



# Audit Report



OIG-SBLF-15-002

SMALL BUSINESS LENDING FUND: Treasury Effectively Monitored Small Business Lending Fund Participants' Compliance with Program Requirements

December 23, 2014

This report was revised on February 6, 2015, to add a statement to Appendix 1 that we conducted this performance audit in accordance with generally accepted government auditing standards. This statement was inadvertently omitted from the audit report.

Office of  
Inspector General

*Department of the Treasury*



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## Abbreviations

Act	Small Business Jobs Act of 2010
CDLF	community development loan fund
OIG	Office of Inspector General
QSBL	qualified small business lending
SBLF	Small Business Lending Fund
SPA	securities purchase agreement
Treasury	Department of the Treasury

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*The Department of the Treasury  
Office of Inspector General*

December 23, 2014

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

This report presents the results of our audit of the Department of the Treasury's (Treasury) compliance monitoring of institutions' annual certification and dividend payment requirements for the Small Business Lending Fund (SBLF). Our 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.<sup>1</sup>

To achieve our first objective, we reviewed the 2012 and 2013 annual certification submissions of all 63 institutions that Treasury determined were noncompliant at some point during those years. For each instance of noncompliance, we verified that the dividend rate Treasury imposed complied with the provisions of the Small Business Jobs Act of 2010 (Act) and the securities purchase agreement (SPA) signed by each participating institution. To achieve our second objective, we analyzed various Treasury monitoring reports and participants' written notifications. We conducted our audit fieldwork from April 2014 to July 2014. A more detailed description of our audit objectives, scope and methodology is contained in appendix 1 to this report.

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<sup>1</sup> Financial institutions in SBLF pay interest or dividends for funds received from Treasury. SBLF participants that also received Capital Purchase Program funds through the Troubled Asset Relief Program must also pay an additional fee if the institution does not increase lending to small businesses.

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## Results in Brief

We determined that Treasury, in accordance with SPA provisions, was reasonable and fair in denying dividend rate adjustments when banks<sup>2</sup> did not comply with annual certification requirements. In 2012 and 2013, 40 banks and 23 community development loan funds (CDLFs) did not submit their certifications within 90 days of the end of their fiscal year as required by the SPAs. As a result, 37 noncompliant banks were assessed the highest annual dividend rate of 5.0 percent to 7.7 percent on the amount of SBLF funding received.<sup>3</sup> The remaining three noncompliant banks had not increased their qualified small business lending (QSBL)<sup>4</sup> more than 2.5 percent over the baseline level, but Treasury did not raise their dividend rates because they were already paying the maximum dividend rate allowed by the Act. None of the 23 noncompliant CDLFs had interest rate adjustments because their SPAs do not have a provision that addresses consequences for noncompliance. In accordance with the Act, the interest rate for CDLFs is capped at 2.0 percent per year for the first eight years in the program and then increases to 9.0 percent per year after that.

We also determined that Treasury effectively monitored participants' SBLF dividend, interest, and incentive fees payments. Each quarter, Treasury reconciled the payments received from participating institutions to the expected dividend, interest, or fee amounts, and then investigated missed payments. One of the original 332 SBLF participants, a C corporation,<sup>5</sup> missed five dividend payments in 2013 and 2014. Of the five missed

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<sup>2</sup> In this report, the terms "banks" and "community banks" encompass banks, thrifts, and bank holding companies with consolidated assets of less than \$10 billion.

<sup>3</sup> Banking institutions that submit certifications past the deadline contained in their SPA are subject to a pro rata number of days at the higher dividend or interest rate until the SBLF program office receives the certification and deems the institution compliant. Once compliant, the dividend or interest rate as listed in their quarterly supplemental reports accrues for all remaining days in that dividend period.

<sup>4</sup> The Act defines QSBL as commercial and industrial loans; loans secured by owner-occupied nonfarm, nonresidential properties; loans to finance agricultural production, other loans to farmers; and loans secured by farmland. Each loan must have an original principal and commitment amount of \$10 million or less, and the borrower must have no more than \$50 million in annual revenue. Loans guaranteed by the U.S. government or for which the risk is assumed by a third party do not qualify as QSBL.

<sup>5</sup> 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.

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payments, two were made later and the remaining three, if not paid, will reduce Treasury dividend revenue by \$122,062. Treasury has concluded that the institution will likely miss additional dividend payments, but the missed dividend payments cannot be recovered on this investment as Treasury invested in the bank's noncumulative preferred stock.<sup>6</sup> However, as allowed by the SPA with the C corporation, we recommend that Treasury name one or more observers to the institution's board of directors if the institution misses five or more dividend payments.

To encourage banks' repayment of all SBLF principal, the Act provided a step-up dividend and interest rate after the initial 4½ years in the SBLF program. Beginning in 2016, the rate paid by all C corporations will rise to 9.0 percent per year. According to Treasury, over 80 percent of SBLF bank participants expect to repay the SBLF principal and exit the program before the step-up rates take effect. However, there is currently no policy to address the disposition of participants that do not fully repay their SBLF principal after the step-up rate takes effect. Therefore, we also recommend that Treasury (1) develop a plan to prepare and assist institutions that plan to repay the principal prior to the dividend and interest rate increase at the participant's 4.5 year anniversary and (2) evaluate the remaining portfolio after the rate increase takes effect.

In a written response, Treasury accepted our recommendations, stating among other things, that it has named an observer to the board of directors of the only institution that has missed five payments to date, and has begun to prepare and assist institutions that plan to redeem prior to the dividend and interest rate increase at the participant's 4½ year anniversary. The management response is summarized in the Recommendations section of the report and the text of the response is included as appendix 2. We believe the corrective actions are responsive to our recommendations.

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<sup>6</sup> If a corporation does not pay dividends to a noncumulative preferred stockholder in a given period, the stockholder loses the missed dividends.

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## Background

Established by the Act, the SBLF is a dedicated fund that provides capital to qualified community banks and CDLFs to encourage small business lending. To-date, Treasury invested a little over \$4 billion of the \$30 billion authorized by the Act in 332 banks and financial institutions. Of this amount, Treasury invested \$3.9 billion in 281 community banks that includes 232 C corporations, and \$104 million in 51 CDLFs. The SBLF funds were distributed to institutions in exchange for preferred stock or other financial instruments subject to dividend or interest payments that vary depending on the amount of the issuer's QSBL.

According to the Act, the more a participating institution increases its QSBL over a baseline<sup>7</sup> level, the lower the dividend or interest rate that it pays to Treasury for the SBLF funding. Initial dividend rates for participating institutions were as follows: C corporation banks and holding companies had rates from 1.0 percent to 5.0 percent per year; and S corporation banks, S corporation holding companies and mutual institutions had rates from 1.5 percent to 7.7 percent per year. After the initial 4½-year period in the program, the dividend rate C corporations pay increases to 9.0 percent per year. On the other hand, participating CDLFs pay a constant interest rate of 2.0 percent per year for the first eight years in the program and 9.0 percent per year after that.

To participate in the SBLF program, each institution signed an SPA that established the program requirements and provisions for noncompliance.<sup>8</sup> SPAs for all participating institutions require quarterly payments of dividend or interest on Treasury's investments in bank securities and financial instruments. The SPA also requires participants to submit two types of annual certifications. The first certification describes the institution's compliance with borrower and federal anti-money laundering requirements, and must be signed by an executive officer of the institution. The second certification must be signed by an independent auditor who attests to the completeness and accuracy

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<sup>7</sup> The baseline was the average amount of QSBL that was outstanding for the four full quarters ending on June 30, 2010.

<sup>8</sup> The Act also specifies the annual certification requirements; however, it does not mandate consequences for noncompliance with those requirements.



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of the institution's supplemental reports.<sup>9</sup> The SPA for banks include a provision stating that if the institution fails to submit the required certifications within 90 days after the fiscal year-end, the bank's QSBL is zero for the purpose of determining the dividend rate payable until that noncompliance is remedied. The SPA for CDLFs does not have a provision for noncompliance.

Of the 281 community banks that received SBLF funds, 137 used some or all of the funds to refinance securities issued under the Troubled Asset Relief Program's Capital Purchase Program. If these 137 institutions have not increased their QSBL over their baseline level as of the 9th quarter, they are required to pay an additional 2.0 percent annual fee on the total amount of outstanding SBLF funding.

## Findings

### **Treasury Followed SPA Provisions in Denying Dividend Rate Adjustments to Noncompliant Banks**

We determined that, consistent with the SPA for banks, Treasury was reasonable and fair in denying dividend rate adjustments as a result of the banks' noncompliance with annual certification requirements. According to Treasury, 40 banks and 23 CDLFs did not submit the required certifications, in 2012 and 2013, within 90 days after their fiscal year-end. As a result, Treasury assessed the highest dividend and interest rates of 5.0 percent to 7.7 percent per year on 37 noncompliant banks. The remaining three noncompliant banks had not increased their QSBL more than 2.5 percent over the baseline level, and therefore, Treasury did not raise their dividend and interest rates because the banks were already paying the maximum rate allowed by the Act. Treasury also did not adjust the interest rate on the 23 noncompliant CDLFs because their SPAs did not have a provision for noncompliance. In addition, the Act already capped interest rates for CDLFs at 2.0

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<sup>9</sup> SBLF participants submit supplemental reports to Treasury every quarter that show the institutions' amount of QSBL. The reports are instrumental in measuring program results and in calculating fees, dividend and interest rates. The independent auditor certification was required for community banks for each fiscal year during which the first 10 quarterly supplemental reports are submitted.

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percent per year for the first eight years in the program and this rate will increase to 9.0 percent per year after that.

### **Treasury Effectively Monitored Payments But Needs to Plan for Participants' Exit From the Program**

Treasury effectively monitored institutions' payments of dividends, interest and annual incentive fees. On a quarterly basis, Treasury reconciled payments received from participating institutions to the expected amounts, and investigated missed payments. From the inception of the SBLF program in June 2011 through July 31, 2014, Treasury received approximately \$265 million in dividends, interest, and fees from SBLF participants,<sup>10</sup> and all but one of the 332 participants made the payments on time. One institution, a C corporation, was late making dividend payments due in July 2013 and October 2013, and as of July 31, 2014, had not made any of the three 2014 dividend payments, which has resulted in \$122,062 in lost dividend income for Treasury.

According to the SPA signed by C corporations, dividends on shares of noncumulative preferred stock are payable quarterly in January, April, July and October of each year. If a C corporation misses a payment, it must submit to Treasury a written notification explaining the reason for the missed payment. If the C corporation misses a dividend payment in five or more dividend periods, the SPA allows Treasury to name an observer to the institution's board of directors. If an institution misses six payments, and if the aggregate liquidation preference of the then-outstanding shares of the preferred stock is \$25 million or more, Treasury is permitted to name two observers to the institution's board of directors.

Treasury has received the required written notifications from the C corporation that missed dividend payments and visited the institution in March 2014, concluding that the corporation will likely continue to miss future dividend payments. Because Treasury's investment in this C corporation is in noncumulative preferred stocks, the institution is under no obligation to pay previously missed dividends before exiting the program. However,

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<sup>10</sup> Total dividends and interest received equaled \$258,691,049 from banks and \$5,790,492 from CDLFs. Total fees received equaled \$427,123 from banks.

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as allowed by the SPA, we recommend Treasury name an observer or observers to the board of directors if the C corporation misses five or more dividend payments.

To encourage the banks' repayment of SBLF principal, the Act provided a step-up dividend or interest rate applicable at the end of each participant's 4.5-year anniversary in the program. For most banks, the step-up rate will take effect in the first quarter of 2016. Based on a survey conducted of SBLF banks, Treasury told us that by the end of the first quarter of 2016, over 80 percent of SBLF bank participants expect to repay the SBLF principal and exit the program. However, there is currently no policy to address the disposition of participants that do not fully repay their SBLF principal after the step-up rate takes effect. Treasury should (1) develop a plan to prepare and assist institutions that plan to repay the principal prior to the dividend and interest rate increase at the participant's 4.5 year anniversary and (2) evaluate the remaining portfolio after the rate increase takes effect.

## Recommendations

We recommend that the Deputy Assistant Secretary for Small Business, Housing, and Community Development:

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

### Management Response

Treasury has named an observer to the board of directors of the only institution that has missed five payments to date, and intends to name an observer to the board of directors of banks that miss five or more dividend payments.

### OIG Comment

Management's actions, taken and planned, meet the intent of our recommendation.

2. Develop a plan to prepare and assist institutions that plan to redeem prior to the dividend and interest rate increase at the

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participant's 4.5 year anniversary; and, evaluate the remaining portfolio after the rate increase takes effect.

Management Response

Treasury has begun to prepare and assist institutions that plan to redeem prior to the dividend and interest rate increase at the participant's 4½-year anniversary and will evaluate the remaining portfolio after the rate increases take place.

OIG Comment

Management's actions, taken and planned, meet the intent of our recommendation.

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We appreciate the courtesies and cooperation provided to our staff during the evaluation. If you wish to discuss the report, you may contact me at (202) 927-5904, or Theresa Cameron, Audit Director, at (202) 927-1011.

/s/

Kieu Rubb  
Acting Special Deputy Inspector General  
Office of Small Business Lending Fund Program Oversight

The objectives of this audit were to (1) determine whether the Department of the Treasury (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 dividend, interest and fee payments. From the Small Business Lending Fund (SBLF) program inception through July 31, 2014, Treasury received \$265 million in dividends, interest, and fees from participating financial institutions. This includes \$1.5 million received as additional dividends and interest from institutions that did not comply with annual certification requirements in fiscal years 2012 and 2013.

The scope of our audit included dividend, interest, and incentive fee payments Treasury received from September 30, 2011, to July 31, 2014. To evaluate whether Treasury was reasonable and fair in denying dividend rate adjustments for noncompliance with annual certification requirements, we reviewed the fiscal years 2012 and 2013 annual certification submissions provided by each of the 63 noncompliant institutions participating in the SBLF program as of December 31, 2013, and were labeled by Treasury as noncompliant with the certification requirement. In addition, we performed testing to verify that the dividend or interest rate imposed for noncompliance complied with the provisions of the Small Business Jobs Act of 2010 and the securities purchase agreement (SPA) signed by the participants.

To evaluate Treasury's efforts to monitor payments, we analyzed SBLF monthly transaction reports for dividends, interest, and fees paid by program participants from September 30, 2011, to July 31, 2014, to identify any missed payments. We also reviewed documents supporting participants' payments. For confirmed missed payments, we performed testing to verify that the provisions for missed dividend payments specified in the SPA were enforced. We also interviewed and sent written inquiries to SBLF program personnel with responsibility for monitoring compliance with dividend payments and annual certification requirements. In addition, we reviewed Treasury procedures for monitoring compliance with program requirements and tracking dividend, interest, and fee payments.

We conducted our audit fieldwork from April 2014 to July 2014. 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.

Appendix 2  
Management Response

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

December 17, 2014

Kieu Rubb  
Special Deputy Inspector General for  
Office of Small Business Lending Fund Program Oversight  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Dear Ms. Rubb:

Thank you for the opportunity to review your draft report on the compliance monitoring of Small Business Lending Fund (SBLF) participating institutions' annual certification and dividend payment requirements (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

The Report found that SBLF was reasonable and fair in denying dividend rate adjustments when necessary and that SBLF effectively monitored participants' program payments. The audit examined the 2012 and 2013 annual certification submissions of the institutions that SBLF had determined were noncompliant with annual certification requirements at some point during those years and reviewed the program terms that applied to each institution. Your audit also reviewed Treasury's monitoring of payments of dividends, interest and annual incentive fees and noted that one of the original 332 SBLF participants missed five dividend payments.

Treasury accepts the Report's recommendations. With respect to the first recommendation, Treasury has named an observer to the board of directors for the only institution that has missed five payments to date. Treasury intends to name an observer to the board of directors of banks that miss five or more dividend payments. With respect to the second recommendation, Treasury has begun to prepare and assist institutions that plan to redeem prior to the dividend and interest rate increase at the participant's 4½-year anniversary. SBLF recently reminded all participants by email of the rate increase that will occur at their institution's 4½-year anniversary with the program. In 2015, Treasury plans to increase its collaboration with participants and their regulators to facilitate redemptions. After the rate increases take place, Treasury will evaluate the remaining portfolio.

Thank you once again for the opportunity to review the Report. We look forward to working with you and your team in the future.

Sincerely,

A handwritten signature in black ink, appearing to read "Jessica Milano".

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

Appendix 3  
Major Contributors to This Report

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Debra Ritt, Special Deputy Inspector General  
Theresa Cameron, Audit Director  
Clayton Boyce, Audit Director  
Sara Emiline Tete Nkongo, Auditor-in-Charge  
Amy Wang, Auditor  
Rose Li, Auditor  
John Gauthier, Referencer



**Department of the Treasury**

Deputy Secretary  
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