Decide with Confidence

Four Fundamentals of Government Lending Oversight

How agencies can strengthen transparency, risk management controls and mission performance in federal loan and grant programs

WHITE PAPER

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Section I: Executive Summary

Federal agencies are facing unprecedented opportunities and challenges. Many will play key roles in administering more than $1 trillion in new or expanding existing loan and grant programs aimed at bolstering financial institutions, finding new energy sources, spurring innovations in technology, addressing global climate change, helping students, homeowners, farmers and small businesses, and reinvigorating our economy. Their missions are essential to our nation's economic well-being. But managing these massive programs is a difficult task, one that has caused many agencies to stumble over the challenges of monitoring their loan and grant portfolios.

"Proven technology now exists, either in available products or through commercially available data services, to help federal credit agencies deploy effective portfolio monitoring systems."

Thomas H. Stanton, "Federal Credit Programs: Managing Risk in the Information Age"

A major problem for agency leaders has been the perceived conflict between mission and risk management. On the one hand, their agencies' missions calls for them to support economic and social goals by providing loans, loan guarantees and grants to home owners, small businesses, farmers, students and other deserving groups. However, as stewards of taxpayers' money, agencies must also manage their loan and grant portfolios to minimize defaults and prevent corruption and abuse. Unfortunately, many agencies don't have the tools or data to strike the right balance. As a result, they either short-change oversight in order to serve constituent borrowers and grantees, or they short-change mission goals to ensure low rates of loan defaults.

But federal agencies do not have to choose between fulfilling their missions and responsibly managing their loan portfolios. New solutions incorporating commercially available data and commercial best practices for credit and fraud risk management can provide government agencies with the transparency they need to strengthen both mission objectives and management controls. The four fundamentals of this approach are: 1) robust information management systems that collect and store relevant loan recipient and lender data; 2) proven analytical and financial models that assess credit risk using not only loan past-performance data, but also commercially available, predictive risk management scores; 3) on-demand reporting tools such as scorecards and dashboards to meet the reporting requirements of agency executives, Congress, the White House and federal laws and regulations; and 4) consistent policies and procedures for reporting and addressing risk problems as they arise.

A case in point is the Small Business Administration, which has achieved significant success applying this strategy for transparency and accountability to its $65 billion portfolio of major loan programs. SBA's Loan and Lender Monitoring System (L/LMS) enables it to deploy limited resources efficiently, especially to identify and proactively address emerging issues, thus supporting the agency's primary mission of helping U.S. small businesses succeed and grow.

The SBA solution represents a promising model for other federal agencies. "Proven technology now exists, either in available products or through commercially available data services, to help federal credit agencies deploy effective portfolio monitoring systems," said Thomas Stanton, an expert on risk management and federal credit programs.[1]

Section II: The Challenge of Lending Transparency and Accountability

The struggle to balance mission goals with risk management imperatives can be seen in the Treasury Department's initial efforts to administer the massive new TARP program. The Government Accountability Office (GAO) reported in December 2008 that the Treasury, in its rush to stabilize the troubled banking industry, had committed more than $150 billion in loan purchases and guarantees without establishing policies and procedures to ensure that banks were using the funds as intended.[2] And in a subsequent report, GAO said Treasury was continuing to commit funds without a "well-defined and disciplined risk-assessment process," which GAO deemed "essential to monitoring program status and identifying any risks of potential inadequate funding of announced programs." [3]

Treasury's difficulties highlight the challenges faced by all agencies that oversee federal loan and grant programs. Even before Congress approved

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[1] Thomas H. Stanton, "Federal Credit Programs: Managing Risk in the Information Age" p. 23. Published by the IBM Center for The Business of Government, April 2005.
[2] "Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability and Transparency," p. 57 (GAO-09-161; December 2008).
[3] "Troubled Asset Relief Program: Status of Efforts to Address Transparency and Accountability Issues," p. 77 (GAO-09-296; January 2009).

TARP, government agencies were already managing more than $1 trillion in federal loans, loan guarantees, and grants. For example:

- The Department of Education's Federal Student Aid program administers nearly $100 billion in grants, work-study and loans to help students with higher education.
- The Department of Agriculture, which serves farmers, ranchers and rural and agricultural partners, has a loan portfolio of more than $100 billion in outstanding debt and is a guarantor to another $30 billion in loans.
- The Department of Housing and Urban Development helps increase home ownership, support community development and access to affordable housing with over $38.5 billion in direct payments, grants and loans.
- The Small Business Administration assists small businesses through loan programs totaling $65 billion.

These and other agencies manage large loan portfolios that are crucial to the prosperity of homeowners, businesses, farmers, students, rural communities and other groups. But as with Treasury's oversight of TARP, these agencies have long struggled to collect the necessary data and put in place the information systems, analytical models, and technical processes for robust risk management.[4] Without the right tools and data, agencies are vulnerable to fraud, cascading defaults and other risks that could undermine their missions while jeopardizing significant segments of the economy and taxpayer dollars.

Federal agencies are making strides, and the Obama Administration has pledged greater transparency and accountability in its management of government programs. Treasury Secretary Timothy Geithner, for example, has called for tighter controls over TARP and other economic initiatives, saying these programs will be revised to include "tough conditions to protect the taxpayer and the necessary transparency to allow the American people

[4] See, for example, "Single-Family Housing: Progress Made, but Opportunities Exist to Improve HUD's Oversight of FHA Lenders," pp. 3-4 (GAO 05-13, November 2003); "Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance is Needed," pp. 11-12 (GAO 01-116, October 2003); and "Small Business Administration: New Service for Lender Oversight Reflects Some Best Practices, but for Use Lags Behind," pp. 10-14 (GAO 04-610, June 2004).

Agencies Responsible for
Direct Loans or Guaranteed Loans

Department of Agriculture
Department of Commerce
Department of Defense
Department of Education
Department of Energy
Department of Homeland Security
Department of Interior
Department of State
Department of Transportation
Department of Treasury
Export-Import Bank of the United States
Health and Human Services
Housing and Urban Development
Presidio Trust
Small Business Administration
Veterans Affairs

Source: INPUT

to see how and where their money is being spent and the results those investments are delivering." [5]

This increased emphasis on transparency, accountability and performance will heighten the mission vs. management dilemma for federal agencies. As budgets tighten, government officials will be hard pressed to stretch thin resources for overseeing the new loans, grants and funding programs planned by Congress and the administration. At the same time, agency leaders will face great pressure to speed the process for approving grants and credit so economic stimulus programs can achieve their desired results. Thus, agencies may conclude that they must choose mission over risk management. And this choice will certainly bring them into conflict with Congress, the White House, and their own desire to be trustworthy stewards of taxpayers' dollars.

Section III: Commercial Best Practices for Lending Oversight

In reality, federal agencies do not have to choose between fulfilling their missions and responsibly managing their loan portfolios. There now exists commercially available proven predictive scores and commercial best practices for risk management that can enable agencies to achieve portfolio risk and reward objectives. Those objectives will differ to some degree between the private sector, which is focused on profit, and the public sector, which is focused on mission goals related to economic growth and helping borrowers that may not be served by commercial markets. But to achieve their mission objectives, federal agencies must still manage their portfolios with an eye on performance.

Although these best practices were developed to manage loan portfolios, they can be adapted to manage the risks associated with grants and new federal programs, such as TARP. Whether agencies are overseeing loans, grants or other large financial portfolios, they must assess, manage and control similar program risks, such as the potential for default, fraud, mismanagement or misuse of funds by recipients. Thus, the essential

[5] Statement before the U.S. Senate Committee on Finance, January 21, 2009, by Treasury Secretary-designate Timothy Geithner

elements of credit risk management apply equally to the different types of portfolios. The four fundamentals of government lending oversight are:

Four Fundamentals of Government Lending Oversight

1. *Robust information management systems that contain data for loan recipients and lenders;*
2. *Proven analytical and financial models that identify and measure credit risk;*
3. *On-demand reporting tools to meet the reporting requirements of agency executives, Congress, the White House and federal laws and regulations;*
4. *Consistent policies and procedures for reporting and addressing risk.*

1. Robust information management systems. Effective oversight requires systems that collect and make available the highest quality data. And because markets and businesses are always changing, information management systems must constantly be updated with data that is timely, accurate and complete. Best practices require agencies to monitor lenders and individual loans within each lender's loan portfolio. Regarding lenders, agencies must have visibility into the portfolio's composition, such as mix of products, geographic concentrations, risk ratings and other characteristics to monitor risk and guard against lender fraud. Regarding individual loans, agencies must have the capability to cross-check and verify a wide variety of information about loan recipients on a continuing basis. For example, understanding a business borrower's complete financial picture—such as the health of its major customers or suppliers—can help agencies proactively assist the borrower and avoid trouble down the road.

2. Proven analytical and financial models. Agency decision makers depend on models and analysis that can identify and measure risk, and provide predictive insight into loan portfolios. Models that rely on past loan performance alone provide inadequate and sometimes misleading, projections of risk, because even borrowers with spotless records can encounter difficulties that put their loans at risk. Proven models leverage commercially available data about the financial health of loan recipients—for example, is a borrower's debt load increasing significantly?—to better estimate future loan performance. Sophisticated algorithms give these models the capability to search and analyze key variables, and to calculate the different levels of risk associated with each lending institution and each of its loans. Such tools can establish exposure limits for a portfolio of loans, as well as limits on selected types of loans. Effective analytical models can also "connect the dots" of seemingly unrelated or innocuous data points to uncover hidden risks, enabling agency officials to take corrective action.

3. On-demand reporting tools. The value of scorecards, dashboards and similar reporting tools cannot be overestimated. Agency officials use them to monitor lenders, allocate scarce oversight resources, and measure performance. These desktop tools allow officials to view general metrics and trends, as well as drill down into portfolio details, through web-enabled reporting portals. For example, a user might view the overall delinquency rate of a particular portfolio and then drill down to examine individual categories of loans within that portfolio. These tools can also help agency officials respond quickly to inquiries from Congress and the White House, and to meet the reporting requirements of federal laws and regulations. Equally important, strong reporting tools enable agencies to tie their activities and budgets to their missions. This provides agencies with robust financial and performance data to craft and then support annual budget requests.

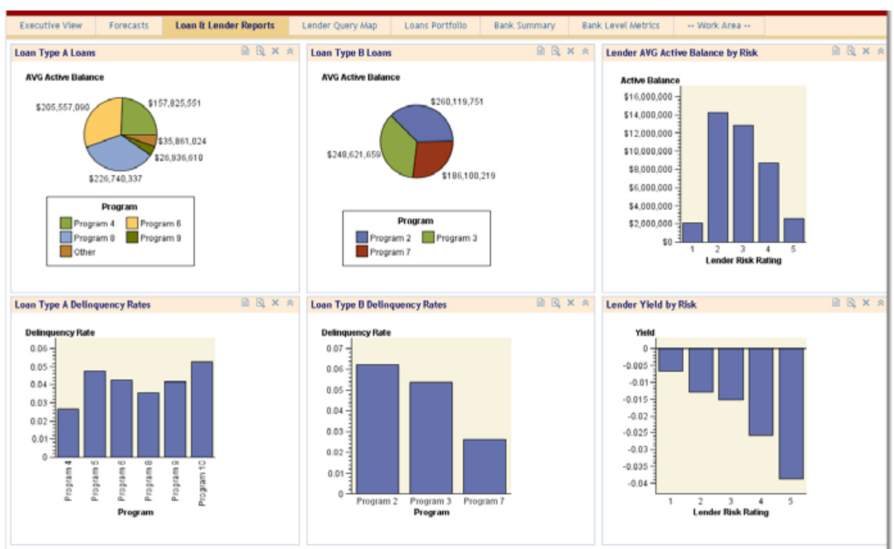

Diagram 1: Reporting tools enable staff to quickly understand the risks of loan programs within specific mission categories and determine whether the programs meet management guidelines. D&B configured the SAS tool pictured above for the Small Business Administration[6].

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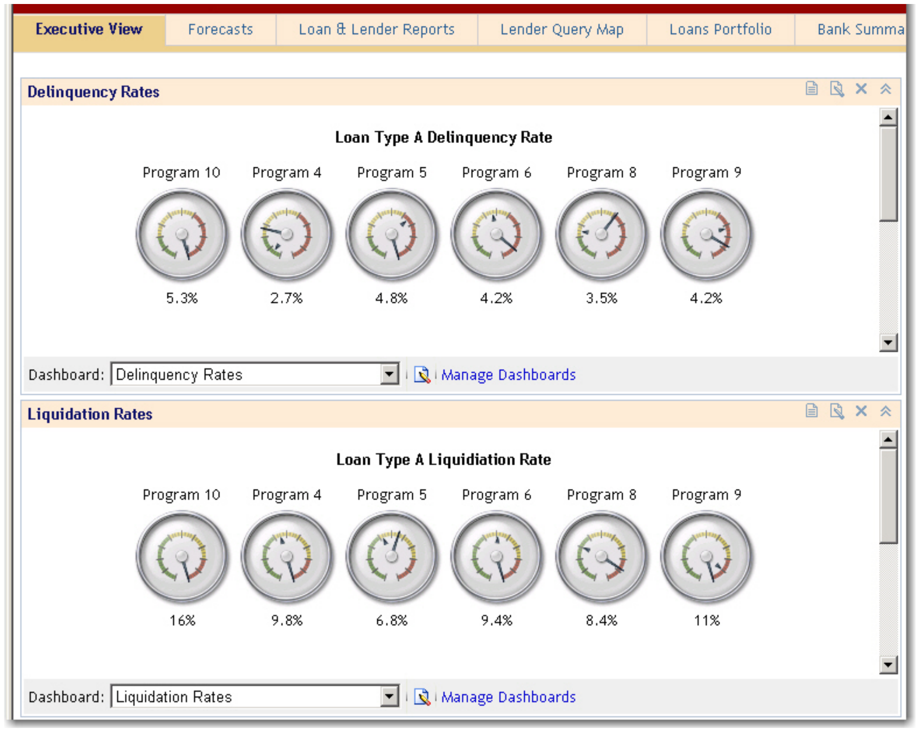

Diagram 2: The small arrows in this reporting tool show a program's risk over the past two years, while the large arrows show risk over the past month, allowing staff to quickly see changes in a program's risk profile. D&B configured the SAS tool pictured above for the Small Business Administration[7].

4. Consistent policies and procedures for reporting and addressing risk. Each agency must establish a risk strategy, including its level of risk tolerance, which reflects both its mission goals and fiduciary responsibilities and work with Congress and Industry to ensure rules and regulations are in place to achieve these goals. This strategy will guide the creation of processes, technology applications, management systems and reporting mechanisms that agency officials will use to monitor loans and initiate actions to mitigate emerging risks. Aligning policies with systems and tools should be a continuous process to ensure that all components of risk management work together to support an agency's mission.

Concurrent with these efforts, the agency must work closely with Congress, industry and other relevant stakeholders, communicating its plans and

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activities, to ensure rules and regulations are put in place that reflect its strategy and support its goals.

Section IV: Case Study: Small Business Administration

"The SBA must balance its oversight responsibilities with its mission of getting credit into the hands of America's small businesses."

Jovita Carranza Former SBA Deputy Administrator June 2008

The Small Business Administration (SBA) was created in 1953 to strengthen the nation's economy by assisting the nation's small businesses. As part of its mandate, SBA guarantees more than $65 billion in loans to small businesses through its two major loan programs, called 7(a) and 504[8] loans. These programs are insured by fees paid by lenders to cover defaults, allowing SBA to currently pursue a "zero-subsidy" policy. SBA established an Office of Lender Oversight—renamed the Office of Credit Risk Management—in fiscal year 1999 to coordinate and centralize portfolio risk management and lender review within the agency.

Although the SBA has continuously worked to improve its oversight capabilities, the agency has been urged by both the White House and Congress to strengthen its ability to review both lenders and individual loans, and to adopt rigorous risk-management techniques. In 1998, the agency began developing a loan monitoring system, but the project proved more complex than anticipated. After three years of effort, the agency was forced to abandon the in-house initiative.

To get its modernization effort back on track, SBA's Office of Credit Risk Management hired Dun & Bradstreet in 2003 to help the agency build both loan and lender monitoring capabilities. As prime contractor, Dun & Bradstreet led a team of industry leaders that brought world-class expertise in the disciplines needed to bolster transparency and oversight, such as credit and fraud risk management, business information and analysis, and predictive analytics.

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[8] Named after Section 7(a) from the Small Business Act authorizing loans to small businesses, 7 (a) loans are the most basic and most used type loan within SBA's business loan programs. The SBA's 504 loan program is a long-term financing tool that provides growing businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings.

With the help of the Dun & Bradstreet team, SBA put in place a credit risk management solution that includes a comprehensive lender review capability, insight into individual loans and lenders, early warning predictive scores, and other features that allow agency leaders to better measure and manage the risk in their small business loan programs. As an integral component of SBA's oversight program, the Loan and Lender Monitoring System (L/LMS) includes commercial off-the-shelf (COTS) tools, such as SAS analytics and SAS business intelligence tools, for effective portfolio management.

"SBA has much deeper insight into our lenders and our loan performance. We know which leaders represent the most risk for us, so we can allocate more resources toward them."

Janet Tasker
Deputy Associate Administrator
SBA's Office of Capital Access

"We certainly have much deeper insight into our lenders and our loan portfolio," said Janet Tasker, Deputy Associate Administrator in SBA's Office of Capital Access, regarding the new system. Especially valuable is its ability to generate a risk rating of SBA lenders. "We know which lenders represent the most risk for us, so we can allocate more resources toward them," Tasker said.

Through the L/LMS solution, SBA officials can assess the risks associated with each of its more than 5,000 lenders from any location, without being on site. This saves time, disruption, and money for both SBA and its lenders, because an on-site review is not required. Instead, SBA can focus its oversight resources to address its most pressing issues by sending reviewers to the loan portfolios identified as having the highest potential risks.

The new solution has proven extremely cost effective. For example, with the L/LMS solution, SBA can conduct quarterly reviews that assess the risk on each of its more than 370,000 7(a) and 504 loans at a cost of less than a penny for every $100 guaranteed by the government. More importantly, the solution provides SBA officials with the visibility and information they need to take proactive steps in managing their loan programs. Consequently, they can achieve their mission goal of helping lenders and borrowers to succeed while simultaneously achieving their current zero-subsidy goal, meaning no extra payments by government for defaulted loans.

In assessing the Dun & Bradstreet solution, GAO said, "The loan monitoring service SBA obtained under contract from Dun & Bradstreet includes an infrastructure that appears to be on par with best practices, including a strong

"The Dun & Bradstreet Service provides SBA with the capability to conduct the type of monitoring and analyses typical among major lenders and recommended by financial regulators. The L/LMS rating system is also both on par with industry best practices and based on sound financial models."

SBA Office of Inspector General

management information system, quality data, and human capital." [9] A subsequent examination of the system by SBA's inspector general echoed this view, stating, "The Dun & Bradstreet Service provides SBA with the capability to conduct the type of monitoring and analyses typical among major lenders and recommended by financial regulators. The L/LMS rating system is also both on par with industry best practices and based on sound financial models." [10]

As evidence of the program's continuing value to SBA, the agency in 2008 awarded Dun & Bradstreet a new five-year contract to build upon the success of the L//LMS solution by providing additional enhancements that incorporate emerging commercial best practices for credit risk management and lender oversight.

Section V: Conclusion

Federal agencies are essential players in the economic recovery programs now underway. Many are being asked to manage billions of dollars in new loans and grants to stimulate business growth, technology innovation, home ownership, alternative energies and other national goals. These responsibilities are not entirely new, but neither are they easy. Agencies have often struggled to effectively manage huge portfolios of loans and grants, especially when facing pressure to speed needed funds to targeted industries and groups.

However, solutions now exist to address longstanding problems of transparency and accountability. By applying best practices for credit and fraud risk management, agencies can gain access to relevant risk and performance data, providing the transparency needed for effectively monitoring both lenders and loans, and grants and grantees. Information management systems and reporting tools bolster accountability by providing agencies with the capability to measure and demonstrate results to the White House, Congress, and other stakeholders.

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[9] GAO Report 04-610, June 2004, p. 15
[10] SBA Office of the Inspector General Report 7-21, May 2007.

For more information on D&B's Government Lending Oversight approach, call 1.800.424.2495 or email government@dnb.com

The SBA's experience in modernizing its lender oversight capabilities serves as a promising model for other federal agencies overseeing large loan or grant portfolios that require risk management. Robust oversight is not an added burden but a key contributor to mission success because it enables agency executives to accurately assess and predict risk, and then take proactive steps to assist lenders and help borrowers and grantees succeed. And in today's uncertain economic environment, effective oversight is not a "nice-to-have" luxury, but a "must-have" capability that resolves the dilemma of mission versus management. By applying best practices for credit risk management, agencies strengthen both mission performance and their oversight responsibilities.