# SBA Policy Notice

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| **TO:** | All SBA Employees and All SBA Supervised Lenders | **CONTROL NO.:** | 5000-1940 |
| **SUBJECT:** | Revised Risk-Based Review/Examination Protocol for SBA Supervised Lenders | **EFFECTIVE:** | January 18, 2017 |

## I. Introduction

SBA's Office of Credit Risk Management (OCRM) is updating its oversight of SBA Supervised Lenders. This revised Risk-Based Review ("Review") and Safety and Soundness Examination ("Examination") protocol is applicable to SBA Supervised Lenders, and is intended to be flexible to take into account individual facts and circumstances. SBA will use this guidance along with judgment and Agency discretion in conducting SBA Supervised Lender oversight activities. An SBA Supervised Lender is a 7(a) Lender that is either a Small Business Lending Company ("SBLC") or a Non-Federally Regulated Lender ("NFRL"). 13 CFR 120.10. Community Advantage Lenders are a type of SBLC. Business and Industrial Development Companies ("BIDCO") are a type of NFRL.

## II. PARRiS Risk Measurement Methodology

The revised protocol includes a composite risk measurement methodology and scoring guide, "PARRiS," which SBA has developed for the oversight of all 7(a) Lenders, including both Federally-regulated and SBA Supervised. See SBA Policy Notice 5000-1332, Revised Risk-Based Review Protocol for SBA Operations of Federally-Regulated 7(a) Lenders (December 29, 2014), SBA Procedural Notice 5000-1351, PARRiS Risk-Based Review – Revised Terminology (September 11, 2015), SBA Policy Notice 5000-1375, FY 2016 Updated Fee Schedule for SBA Oversight of 7(a) Lenders (March 23, 2016) and SBA Information Notice 5000-1397, Updated PARRiS Methodology for Oversight of SBA Operations of Federally-Regulated 7(a) Lenders (November 8, 2016). PARRiS is an acronym for the specific risk areas or components that SBA reviews for 7(a) Lenders. The components and their measurement objectives are as follows:

| Component | Measurement Objective |
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| "P" - Portfolio Performance | Degree of financial risk to SBA that a Lender presents considering overall portfolio performance indicators and attributes. |
| "A" - Asset Management | Quality of the origination, servicing and liquidation practices in the Lender's SBA operation. This component also includes an assessment of the effectiveness of the Lender's SBA program management and related risks. |
| "R" - Regulatory Compliance | Lender's compliance with SBA Loan Program Requirements. |

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| "Ri" - Risk Management | Overall institution risk and a Lender's use of an effective governance model to identify, understand, and mitigate risk exposure in its 7(a) portfolio. |
| "S" - Special Items | Additional key metrics or items that are not included in the other components but may pose risk to SBA or present program integrity concerns. |

The PARRiS components cover the areas that SBA has traditionally reviewed for all 7(a) Lenders: portfolio performance, credit administration, compliance with SBA Loan Program Requirements and SBA operations management under 13 CFR 120.1050(a). Each PARRiS component includes qualitative and quantitative performance factors. (See Appendix A for a list of the quantitative and qualitative factors currently being used for each PARRiS component.) The quantitative factors are benchmarked and scored against set risk tolerance levels established by SBA, producing a PARRiS Score (described in Policy Notice 5000-1332 under Lender Profile Assessment). The qualitative factors will include, but not be limited to, consideration of: compliance with SBA Loan Program Requirements (as defined under 13 CFR 120.10), changes in Lender's loan policies, management and staff capabilities and any other aspect of the Lender's SBA program. Review of the qualitative and quantitative factors allows SBA to better identify a Lender's specific risk areas, assess the level of risk a Lender poses to SBA, and make recommendations for corrective action as needed.

The PARRiS methodology also features "flags" that are intended to highlight additional areas that SBA will be monitoring in identifying risk. Flags do not contribute to a Lender's PARRiS Score but may factor into a Lender's Review Assessment or trigger a review when combined with other considerations. <u>The PARRiS methodology, including but not limited to the factors and flags, may be revised from time to time.</u>

## III. SBA Supervised Lender Review/Examination Protocol

The SBA Supervised Lender protocol also includes assessment of requirements specific to SBA Supervised Lenders, as set out in 13 CFR 120.460 through 120.490 and SOP 51 00. This protocol also includes requirements specific to 7(a) Lenders engaged in participating lender financings as set out in 13 CFR 120.420 through 120.435, as applicable. SBLCs generally receive a Safety and Soundness Examination at least biennially (with the exception of Community Advantage Lenders that are a type of SBLC). All other SBA Supervised Lenders may be selected for Reviews or Examinations based upon the size of their SBA portfolio, as well as risks identified (e.g., during Annual and Quarterly Condition, Certification of Capital Compliance, Delegated Authority and Lender Profile Assessment (LPA) Reviews) and Corrective Action assessments from previous Examinations or Reviews. Additional guidance regarding oversight of Community Advantage Pilot Program Lenders ("CA Lenders"), which are a type of SBA Supervised Lender, is set out in the Community Advantage Participant Guide (version 4.0 effective December 28, 2015) and in Federal Register Notices published at 76 FR 9626 (February 18, 2011), 76 FR 56262 (September 12, 2011), 77 FR 6619 (February 8, 2012), 77 FR 67433 (November 9, 2012), and 80 FR 80872 (December 28, 2015).

In addition to those levels of reviews published by SBA in the Policy Notice 5000-1332 referenced in section II above, SBA's revised Risk-Based Review protocol for SBA Supervised Lenders features the following additional levels of review:

1. Annual Report Review and Quarterly Condition and Certification of Capital Compliance Review
2. Safety and Soundness Examination

A detailed discussion of these additional review/examination types follows.

1. <u>Annual Report and Quarterly Condition, and Certification of Capital Compliance Reviews</u>

Each SBA Supervised Lender is required to submit Annual and Quarterly Condition Reports to SBA, as well as a Certification of Compliance with SBA's minimum capital requirements as set forth in 13 CFR 120.462, 120.464, 120.471, 120.472 and 120.474. These reports are analyzed each quarter in order to assess overall financial health, identify any material change in financial or other condition, and assess compliance with SBA minimum capital requirements. The Community Advantage Participant Guide (version 4.0 effective December 28, 2015) outlines specific requirements for which Community Advantage Lenders must comply with respect to Quarterly Reporting and Annual Report with Audited Financial Statements.

2. <u>Safety and Soundness Examination ("Examination")</u>

A Safety and Soundness Examination is a comprehensive review of all aspects of an SBA Supervised Lender's operations. Examinations are conducted at the Lender's location but may include a virtual portion. Each Examination consists of two parts, the first part is specific to SBA Supervised Lenders, and the second part is applicable to all 7(a) Lenders and is referred to as the PARRiS Review. The objective of the SBA Supervised Lender-specific part of the Examination is to assess the SBA Supervised Lender's performance on measures that are generally required for SBA Supervised Lenders only. The SBA Supervised Lender-specific part may include the following components:

- Financial Condition: capital, earnings, liquidity, sensitivity analysis;
- SBA Supervised Lender-specific management requirements (e.g., credit policy; internal control policy);
- SBA Supervised Lender-specific regulatory requirements (e.g., capital plan and Annual and Quarterly Condition Reporting); and
- SBA specific requirements related to financings: sales, pledges, lines of credit, securitizations and participations.

A Lender selected for an Examination will receive an engagement letter and request for certain information (e.g., loan files, loan policies and procedures, SBA lending organizational chart, and copies of audits). The LPA diagnostic serves as the preliminary part of the Examination, and will be used to direct the attention and activities of the examiners. All Examinations include reviews of loan files which may consist of both random and judgmental selections, and may incorporate, for example, additional past due and delinquent loans, loans in liquidation and/or loans in active purchase, if they are areas of concern. SBA works to coordinate Delegated Authority Renewal Reviews of SBA Supervised Lenders with the timing of a Lender's Safety and Soundness Examination.

This SBA Supervised Lender protocol, like the PARRiS methodology, may be revised and is subject to periodic adjustment. SBA will use judgment and discretion and may consider matters such as risks identified, changing economic conditions, and Agency resources in making periodic adjustments.

## IV. Review Fees

SBA currently charges 7(a) Lenders, including SBA Supervised Lenders, fees for the quarterly off-site/monitoring reviews conducted through the Loan and Lender Monitoring System (L/LMS). SBA also charges 7(a) Lenders, including SBA Supervised Lenders, fees to cover the costs of the following reviews: (1) LPA; (2) Analytical Reviews; (3) Targeted Reviews; (4) Full Reviews; and (5) Delegated Authority Reviews, as applicable. SBA may also determine on a case-by-case basis to assess fees for Other Reviews. 13 CFR § 120.1070. See also, Policy Notices 5000-1375 (March 23, 2016) and 5000-1332 (December 29, 2014) for more information on these fees. With the updates to the protocol described in this Notice, the fees assessed for SBA Supervised Lender-specific Reviews or Examinations will be assessed as set forth below.

a. Annual Report and Quarterly Condition, and Certification of Capital Compliance Reviews
In the past, SBA has conducted this type of review remotely as a virtual review of data, analytics and submission of information by the Lender. These reviews will be conducted with the assistance of SBA's contractors, and the Lender may be assessed a fee to cover the contractor costs that SBA incurs in relation to the Review. However for FY 2017, SBA does not anticipate charging a fee for these Reviews.

b. Safety and Soundness Examinations
This Examination will be conducted on-site with the assistance of SBA's contractors, and the Lender will be assessed a fee to cover SBA's costs. For FY 2017, SBA estimates the cost of an Examination to range between approximately $27,000 and $86,000 plus expenses incurred in relation to the Examination.

c. Billing
For each of the SBA Supervised Lender-specific types of Reviews and Examinations, SBA will bill each Lender for the amount owed following the completion of the Review or Examination.

## V. Review Report and Assessment Categories

Examinations, along with Analytical, Targeted and Full Reviews, generally culminate in a Report (Report). In general, the Report will include a summary assessment and may include individual assessments for each component. The summary assessment generally bears a close relationship to the component assessments. However, the summary assessment is not a mathematic average of the component assessments because some components may be given more weight than others. In addition to the current assessment categories of: (i) “Acceptable”; (ii) “Acceptable with Corrective Action Required”; and (iii) “Less Than Acceptable with Corrective Action Required”, SBA has added a fourth category of “Marginally Acceptable with Corrective Action Required”. A Lender in the “Marginally Acceptable with Corrective Action Required” category requires close supervisory attention and monitoring to promptly correct the serious compliance and risk management practices in the Lender’s SBA loan operations that, if not corrected, will negatively impact the Lender’s SBA loan operations and expose SBA to an unacceptable level of financial and/or program risk. SBA will use judgment and discretion in assigning review assessments.

*Questions*

Questions on this revised protocol may be directed to Adrienne Grierson, Deputy Director, Office of Credit Risk Management at Lender.Oversight@sba.gov.

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Administrator

**Appendix A – Current PARRiS Component Factors**

The quantitative[1] and qualitative PARRiS factors currently analyzed for each component include, but are not limited to:

"P" - Portfolio Performance

| Quantitative Factors | Qualitative Factors |
|---|---|
| • 5-year cumulative net yield | • Loan acquisition impact |
| • 12-month default rate | • Local/regional economic conditions |
| • 5-year default rate | • Changes in loan policies and practices |
| | • Geographic distribution of Lender's 7(a) portfolio and Lender's management of that distribution |
| | • Composition of portfolio |

"A" - Asset Management

| Quantitative Factors | Qualitative Factors |
|---|---|
| • High risk origination rate | • Credit administration (e.g., creditworthiness, repayment ability, closings, IRS transcripts) |
| • Early problem loan rate | • Servicing (e.g., current borrower financials, insurance renewals, borrower visits, UCC filings) |
| • Stressed loan rate (Past Due + Delinquent + Deferred Loans) | • Liquidation and resolution risk (e.g., action plans, active purchases management) |
| | • Mission risk (e.g., risk associated with particular lending program) |

R"- Regulatory Compliance

| Quantitative Factors | Qualitative Factors |
|---|---|
| • Loans in default status over 3 years rate | • Loan eligibility |
| • 1502 reporting rate | • Accurate SBA Form 1502 submission |
| • 24 month repair/denial rate | • Timely and accurate remittances such as liquidation proceeds, guarantee fees, receivables and SBA Form 172 payments |
| | • Accurate SBA Form 159 reporting submission |
| | • Packaging and referral fees |
| | • Compliance with required corrective actions |
| | • Lender Service Provider (LSP) Agreements, where required |

[1] SBA will provide definitions for each of the quantitative factors on the PARRiS tab on SBAOne

“Ri” - Risk Management

| Quantitative Factors | Qualitative Factors |
|---|---|
| • Forecasted Purchase rate[2] | • Board approved internal control policies and practices, including independent loan review and loan classification system |
| • Primary Federal Financial Institution Regulator total risk-based capital rate [3] | • Management and staff capabilities |
| • Non-performing asset ratio[4] | • Day-to-day responsibility for SBA program management |
| | • Oversight and management of LSPs (if applicable) |
| | • Operating plan and strategy |
| | • Adherence to credit and operating policies and LSP Agreements (the latter if applicable) |

“S”- Special Items

| Quantitative Factors | Qualitative Factors |
|---|---|
| • Average SBPS score (weighted) | • Loan participations and pledges |
| • 5 Year Charge-off rate[5] | • Fraud, waste and abuse matters |
| • Most recent regulatory action (Public Corrective Action with Regulator) (no/yes indicator)[6] | • Evaluation of regulatory orders for impact on SBA portfolio and program risk |
| | • Other items of concern |

The PARRiS methodology also features “flags” that are intended to highlight additional areas that SBA will be monitoring in identifying risk. Currently, the PARRiS flags include: (1) loan agent rate over last 5 years; (2) industry concentration rate; (3) franchise rate; (4) sold or secondary market sale rate; (5) acquired loan rate; (6) loans greater than $2 million approved over the last 12 months; (7) rapid portfolio growth; and (8) early default. These flags are subject to change based on risks identified in the portfolio.

[2] The Forecasted Purchase rate measures a 7(a) Lender’s portfolio-level purchase probability (as a percentage) over the next 12 months, calculated from the dollar-weighted loan-level projected purchase rate (PPR) for each loan.

[3] Total Risk-Based Capital Rate is in development for these lenders; will default to “Moderate Risk” in the interim.

[4] Non-performing Asset Ratio is in development for these lenders; will default to “Moderate Risk” in the interim.

[5] The 5 Year Charge-off rate measures the total dollars charged-off for loans from this lender during the past 5 years as a percentage of the total gross dollars outstanding in the lender’s portfolio plus total dollars charged-off during the past 5 years.

[6] Public Corrective Action for SBA Supervised Lenders is any public enforcement action conducted by SBA.