Thank you for the opportunity to review the draft report entitled *Corrective Action Verification: Treasury Effectively Monitored Small Business Lending Fund Participants' Compliance with Program Requirements* (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

The Report examined the actions Treasury took in response to the recommendations made by your office in the report entitled *Treasury Effectively Monitored Small Business Lending Fund Participants' Compliance with Program Requirements*. We are pleased that the Report found that Treasury's actions met the intent of the recommendations.

Thank you once again for the opportunity to review the Report. We look forward to continuing to work with your office in the future.

Sincerely,

Jessica Milano

Jessica A. Milano
Deputy Assistant Secretary for Small Business,
Community Development, and Housing Policy

John B. Gauthier, Audit Manager
Marco T. Uribe, Auditor-in-Charge
Anthony R. Pemberton, Auditor
Kevin A. Guishard, Referencer

Department of the Treasury

Deputy Secretary
Deputy Assistant Secretary for Small Business, Community Development, and Housing
Office of Strategic Planning and Performance Management
Office of the Deputy Chief Financial Officer, Risk and Control Group

Office of Management and Budget

OIG Budget Examiner

Treasury OIG Website

Access Treasury OIG reports and other information online:
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