
REPORT BY THE

Comptroller General

OF THE UNITED STATES

The Surety Bond Guarantee Program: Significant Changes Are Needed In Its Management

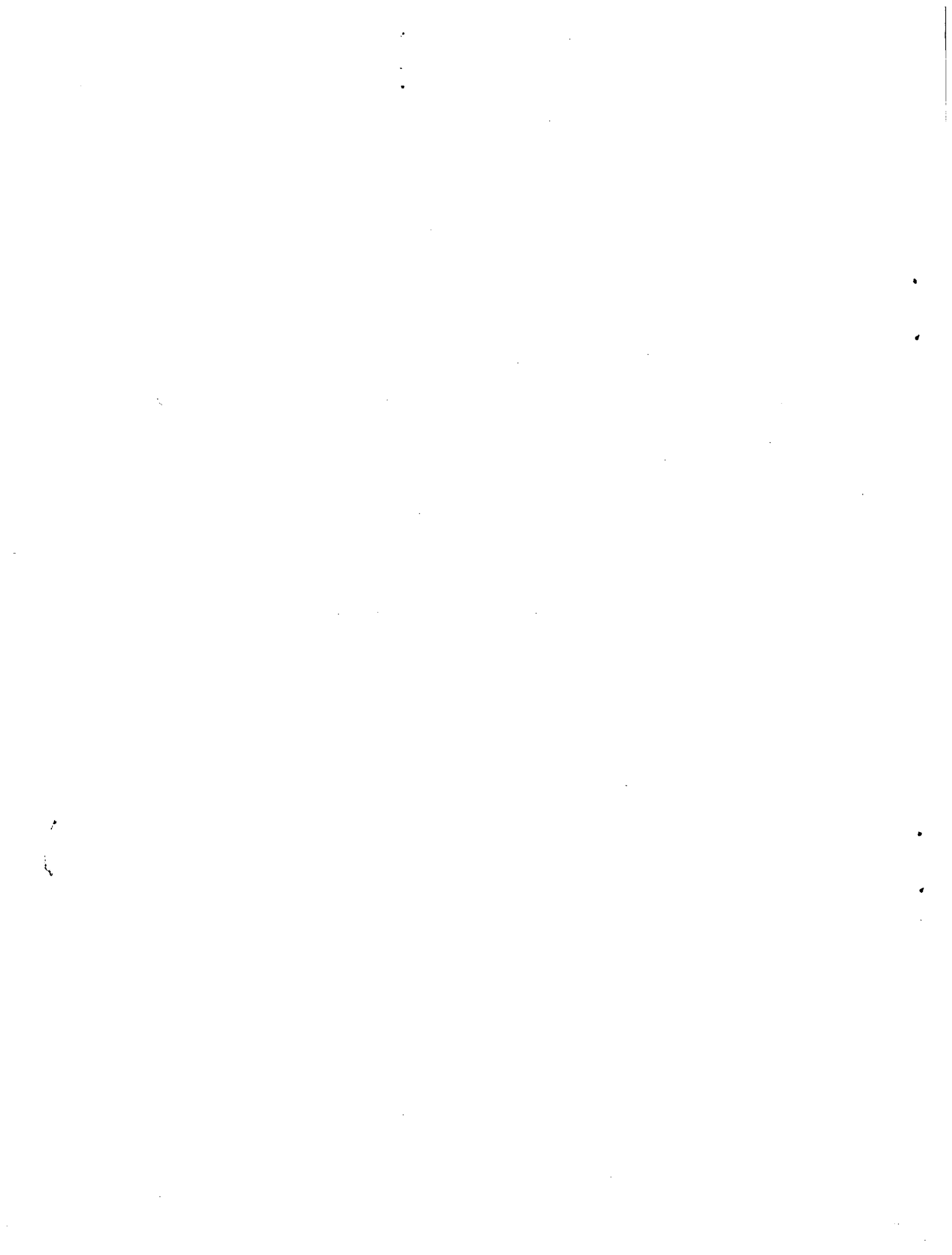
The Surety Bond Guarantee Program was established to guarantee up to 90 percent of a surety company's losses on bonds issued to small businesses which cannot obtain bonding without the guarantee. Since 1971, the program has guaranteed bonds on more than 91,000 contracts totaling \$6.3 billion.

The program is not being managed effectively. GAO recommends changes so that

- bond guarantees are based on reliable data,
- the Small Business Administration and the surety companies minimize losses,
- contractors are assisted in obtaining bonding from the private market, and
- the Small Business Administration pro-
vide assistance to pro-
tectors.

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OFFICE





COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-196849

The Honorable Gaylord Nelson
Chairman, Select Committee on
Small Business
United States Senate

Dear Mr. Chairman:

This report describes the management of the Small Business Administration's Surety Bond Guarantee Program and suggests ways to improve the program's operation. Our review was made pursuant to your committee's request of August 30, 1978.

As agreed with your office, we are referring several matters to the Small Business Administration's Inspector General for further investigation. Also, as arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time we will send copies to the Administrator, Small Business Administration, and make copies available to other interested parties, unless you inform us that the Committee will hold hearings at which the report will be used.

Sincerely yours,

James A. Stacks

Comptroller General
of the United States

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ACQUISITIONS



COMPTROLLER GENERAL'S
REPORT TO THE SENATE SELECT
COMMITTEE ON SMALL BUSINESS

THE SURETY BOND GUARANTEE
PROGRAM: SIGNIFICANT
CHANGES ARE NEEDED IN
ITS MANAGEMENT

D I G E S T

The Small Business Administration (SBA) is not managing the Surety Bond Guarantee Program satisfactorily. For example:

- Bond guarantees often are based on unreliable underwriting data and superficial reviews. (See pp. 8-20.)
- SBA and the surety companies are making little effort to minimize losses. (See pp. 21-28.)
- The program is not "graduating" significant numbers of contractors into the private surety bonding market. (See pp. 29-34.)
- SBA is not providing management assistance to Surety Bond Guarantee Program contractors. (See pp. 35 and 36.)

SBA can guarantee up to 90 percent of a surety company's losses on bonds executed for small businesses which can be reasonably expected to perform as required by the contract and which cannot obtain bonding without the guarantee. The program is intended to assist small businesses develop sufficiently to secure bonds without the guarantee. (See pp. 1-3.)

The contractor pays the surety company a bond premium not to exceed 1.5 percent of the first \$250,000 or 1 percent of the amount exceeding \$250,000. In addition, the contractor pays SBA a \$10 application fee and 0.2 percent of the contract amount. (See p. 4.)

Since 1971, SBA has guaranteed bonds on more than 91,000 contracts totaling \$6.3 billion. Many of the contractors involved could not have obtained bonding without the SBA guarantee. SBA reported a net cost of \$98.4 million for the Surety Bond Guarantee Program through April 1979, but SBA also reported significant savings to the Federal, State, and local governments because the low bidder on

many contracts had surety bond guarantees.
(See p. 7.)

UNDERWRITING

SBA approves most surety bond guarantee applications based on limited reviews of incomplete or erroneous underwriting data. Surety agents who underwrite a contractor's bond request frequently provide SBA outdated, inaccurate, incomplete, or inconsistent data as support for the guarantee submission. GAO's review of 639 applications showed that 87 percent contained unreliable data. Many deficiencies involved essential underwriting elements. Working capital, for example, was incorrectly reported on 31 percent of the applications. (See pp. 8 and 9.)

Program officials generally perform only a cursory review of the data, depending heavily on the agent's decision regarding guarantee approval. Even when discrepancies are found, SBA often does not take appropriate corrective action. Although serious underwriting deficiencies are common, SBA had approved 96 percent of bond guarantee applications since the program began. (See pp. 11 and 12.)

Neither SBA nor participating sureties have established adequate underwriting criteria or guidelines to assist program personnel or surety agents in analyzing contractors' bond requests. (See p. 13.)

SBA-guaranteed contractors have defaulted on about 5,600 contracts, and the Surety Bond Guarantee Program has incurred a net cost of \$98.4 million. GAO believes, however, that losses can be reduced if SBA receives reliable underwriting data, adequately reviews it, and takes appropriate actions.

LOSS MINIMIZATION

SBA and participating sureties are making little effort to minimize losses. Neither SBA nor most of the sureties are attempting to prevent contractor defaults. After a default occurs, the cost to SBA is significant. (See pp. 21-23.)

In addition, specialty sureties--companies which specialize in writing SBA-guaranteed bonds--are more costly to SBA. These higher costs result in part because most specialty sureties do not have the capability to handle claims internally. The specialty sureties charge SBA for claims handled by outside attorneys. Conversely, the large standard surety companies, which predominantly write bonds in the private market, generally handle claims internally at minimal cost to SBA. SBA does not know, however, whether the reimbursement rates for claims handling are reasonable and realistic for the standard sureties and the specialty sureties.

The higher cost specialty companies write 93 percent of the bonds for the Surety Bond Guarantee Program. (See pp. 23-25.)

GRADUATION

The Surety Bond Guarantee Program is not significantly contributing toward graduating contractors into the private bonding market. GAO's review of 123 randomly selected contractors not currently participating in the program showed that only about 6 percent had actually graduated. (See p. 29.)

Contractors currently participating in the program may qualify for the private bonding market. For example, some contractors with good financial positions have participated in the program for several years. (See p. 30.)

The lack of program graduates may result in part because neither SBA nor the surety companies encourage graduation. GAO's review of 273 randomly selected contractor files from three high volume SBA regions showed only one instance where SBA formally questioned whether a contractor should remain in the program and encouraged him to obtain bonding without the SBA guarantee. In addition, the surety companies writing most of the program's bonds write few, if any, bonds without SBA's guarantee; so these companies have no incentive to graduate contractors. Furthermore, the absence of SBA procedures and

guidelines regarding contractor graduation probably contributes to this inadequate emphasis on graduation. (See pp. 30 and 31.)

MANAGEMENT ASSISTANCE

SBA does not identify the need for management assistance or provide it to Surety Bond Guarantee Program contractors. SBA relies on the contractor or surety companies to recognize the need for management assistance and request it when applying for a bond guarantee. GAO's review of 273 randomly selected contractors showed only five instances in which management assistance was requested.

Adequate and timely management assistance could minimize defaults or significantly enhance a contractor's ability to obtain subsequent bonding in the private market. (See pp. 35 and 36.)

RECOMMENDATIONS

The Administrator, SBA, should:

- Develop underwriting guidelines to assist program personnel and surety companies in evaluating contractors' surety bond guarantee applications and require program officers to verify the data contained in selected contractor applications.
- Direct program officers to decline applications with outdated, inaccurate, inconsistent, or incomplete underwriting data and to refuse to do business with agents who repeatedly submit unreliable data.
- Establish and enforce guidelines regarding surety responsibilities for monitoring contractor progress and preventing defaults.
- Establish a claims-handling reimbursement rate(s) which will result in a reasonable and equivalent net claims-handling cost for the two types of sureties in the program--those which have an in-house claims-handling capability and those which do not.

- Establish graduation criteria and procedures for formally encouraging and assisting contractors to obtain private bonding and place incentives on the surety companies to graduate contractors.
- Identify the management assistance needs of Surety Bond Guarantee Program contractors and provide timely and adequate management assistance to them.

SBA COMMENTS, SURETY COMPANY COMMENTS,
AND GAO'S EVALUATION

GAO provided the draft report to SBA for review and written comment. In addition, selected segments of the draft were sent to seven surety companies and one surety agent. SBA, five surety companies, and the surety agent commented on the draft report. SBA does not refute the facts contained in case files or quotations from people interviewed, but it disagrees with certain recommendations relating to underwriting, loss minimization, and graduation.

After considering SBA's views, GAO maintains that the recommendations are appropriate and necessary. SBA did not furnish any additional facts or opinions which would cause GAO to modify its position.

The surety companies and the surety agent provided mixed reactions. One company, for example, believes the report treats the subject objectively. Two others question the value of the proposed report and contend that the conclusions were not substantiated by the audit. However, these two companies did not provide factual data or convincing arguments to support their position. Therefore, these comments did not result in any substantive changes to the report.

SBA's comments, surety companies' comments, and GAO's evaluation are included at the end of each chapter. SBA's complete comments are included as appendix II.



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ABBREVIATIONS

GAO	General Accounting Office
SBA	Small Business Administration

CHAPTER 1

PERSPECTIVE

The Surety Bond Guarantee Program began national operations in 1971 to guarantee contract bonds for small construction, service, or supply contractors. Since that time, the Small Business Administration (SBA) has guaranteed bonds on more than 91,000 contracts for about \$6.3 billion. More than \$1.3 billion of these contracts were guaranteed during fiscal year 1978. SBA reported a program cost of about \$98.4 million through April 1979.

The Congress provided for surety bond guarantees in the Housing and Urban Development Act of 1970 to alleviate bonding difficulties confronting the small contractor. The Congress intended to assist the small contractor to develop sufficiently to secure bonds without the guarantee.

The act, which authorizes SBA to guarantee up to 90 percent of a surety company's losses from breach of contract, is intended to assist all qualified small contractors. Since 1971, about 15 percent of the bond guarantees have been for minority contractors.

SURETY BONDING

Surety bonding is often a prerequisite, especially for construction work, to the award of both Government and private contracts. The Miller Act, for example, requires surety bonds on all Federal construction contracts of \$25,000 ¹/ or more. Many State and local governments have adopted their own versions of the Miller Act.

The surety bonding relationship is basically a three-party relationship in which the surety, for a fee, makes itself responsible for obligations which the contractor owes the owner or other persons with whom it contracts. When, as a result of this obligation, the surety incurs a loss, it can sue the contractor to recover its loss. Also, the surety takes over the contractor's rights to payments from the owner.

Where bonding is required, the contractor usually must obtain all of the three main types of bonds: (1) bid bonds, (2) payment bonds, and (3) performance bonds. While the

¹/The Congress raised the limit from \$2,000 to \$25,000 in Nov. 1978.

latter two bonds describe separate obligations, they usually are combined in one transaction, so that one premium covers both. Each is described separately below:

- A bid bond is presented with a bid on a proposed contract. It is a joint guarantee by the bidder and a surety company to the owner that, if such bid is accepted by the owner, the bidder will provide performance and payment bonds and enter into a contract with the owner to perform the job according to the owner's specifications for the sum of the bid amount.
- A performance bond is a guarantee jointly by the contractor and a surety company to the owner that the contractor will satisfactorily perform the contract in accordance with plans, specifications, and all contract documents.
- A payment bond is a joint guarantee by the contractor and a surety company to the owner that the contractor will pay promptly the wages of all workmen employed by the contractor on the job; the invoices for all materials used by the contractor on the job; the invoices for all subcontractors; and all other direct job costs.

HOW THE SURETY BOND GUARANTEE PROGRAM WORKS

SBA does not directly bond a contractor. If small contractors need a surety bond, they contact their agents and apply by providing various background, credit, and financial information required by the surety company. The agent submits this information to the surety company 1/ which decides whether to

- execute the bond without SBA's guarantee,
- execute the bond only with SBA's guarantee, or
- decline the bond even with SBA's guarantee.

The above process is known as underwriting.

1/For companies writing most of the SBA-guaranteed bonds, a general agent has the power of attorney and may make these decisions without consulting the surety company.

If the surety decides to execute the bond with SBA's guarantee, it forwards to SBA the contractor's application along with underwriting information such as the applicant's experience and financial position. SBA reviews the information and approves or disapproves the bond guarantee.

SBA can approve a bond guarantee only if the following conditions are met:

- The party seeking the bond is a small business concern. 1/
- The bond is required in order for the party to bid on or perform the contract.
- The bond is not otherwise obtainable under reasonable terms and conditions.
- The applicant can be reasonably expected to perform as required by the contract.
- The contract meets requirements established by SBA for feasibility of successful completion and reasonableness of cost.
- The terms and conditions of the bond are reasonable in light of the risk involved and the extent of the surety's participation.

In the event of default by the contractor, the surety company is obligated to complete the contract. The SBA Guarantee Agreement specifies that the surety shall take charge of all claims matters arising under the bonds; determine its liability; compromise, settle, or defend any claim or suit; and take such action as it deems necessary to minimize loss. The surety has the right to recover any losses it sustains from the contractor. In addition, SBA must reimburse the surety for 80 to 90 percent 2/ of its unrecovered losses.

1/Generally, any construction concern is considered small if its annual receipts for its preceding fiscal year or its average annual receipts for its preceding 3 fiscal years do not exceed \$3.5 million.

2/SBA guarantees 90 percent of bonds less than \$250,000 and 80 percent of bonds from \$250,000 to \$1,000,000.

Surety fees

The contractor pays the surety agent a minimal bid bond fee (usually up to \$15) and pays SBA a \$10 application fee. The contractor also pays the surety company a performance and payment bond premium not to exceed 1.5 percent of the first \$250,000 or 1 percent of the amount exceeding \$250,000. The surety company pays SBA 20 percent of this premium. In addition, the contractor pays SBA a \$10 application fee (if not paid on the bid bond) and 0.2 percent of the contract amount.

Program cost

Since program inception in 1971, SBA reported a net program cost of \$98.4 million including gross expenses and claims of \$135.2 million. This amount is offset by contractor and surety fees of \$26.4 million and recoveries of claims paid totaling \$10.4 million. As of April 30, 1979, about 5,600 defaults had occurred.

Surety Bond Guarantee Program organization

SBA's Surety Bond Guarantee Program organization consists of a central office in Washington, 10 regional offices, and 9 district offices within the Atlanta region. ^{1/} Program staffing in June 1979 included 57 people as follows: central office--5 professional and 2 clerical staff members; field offices--26 professional and 24 clerical staff members.

The SBA central office has responsibility for the following four aspects of the program:

- Administering the national program.
- Coordinating with sureties, contractors, bond agents, various trade associations, as well as with other internal and external governmental bodies.
- Approving all bond guarantees exceeding \$500,000.
- Processing all claims from surety companies.

The field offices have the day-to-day operational responsibility for developing and implementing the Surety

^{1/}The Atlanta region has decentralized its program to all its district offices, but the other regions have not.

Bond Guarantee Program within their respective jurisdictions. These offices handle inquiries regarding the program, process surety bond guarantee applications, determine if the contractor is eligible, and approve or decline all applications of \$500,000 or less.

SURETY COMPANIES

More than 100 surety companies have requested bond guarantees from SBA, but the primary activity involves "specialty" surety companies--those companies which primarily write SBA-guaranteed bonds. These specialty companies, which emerged as a result of the Surety Bond Guarantee Program, dominate the program. During the period October 1, 1978, through April 30, 1979, for example, the specialty companies accounted for 93 percent of the bonds. Two specialty companies alone accounted for more than 66 percent of the bonds.

SCOPE OF REVIEW

We did detailed audit work at the SBA central office in Washington, D.C., and the SBA Chicago, Dallas, and Atlanta regional offices 1/--the regions with about 60 percent of the Surety Bond Guarantee Program activity during fiscal year 1978. In addition, we performed some limited work at the SBA Denver and Kansas City regional offices. We also visited selected surety companies, agents, and contractors; and we met with the Surety Association of America.

We reviewed pertinent legislation; analyzed samples of underwriting and claim files; reviewed applicable correspondence; and interviewed appropriate officials regarding program policies, procedures, and practices. We employed an experienced surety consultant to assist us in the specialized review of underwriting and claims. The consultant has extensive experience in both of these review areas.

Our review of contractor files included 273 randomly selected contractors at the regions where we performed detailed work. We used a random sampling computer program to make our selection. In order to evaluate current underwriting practices, we limited our review of underwriting to the 150 contractors who had applied for bond guarantees since January 1, 1977. We reviewed the remaining 123 contractor files to determine whether the Surety Bond Guarantee Program is meeting its goal of graduating contractors into the private bonding market. Since these 123 contractors are not

1/ We concentrated our Atlanta region work in the two largest districts--Atlanta and Nashville.

currently requesting bond guarantees, they would be the most likely group to have graduated.

In addition, we reviewed the files of 34 defaulted contractors in order to evaluate claims and underwriting functions. We selected contractors bonded by both specialty and standard sureties in the Chicago, Dallas, and Atlanta regions.

We reviewed all internal audit reports and other SBA reports pertaining to the Surety Bond Guarantee Program, and we discussed their current and planned work with SBA audit personnel. Our review of SBA's internal audit work was limited because this area was addressed in the following GAO reports:

--"Management Control Functions of the Small Business Administration--Improvements Are Needed," GGD-76-74, dated August 23, 1976.

--"Efforts to Improve Management of the Small Business Administration Have Been Unsatisfactory--More Aggressive Action Needed," CED-79-103, dated August 21, 1979.

Statements in this report regarding surety companies are based on the procedures and practices of the companies writing the majority of the SBA-guaranteed bonds. These statements may not be applicable to some participating surety companies. Surety company and contractor names are not included in this report to prevent the disclosure of proprietary information.

SBA COMMENTS, SURETY COMPANY
COMMENTS, AND OUR EVALUATION

Four surety companies and SBA commented on this chapter of our report. One surety questions the validity of overall conclusions about the Surety Bond Guarantee Program based on such a limited sample of contractor files. In addition, three sureties said the report does not recognize the overall benefits of the program, particularly the contract savings which have resulted from the difference between the low bidder with an SBA guarantee and the next lowest bidder. Finally, SBA believes the report fails to recognize the true productivity of the program. SBA said, for example, that the report acknowledges that 50 SBA employees in 19 offices have assisted small businesses in obtaining over 91,000 bonded jobs worth \$6.3 billion; but the report fails to indicate that an additional 90,000 guarantees were extended to contractors who were not low bidders.

Regarding the comment on our sample size, the surety needs to recognize that valid statistical projections can be made with samples which are minute relative to their universe. Our findings were presented, however, in relation to the files reviewed rather than statistically projecting the sample results to a national scale. Furthermore, in view of the overwhelming nature of our sample findings and the fact that the sample was randomly selected from three SBA regions, with about 60 percent of the program's activity, we believe our findings indicate trends on a broad-scale basis.

Regarding program benefits and productivity, our review was directed toward evaluating the management of the Surety Bond Guarantee Program rather than examining the benefits of the program. The program has obviously provided some benefits. The report points out on page 1, for example, that SBA had guaranteed bonds on more than 91,000 contracts. In addition, a 1977 SBA study estimated that the Federal Government had saved \$45 million (compared to a net Surety Bond Guarantee Program cost at that time of \$73 million) and the State and local governments had saved \$100 million because the low bidders on many contracts had surety bond guarantees.

CHAPTER 2

SURETY BOND GUARANTEES ARE OFTEN BASED ON UNRELIABLE DATA AND SUPERFICIAL REVIEWS

SBA approves most surety bond guarantee applications based on limited reviews of incomplete or erroneous underwriting data. Surety agents who underwrite a contractor's bond request frequently submit outdated, inaccurate, inconsistent, or incomplete contractor financial and management information; and SBA reviews of this information are generally superficial. This poor underwriting by surety agents and SBA is caused in part by inadequate SBA guidelines.

The surety or agent underwrites a contractor's bond request by analyzing a number of factors, including the contractor's financial capacity, technical capability, and character. SBA requires the agents to furnish this and other types of financial, management, and personal history information to support the contractor's bond guarantee application. Although SBA personnel are responsible for reviewing this information and making a decision to approve or deny the request, they normally depend heavily on the surety's decision to provide the bond.

The following paragraphs discuss the quality of underwriting information submitted by the surety agent, the adequacy of SBA reviews of this underwriting information, and our consultant's observations regarding the underwriting.

UNDERWRITING INFORMATION IS OFTEN OUTDATED, INACCURATE, INCONSISTENT, OR INCOMPLETE

Surety agents frequently provide incomplete or erroneous underwriting information to SBA. Our review of 639 applications--from the 150 underwriting files--showed that 555 (87 percent) contained at least one or more elements of data which were outdated, inaccurate, incomplete, or inconsistent. The most common underwriting deficiencies were:

<u>Underwriting deficiency</u>	<u>Percent of appli- cations containing deficiency</u>
Working capital inaccurate	31
Net quick assets inaccurate	53
Contractor's work in process not submitted	31
General indemnity agreements not in file	50
Income statement outdated or not submitted	33
Accounts receivable not verified	36
Bank balance not verified	18
Need for SBA assistance not explained	36
Personal history statement outdated	23

All applications reviewed at the Chicago regional office and Nashville district office contained underwriting deficiencies; 90 percent of the applications reviewed in Atlanta were deficient; and 65 percent of those reviewed in Dallas had underwriting shortcomings. Some of these underwriting deficiencies would not have altered SBA's decision on the application, but many involved essential underwriting elements. Some examples of major underwriting elements are shown below.

Working capital and net quick assets

Working capital (current assets minus current liabilities) and net quick assets (working capital minus prepaid expenses and a portion of inventory) are two important measures of a contractor's ability to meet short-term obligations such as payroll, supplies, and other operating expenses. An accurate representation of this information, in concert with other underwriting data, is essential for SBA to make an informed bonding decision.

Nearly one-third of the applications we reviewed, however, did not accurately report the contractor's working capital, and more than one-half misstated net quick assets. For example:

--An Atlanta surety agent reported that a contractor had working capital of \$164,233, but our examination of financial statements showed a negative working capital of \$42,822.

--An agent reported to SBA's Dallas regional office that a contractor had \$83,151 in net quick assets. Our

examination of the contractor's financial statements, however, showed negative \$74,242 net quick assets.

In addition, our consultant's review of 34 selected default cases showed overstatements of contractors' financial positions, including the following example.

	Reported by agent to SBA	Consultant's computation (note a)
Working capital	\$105,000	\$ 3,062
Net quick assets	674,600	-39,714

a/The consultant's computation was based on financial statements submitted along with the application.

This inaccurate information was reported to SBA on seven bond applications from the same contractor. Despite this inaccurate information, SBA approved bond guarantee requests for payment and/or performance bonds totaling \$1,387,000. This same contractor defaulted on 13 contracts with SBA bond guarantees, and to date, SBA has paid claims of more than \$778,900.

Work in process

As noted earlier, 31 percent of the applications we reviewed did not include a report of the contractor's work in process. Our consultant pointed out that a work-in-process schedule for both bonded and unbonded work is an extremely important underwriting tool. It assists in measuring the contractor's ability to complete a particular contract successfully in light of total workload rather than the individual bond. Without a work-in-process schedule, the underwriter is not in a position to determine whether the contractor is exceeding work capacity.

General indemnity agreements

Our review showed that about 50 percent of the sample SBA files did not contain a properly executed indemnity agreement. In the event of default, the indemnity agreement generally provides the surety company access to the contractor's assets as compensation for losses sustained. Our consultant therefore believes that the indemnity agreements from the corporation and its owner and executives are mandatory to maximize loss recoveries because such agreements would provide surety companies access to (1) corporation assets and (2) personal assets of corporation owners and executives. Because this underwriting element is so essential to minimizing

losses, our consultant believes that SBA should enforce the requirement that a copy of indemnity agreements be provided.

SBA APPLICATION REVIEWS
ARE GENERALLY SUPERFICIAL

SBA does not adequately evaluate contractors' bond guarantee applications. Program officials generally perform a cursory review of the applications and the surety agent's underwriting submission, depending heavily on the agent's decision regarding guarantee approval. Even when discrepancies are found, SBA often does not take appropriate corrective action. Although serious underwriting deficiencies are common, SBA has approved 96 percent of all bond guarantee applications since the program began.

SBA officials concede their underwriting reviews are inadequate and attribute the deficiency to inadequate staffing. Although the SBA central office estimates that an average of 2 hours should be spent on each application, SBA personnel we visited devoted only about 30 minutes to each request from the time it was received until the final papers were filed. These limited reviews result in serious discrepancies going undetected. In the Chicago SBA region, for example, one surety company advised SBA that it refused to bond a contractor, even with an SBA guarantee, because of the contractor's extremely poor financial condition. Despite this warning, SBA approved an application for this contractor a few months later. The application showed \$150,000 net quick assets, but the accompanying financial statements showed negative \$107,000 net quick assets.

In other instances when discrepancies are detected, SBA often does not take sufficient action to prevent their recurrence. SBA approves guarantee applications as submitted or merely returns them to the agent, pointing out the underwriting shortcomings and suggesting that they not be repeated. For example, toward the end of our review the Atlanta district office wrote 190 letters to surety agents during a 4-month period delineating the agents' underwriting deficiencies. Although one agent received 79 of these letters repeatedly admonishing him for submitting outdated financial data and inaccurate contract start dates, he continued to submit bond guarantee applications with unreliable data. SBA continued to approve the applications and guarantee the bonds.

As noted above, program officials perform inadequate underwriting reviews. However, in the latter stages of our review, the Atlanta district office began verifying certain underwriting data for selected bond guarantee applications.

SBA also found significant discrepancies in the data submitted by surety agents. In one instance, an agent indicated that a contractor had a \$200,000 unused bank line of credit; but when SBA checked with the bank, it found the contractor actually owed \$177,620 against the line of credit. Agents also reported to SBA that a line of credit existed four other times when, in fact, SBA found that none existed. In another case, program officials discovered that a contractor's balance sheet dated March 31, 1979, was a duplicate of one dated December 31, 1977.

In one of these instances, the managing general agent who underwrites SBA-guaranteed bonds for a particular surety also handles claims for that same surety. Under this arrangement, the agent earns a fee for each bond written plus hourly reimbursement for claims-handling expenses if the contractor defaults. For instance, if the contractor defaults on an SBA-guaranteed bond, the agent bills the surety \$50 per hour for his time and \$35 per hour for his staff engineer's time spent on the claim. The surety in turn bills SBA for up to 90 percent of these costs. This agent estimated that he spent 90 percent of his workday investigating claims resulting from contractor defaults. Although we did not identify any examples, we believe the agent could have an incentive to secure a bond guarantee for a contractor who will likely default.

CONSULTANT'S OBSERVATIONS

In addition to 34 selected default cases, we chose 18 files from our random sample of active contractors for the consultant to review. We believe these files exemplified inadequate underwriting by surety agents and SBA program officers. Our consultant confirmed that underwriting analyses are often unsatisfactory. For active contractors, he found that (1) underwriting was unacceptable in about 45 percent of the cases and (2) underwriting was only marginal in another 17 percent. In addition, he discovered that poor underwriting was prevalent in the default cases. He noted, for example, that 42 percent of the contractors who defaulted had negative working capital and/or negative net quick positions when SBA guaranteed their bonds.

The consultant expressed serious reservations regarding the lack of attention that agents and SBA personnel are giving to important underwriting elements such as working capital and net quick asset positions, contractor's work in process, general indemnity agreements, and bank lines of credit. His thoughts concerning the first three underwriting elements were discussed in the prior section.

The consultant believes that SBA and surety agents should focus much more attention on bank lines of credit. Although a contractor's bank line of credit could also significantly influence the underwriter's final bonding decision, default files which the consultant reviewed showed instances where lines of credit were not verified by either surety agents or SBA. In three instances where SBA did verify the banking arrangement, the line of credit was exhausted in one case; no line of credit existed in another; and the line of credit had been withdrawn in the third. Our consultant believed that the latter case should have been a clear signal of danger, indicating a loss of confidence by the banker.

UNDERWRITING GUIDELINES
ARE INADEQUATE

Neither SBA nor participating sureties have established useful underwriting guidelines to assist program personnel or surety agents in analyzing contractors' bond requests. SBA has provided some general guidelines in the standard operating procedures, but they do not address underwriting analyses. In addition, SBA officials concede that these procedures are outdated and need revising. The program officers we interviewed stated that in the absence of agency standards, they rely on their own experience and judgment to make decisions. Likewise, the most active sureties in the program have not imposed minimum underwriting standards on their agents that investigate the contractor's bond request; consequently, underwriting could vary significantly even within a surety company.

In addition, in some instances the existing program application forms do not require sufficiently detailed responses by surety underwriters. (See app. I.) The agent, for example, may answer "no" to questions such as:

- Was the contractor's work on hand verified?
- Has the surety checked with suppliers?
- Were payables and receivables verified?
- Has surety verified bank balance?

SBA has approved bond guarantees without this important underwriting information or knowing why the verifications were not made.

CONCLUSIONS

SBA approves most surety bond guarantee applications based on limited reviews of incomplete or erroneous underwriting information. Although serious underwriting deficiencies are common, SBA has approved 96 percent of all bond guarantee applications since the program began.

Surety agents who underwrite a contractor's bond request routinely provide SBA outdated, inaccurate, incomplete, or inconsistent data as support for the guarantee submission. In turn, program officials generally perform only a cursory review of the data, depending heavily on the agent's decision regarding guarantee approval. We believe that losses can be reduced if SBA receives reliable underwriting data, adequately reviews it, and takes appropriate actions.

SBA officials concede their underwriting reviews are inadequate and attribute the deficiency to inadequate staffing. We believe, however, that SBA's existing staff could significantly improve its underwriting reviews by randomly selecting contractor applications for indepth verification and evaluation rather than performing cursory reviews on all applications. They would, however, have to take decisive action on review results, declining applications with unreliable information and refusing to do business with agents who repeatedly submit erroneous data.

In addition, neither SBA nor participating sureties have established meaningful underwriting guidelines to assist program personnel or surety agents in analyzing contractors' bond requests. We recognize that underwriting is not an exact science and explicit criteria are too restrictive. Program officers, however, should have at their disposal some guidelines, perhaps in the form of an operating manual, establishing the framework for the program. In general, such a manual should explain how financial statements are valued and analyzed by an underwriter, set parameters for acceptable contractor financial positions, and define the relationships among various elements of financial data.

RECOMMENDATIONS

We recommend that the Administrator, SBA:

- Develop underwriting guidelines, as discussed above, to assist program personnel and surety companies in evaluating contractors' surety bond applications.
- Establish procedures for program officers to conduct indepth verification and evaluation of selected contractor applications.

--Direct program officers to decline applications with erroneous data and refuse to do business with those agents who repeatedly submit unreliable data.

SBA COMMENTS, SURETY COMPANY
COMMENTS, AND OUR EVALUATION

SBA and four surety companies commented on this chapter of our report. SBA's comments dealt primarily with the recommendations rather than the factual material. Two surety companies commented very briefly on this chapter, but two others strongly objected to the material presented. These latter two companies, however, presented mostly unsubstantiated arguments and irrelevant or erroneous material to support their comments. SBA and surety company comments are summarized below by subject area along with our evaluation of them.

General comments

One specialty surety company pointed out that reviews of surety company underwriting files would reveal that the majority of them are deficient in some manner, and two specialty companies stated that underwriters or consultants reviewing the same files would not reach identical conclusions. In addition, one of these surety companies questioned whether the reported underwriting deficiencies were significant.

These companies apparently ignored our explanation of underwriting deficiencies and the significance of some of the examples. The report acknowledges that some of the underwriting deficiencies would not have altered SBA's decision on the application, but it also shows that many deficiencies involved essential underwriting elements. The examples discussed on pages 9 and 10 of the report clearly show that (1) the number of deficiencies in major underwriting elements were significant, for example, working capital inaccurate on 31 percent of the applications, and (2) the size of the deficiencies was also significant, for example, working capital overstated by 200 to 3,400 percent. Many other examples were noted during our review, but the report would have been too voluminous if all were included.

The sureties' statement that underwriters will reach different decisions on the same file may be true in borderline cases. We instructed our consultant, however, to classify underwriting as "marginal" or "unacceptable" only if the cases clearly fell into those categories. If the case was borderline or judgmental, he classified the underwriting as "acceptable." In addition, he was thoroughly briefed on the

purposes and intent of the Surety Bond Guarantee Program, and he reviewed the underwriting accordingly.

Working capital and net quick assets

One surety acknowledged that formulas are available for determining working capital and net quick assets, but it stated that accountants analyzing the same data will often arrive at different answers. Another surety stated that our definition of net quick assets may be too restrictive for underwriting the class of contractor in the Surety Bond Guarantee Program.

The sureties apparently missed the point that SBA needs consistent, accurate financial information in order to decide whether bonds should be guaranteed. SBA should be able to expect that net quick assets, for example, are computed essentially the same on each application it reviews unless adequate justification is provided for deviations. While we recognize that accountants analyzing the same data may reach different answers, these answers will not vary significantly if generally accepted accounting procedures are used.

Work in process

One specialty surety company questioned the importance of a missing work-in-process report as long as SBA and the surety agent knew that the report was missing. It also questioned whether (1) other data in the file would have provided this information and (2) new contractors would need work-in-process statements.

The comment regarding importance of work-in-process statements is completely contrary to comments made by other surety companies and our consultant. One large standard surety company commented, for example, that the best tool the surety company has in avoiding default is declining bonds when the contractor would be overextending itself by undertaking more work than it can adequately handle. This statement is also consistent with our consultant's opinions expressed in the report. Without work-in-process statements, however, neither the surety nor SBA could know when the contractor is becoming overextended.

Regarding the comment on other available information, we did not classify a work-in-process report as "not submitted" if (1) satisfactory substitute information was available or (2) the contractor stated that no work was in process.

General indemnity agreements

One specialty surety company stated:

"* * * the report should make clear that because of the high-risk nature of the class of business being bonded under the Surety Bond Guarantee Program, the opportunity to make any recovery against the contracting business entity or the principal owners thereof is relatively rare. It makes little sense for a Surety to bring suit against a defaulted and bankrupt contractor to recover a loss. The end result of such an effort is no more than to increase the amount of the loss."

The surety's comment, however, does not negate the point that indemnity agreements should be obtained by the surety and copies should be provided to SBA. In addition, the surety company should pursue recovery to the fullest extent practicable. The surety apparently failed to recognize, as pointed out on page 30 of the report, that some contractors have substantial company and personal assets.

Underwriting guidelines

SBA stated that the underwriting form (see app. I) provides adequate guidance to both SBA field offices and surety companies. SBA officials stated the form leads an underwriter through the various steps encountered in determining the credit and capacity of a contractor. They further stated that manuals have not been developed because such material would hinder SBA's efforts to assist minority contractors, whose balance sheets, assets, and experience are generally much weaker.

One specialty surety company stated that, although desirable, it is practically impossible to establish a complete set of underwriting guidelines to apply to all contractors. Another specialty surety company stated that it has established underwriting guidelines and therefore the report was incorrect to state that participating sureties have not established useful underwriting guidelines.

The report recognizes that explicit underwriting criteria would be too restrictive, but we believe that an operating manual establishing basic parameters for the program would be useful and practical. Our consultant fully supports this position. SBA could develop this manual with surety company participation. Examples of data which could be addressed in such a manual are included in the report.

We do not agree that the underwriting form provides sufficient guidelines to the SBA field offices and surety companies. The form provides some helpful guidance, but it does not set parameters for acceptable contractor financial positions, discuss the relative importance of underwriting elements, define the relationships among various elements of financial data, or explain how financial statements are valued and analyzed. The underwriting deficiencies noted in this report show an immediate need for this type of guidelines. For example, working capital was incorrectly computed on 31 percent of the applications, and work-in-process reports were not obtained 31 percent of the time. In addition, several SBA field office officials said they needed more guidance, and an official from the surety writing the largest number of SBA-guaranteed bonds said his company would not object to more guidelines if the surety had some input in developing them.

In addition, as discussed on page 13 of the report, the underwriting form offers the SBA officials and surety companies too much flexibility. The surety agent can simply answer "no" to questions such as:

- Was the contractor's work-in-process verified?
- Has the surety checked with suppliers?
- Were payables and receivables verified?
- Has surety verified bank balance?

The SBA officials can approve bond guarantees without this important information or knowing why the verifications were not made.

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Regarding the surety company which stated that it has established underwriting guidelines, a representative of the managing general agent (which is responsible for underwriting) for this surety told us that the company did not impose specific underwriting restrictions or guidelines on agents. He said that the surety had prepared an underwriting manual several years ago, but it was not really used by the agents.

Comments on recommendations

SBA made the following comments about our recommendations on (1) indepth underwriting reviews and (2) declining

applications with erroneous data and suspending agents who repeatedly submit unreliable data.

"The need for indepth reviews in certain instances is appropriate. As a result of GAO's comments and our own reviews, we know that SBG [surety bond guarantee] clients of long term and those which undertake larger than average jobs need periodic indepth review. We will take steps to implement this recommendation.

"The final recommendation indicates that the GAO team possibly missed the fact that sureties themselves screen out many applicants without ever going to SBA. The figure is probably twice to three times the number actually forwarded to SBA. Declines by SBA represent about 3 percent of applications received. We will not attempt to suspend agents who are under contract with sureties. We will continue, however, to inform sureties, as we have in the past, of poor performers and let sureties take appropriate action. Failure on the part of surety to take corrective action can trigger action by SBA to punish the surety. Statutory language exists to support this approach."

Regarding the indepth reviews, we believe that SBA needs to take additional actions other than those described above. The indepth reviews should not be confined only to long-term clients or those undertaking larger than average jobs. The indepth reviews should be directed toward detecting significant discrepancies in underwriting data submitted to SBA (such as those cited on pp. 11 and 12 of the report) and correcting the source of the problem. In order to do this, SBA would have to examine a cross section of applications from all surety agents.

Regarding SBA's comment on declining applications and suspending agents, we do not believe that SBA has a reasonable estimate of the applicants screened out by the sureties. The surety companies and agents we interviewed had no statistics on the number of applications declined at the surety or agent level, and the gross estimates varied greatly from agent to agent.

In addition, if SBA relies on surety companies to correct the problems as it has in the past, we do not expect significant improvements in the program. The report shows on page 11, for example, that a district office wrote 79 letters to one agent during a 4-month period delineating underwriting deficiencies, but the agent continued to submit applications with erroneous data. SBA continued to approve the applications and guarantee the bonds.

Agent underwriting bonds and
handling claims on same bonds

The managing general agent discussed on page 12 of this report commented that, in his opinion, claims must be closely scrutinized and dealt with by the managing general agency. He stated that under this arrangement many problems have been solved before they developed into claims. The agent added, however, that a claims service will handle the claims in the future but he will continue to closely observe and participate in the process.

Rather than disagreeing with the facts contained in this section of our report, the agent's comments appear to be directed at explaining (1) his involvement in claims handling and (2) a new claims-handling system which he is implementing. We maintain, however, that the agent should not be collecting premiums for writing bonds and fees for handling claims on the bonds. We further believe that SBA should examine the agent's new claims-handling system to determine his involvement and interest in the claims service.

CHAPTER 3

SBA AND THE SURETY COMPANIES

ARE NOT MINIMIZING LOSSES

SBA and participating sureties are making little effort to minimize losses. Neither SBA nor most of the sureties are actively attempting to prevent defaults, even though the cost to SBA is high after a default occurs. In addition, the specialty sureties are more costly to SBA than standard companies because the losses incurred by the specialty sureties are generally higher. Specialty surety companies, for example, routinely charge for claims handling by independent attorneys, but the standard companies do not. SBA has no systematic method for verifying surety company claims.

SBA AND THE SURETY COMPANIES ARE NOT PLACING SUFFICIENT EMPHASIS ON PREVENTING DEFAULTS

Generally, SBA and the surety companies writing most of the SBA guaranteed bonds are not placing sufficient emphasis on preventing contractor defaults. SBA guarantees many bonds without sufficient information to determine whether the contractor can adequately handle the projected workload. In addition, neither SBA nor many of the surety companies monitor contractor progress sufficiently to detect potential defaults before they occur. Consequently, SBA and many surety companies are not in a favorable position to minimize the number of defaults and resulting program losses.

In the private bonding market, however, the standard sureties place considerable emphasis on preventing defaults. According to the Surety Association of America, "the surety's fee is essentially a flat rate charge for the services performed by the surety and, as such, it is more related to averting or controlling loss than to funding the ultimate loss." The Surety Association of America also states that the standard surety as a matter of course monitors the work in process of a bonded contractor to insure that it does not overextend its total resources. In addition, two of those standard sureties we visited told us that they monitor job progress. If a contractor gets into a potential default situation, the surety may be able to arrange for the loan of supervisory personnel, skilled technicians, or special equipment from other contractor-clients of the surety.

Monitoring contractor's work programs

SBA and many surety companies should place additional emphasis on examining a contractor's total work program and

assessing its capability to handle the workload. As shown in the previous chapter, 31 percent of the contractor applications did not contain a work-in-process report or satisfactory substitute information. One standard surety company believes, however, that the best tool for preventing a default is declining bonds where the contractor would be overextending itself by undertaking more work than it can handle. Without work-in-process statements, neither the surety nor SBA could know when the contractor is becoming overextended.

Monitoring job progress

SBA and many surety companies should place additional emphasis on monitoring a contractor's progress during the job to prevent defaults or minimize losses. SBA operating procedures require the central office to prevent defaults, if possible, but we found that the SBA central office often does not learn of a default until long after it has occurred. In our sample of 34 defaulted contractors, we identified actual default dates on 15 bonds. The time lapse between the date the surety learned of the default situation and the date the surety notified SBA ranged from about 1 week to slightly more than 1 year. In 8 of the 15 cases, the lapse was 3 months or more.

SBA relies on the participating surety companies to prevent defaults. Our review of the 34 defaulted contractors, however, showed no evidence that the surety companies attempted to prevent the default. According to the claims manager for one major specialty surety, his company usually does not learn of a potential default situation until it is too late to prevent the actual default.

Some sureties, however, monitor job performance in an attempt to prevent defaults. During our review, we talked to three major standard sureties about their monitoring practices, and officials from two companies told us they monitor job progress. One company official said visits are made to job sites. Officials from the second surety said its representatives meet quarterly with contractors to discuss their financial positions, problems, and future plans; visit contractors' job sites and offices; and require either monthly or quarterly work-in-process reports. In addition, as a bonded job nears the projected completion date, the surety sends inquiries to the architect to determine if the bonded work is acceptable and progressing on schedule.

Other sureties do not believe that it is economically feasible to perform vigorous onsite monitoring for all bonded contractors. In lieu of onsite monitoring, one small

specialty surety sends a general status inquiry every 30 days for each active bond. If there is no response within 2 weeks, a second notice is mailed. After another week, it begins to make phone calls.

Some other specialty sureties told us that status inquiries were sent; but the two largest specialty surety companies did not know the frequency with which the inquiries were sent because they rely on agents to send the inquiries and follow up on them. This process is apparently inadequate since one company told us it did not usually learn of a default situation early enough to prevent the default.

In a July 1977 memorandum to an SBA audit group, SBA's General Counsel made the following general observation about the services of specialty sureties:

"The 'surety' lacks the ability and capacity to make underwriting decisions, to service the bonds it issues, or to adjust claims made against bonds issued. In order to perform these services to even a minor extent these 'mail drop' sureties engage the services of independent contractors, e.g., general agents, attorneys, engineers, management and technical consultants, and others * * *.

"The question SBA really should be pondering is what it expects surety companies to provide in exchange for 80 percent of the premium and the 80 to 90 percent guarantee they get from SBA, * * *."

This observation was not addressed to the Surety Bond Guarantee Program Office for direct action.

SPECIALTY SURETY COMPANIES
ARE COSTING SBA MORE
THAN STANDARD COMPANIES

Specialty surety companies are more costly to the Surety Bond Guarantee Program than the standard companies. The losses incurred by the specialty sureties are generally higher than those by the standard surety companies. The higher losses may result in part because the specialty surety companies use outside attorneys extensively in handling claims and bill their costs to SBA.

Our review showed that the specialty surety loss rates (losses incurred compared to value of bonds written) exceed those of the standard surety companies by about 30 percent. This is particularly significant in view of

the fact that specialty companies write 93 percent of the program's bonds. Our loss rate comparison considered the four specialty companies and the four standard companies which have written the most SBA-guaranteed bonds.

Our review also showed that specialty sureties' charges for outside attorneys and claims adjustors significantly exceed standard sureties'. In a sample of claims cases, the SBA payout to specialty sureties for independent attorney fees and claims-adjusting fees averaged 6.4 percent of the total amount paid. For the standard sureties in our sample, the payout for these fees averaged 0.4 percent.

SBA incurs larger attorney and claims-adjusting fees from the specialty sureties because of the way they operate as compared to standard companies. The primary specialty companies in the program either have no internal claims department or only very limited ones. Consequently, the specialty companies routinely employ networks of independent attorneys or claims-adjusting firms to handle claims cases. The sureties in turn charge SBA for up to 90 percent of these costs. One claims-adjusting firm which handles all claims for the largest writer in the program is a wholly owned subsidiary of the surety's managing general agent, and it has the following hourly billing rates:

Claims manager	\$75.00
Claims attorney	60.00
Administrative manager	40.00
Claims examiner	20.00
Trust account clerk	20.00
Attorney trust account clerk	20.00

In addition, this firm routinely employs independent attorneys. Up to 90 percent of these claims-adjusting and attorney fees are ultimately charged to SBA.

The standard sureties handle most of their claims work internally at no cost to SBA. The standard companies employ outside attorneys only when a case involves complex legal problems or goes into litigation.

In the previously mentioned July 1977 memorandum, SBA's General Counsel also addressed the specialty surety's lack of in-house legal resources:

"A surety company also should have adequate in-house legal resources to handle a considerable amount of the work involved in negotiating most claims, and

should not have to hire outside attorneys and charge SBA for such services.

"Actually what has happened is that SBA has permitted the creation of a whole new industry wherein SBA finances, through an expansion of the definition of loss, those services which SBA should reasonably expect would be provided at no cost to SBA. It is inconceivable to me that Congress intended or even contemplated such a development."

SEA HAS NO SYSTEMATIC
METHOD FOR VERIFYING SURETY
COMPANY CLAIMS

SBA has not implemented sufficient controls to ensure that all claims submitted by surety companies are legitimate and supported by source documents. Generally, surety forms submitted to SBA are not accompanied by claimants' invoices, drafts, payroll sheets, or other documents supporting the claim. Participating sureties submit either a computerized claim reimbursement document or a standard SBA form which only itemize the claims. They must, however, submit an affidavit stating that supporting documentation exists.

SBA has performed only minimal work to verify these surety claims. Although Surety Bond Guarantee Program officials recognize the need for verifying surety claims, they told us that staff shortages and a backlog of work have limited this work to a review of one surety company. These officials also told us they would like to review additional surety companies in the future.

CONCLUSIONS

The sureties and SBA are not adequately attempting to prevent contractor defaults. When defaults occur, specialty surety companies are more costly to SBA than standard companies. Specialty surety companies, for example, employ and charge SBA for up to 90 percent of outside attorney and claims-adjusting fees. Although the small specialty companies may not have established claims departments throughout the country, we believe this differential compensation between the standard and specialty companies is questionable.

RECOMMENDATIONS

We recommend that the SBA Administrator establish and enforce guidelines regarding surety responsibilities in the areas of monitoring contractor progress and preventing defaults.

We recommend that the SBA Administrator analyze the net claims-handling costs for the two types of sureties in the program--those that have an internal claims-handling capability and those that do not. Based on the results of this analysis, the Administrator should revise the reimbursement rate to a level(s) which will result in a reasonable and equivalent net claims-handling cost for all sureties regardless of whether they have an internal claims-handling capability.

We also recommend that the Administrator establish a systematic procedure for indepth verification of selected surety company claims.

SBA COMMENTS, SURETY COMPANY
COMMENTS, AND OUR EVALUATION

SBA and three surety companies commented on this chapter of our report. These comments are summarized below along with our evaluation.

Preventing defaults

SBA and two surety companies disagree with our contention that the standard surety companies monitor contractor progress. SBA also disagrees with our recommendation that the SBA Administrator establish and enforce guidelines regarding surety responsibilities for monitoring contractor progress and preventing defaults.

One standard surety company believes that we may be misleading the reader in our discussion of standard surety monitoring practices. This company states that it is not economically feasible for sureties to monitor thousands of contracts in progress; it considers monitoring to be part of the original underwriting. SBA generally agrees with this surety's comments and believes our recommendation regarding contractor monitoring is not practical or cost effective.

We made some revisions in this section of the draft report to avoid any misinterpretation by the reader. Some of the surety comments were incorporated in the report to clarify it.

We disagree with SBA, however, regarding the recommendations on contractor monitoring. We maintain that contractor monitoring--work program monitoring and job progress monitoring--is essential if SBA expects to prevent defaults and minimize losses. We believe that it is economically feasible for even specialty sureties to perform some form of monitoring. For example, the sureties could carefully evaluate a

contractor's total workload versus its capacity before approving another bond; and, as a minimum, it could send status inquiries to selected contractors every 30 days and follow up on them.

Specialty surety companies
are more costly to SBA

Three specialty surety companies disagree with some of the information presented in this section. In addition, SBA disagrees with our recommendation that the SBA Administrator analyze the net claims-handling costs for the two types of sureties in the program, and revise the claims-handling reimbursement rate to a level(s) which is equitable to SBA and all sureties.

The surety company writing the most SBA-guaranteed bonds made several comments on this section of our report. It contends that since specialty surety companies are small, they cannot afford a network of branch offices to service only surety claims. Therefore, they have to rely more on outside consultants and attorneys. This same surety attempted to refute our analysis which shows that the specialty surety loss rates exceed those of the standard companies. In doing this, it computed an average program loss rate for six standard companies and compared this to its own loss rate.

Our report does not recommend that specialty sureties establish networks of branch offices throughout the country. We are simply pointing out that SBA incurs larger attorney and claims-adjusting fees from specialty sureties because they use outside resources extensively and bill SBA for up to 90 percent of these costs. The standard sureties, however, generally handle claims internally and receive no reimbursement from SBA. We recognize that since the standard companies have established branch offices which handle claims, they may be able to perform the claims-handling function at a somewhat lesser cost; but it costs them something.

Regarding this surety's analysis of standard surety loss rates versus its own, we must point out that its comparison is totally erroneous. First, the surety neglected to include the program's most active standard surety, which has a relatively low loss rate. Secondly, the surety overstates the loss rate for one standard surety company in its analysis by almost 200 percent. If these errors were corrected, the surety's analysis would show that its loss rate significantly exceeds the average rate for the standard sureties.

We maintain that our analysis, which compared the average loss rate of the four most active standard sureties and the four most active specialty sureties, is the most valid.

Our analysis showed that the average loss rate for the specialty sureties is about 30 percent higher than the average rate for the standard companies.

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Two other specialty sureties believe that we are unduly harsh in our criticism of specialty surety participants. These companies point out that the standard sureties have given only lip service to the Surety Bond Guarantee Program. One of these sureties believes that our comparison is based on insufficient data and inadequate examination of the subject as well as limited opinions.

Our report recognizes that standard surety companies have participated in the Surety Bond Guarantee Program to only a limited extent. In addition, it emphasizes that statements regarding surety companies are based on the procedures and practices of the companies writing the majority of SBA-guaranteed bonds. These statements may not be applicable to some participating surety companies.

We disagree that our conclusions are based on insufficient data. The company which made this comment provided no evidence to support its claim. In addition, one specialty surety commented that, generally, we had done a fine job of investigation and review; and a standard surety stated that the report treated the subject in a very objective manner. SBA also stated that the report represents the results of a comprehensive examination.

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Finally, we do not understand SBA's disagreement with our recommendation that the SBA Administrator analyze the net claims-handling costs for the two types of sureties in the program and revise the claim-handling reimbursement rate to a level(s) which is equitable to SBA and all sureties. SBA considers this recommendation unrealistic and impractical because its consequences to small and minority contractors would be extremely bad.

This recommendation is simply directed at establishing a reimbursement rate(s) which is equitable to SBA, standard surety companies, and specialty companies. Under current procedures, SBA pays a substantial portion of specialty surety claims-handling costs since specialty sureties routinely use outside attorneys. On the other hand, standard companies generally handle claims internally without any reimbursement from SBA. SBA does not know, however, whether the reimbursements are realistic and reasonable.

CHAPTER 4

THE PROGRAM IS NOT GRADUATING

SIGNIFICANT NUMBERS OF

CONTRACTORS

The Surety Bond Guarantee Program is not significantly contributing toward graduating contractors into the private bonding market. This lack of program graduates may result in part from inadequate SBA practices and procedures. In addition, the surety companies writing most of the program's bonds have no methods or incentives to graduate contractors.

The Congress provided for the Surety Bond Guarantee Program to alleviate bonding difficulties confronting the small contractor, but it did not intend for contractors to remain indefinitely in the program. One of the program's fundamental objectives is to increase the bondability of participating contractors so they can make the transition to the private bonding market or graduate.

CONTRACTORS ARE NOT GRADUATING

Our review disclosed that few contractors are graduating from the Surety Bond Guarantee Program. We also found that many contractors currently in the program may qualify for standard market bonding.

Our review of 123 randomly selected contractors who had not participated in the program during the last 2 years showed that only about 6 percent had graduated. We considered a contractor as a graduate if it (1) had received more than one SBA bond guarantee and (2) later obtained bonding in the private market.

Our review of 150 active contractor files showed that many of the contractors had been participating in the program for several years. One contractor, for example, applied for more than 160 SBA-guaranteed bonds during the last 4 years, received 36 contract awards, and performed successfully on each contract. Several other participating contractors have applied for more than 50 SBA guarantees during 3- to 5-year periods.

We believe, however, that many participating contractors may qualify for private market bonding. Our consultant

reviewed 18 of our sample of active contractors which we believe had graduation potential and concluded that: seven should qualify for private market bonding based on their track record, financial position, and management expertise; four may qualify when they have been in the program long enough to know whether their upward trend will remain consistent; and one contractor should have qualified for private bonding without entering the SBA program. Our consultant recognized that underwriting is not an exact science and that underwriters have considerable discretionary authority, so he very conservatively examined the qualifications of these contractors. Among the seven contractors he believed were qualified for private bonding, one contractor had net worth of \$200,000 and net quick assets of \$112,000, and he had successfully performed on 36 contracts since July 1975. Another contractor with net worth of \$190,000 and net quick assets of \$146,000 has successfully performed 12 contracts. Both contractors, however, are still actively participating in the Surety Bond Guarantee Program.

SBA AND SURETY COMPANIES DO NOT ENCOURAGE GRADUATION

Neither SBA nor the surety companies encourage contractors to graduate from the Surety Bond Guarantee Program. This may be caused in part because SBA has no procedures for monitoring or encouraging graduation.

Our review of 273 randomly selected contractor files showed only one instance where SBA formally questioned whether a contractor should remain in the program and encouraged him to obtain bonding without the SBA guarantee. One surety bond officer told us that he believed it improper to encourage a contractor to change surety companies in order to obtain private bonding.

The participating specialty surety companies also do not encourage graduation. These companies, which write more than 93 percent of the program's bonds, write few, if any, bonds without the SBA guarantee. These companies would have to place a contractor with another surety to graduate it from the program and, consequently, lose its premium. The specialty sureties therefore have no incentives to graduate contractors participating in the Surety Bond Guarantee Program.

The lack of emphasis on graduation may result because SBA has no procedures for monitoring or encouraging contractor graduation. SBA "Standard Operating Procedure 50-45," Bulletin No. 7, provided SBA with specific instructions for

monitoring contractor graduation, but this bulletin expired June 1, 1977. The bulletin required, among other things, that SBA

- obtain estimates from sureties of the time required to make a contractor bondable without an SBA guarantee,
- verify the graduation estimates of specialty sureties,
- question sureties as to why a contractor with 2 years in the program and a profitable operation is not eligible for standard bonding, and
- require the contractor to submit decline letters from two standard sureties if SBA believes the contractor should be graduated.

Although the Director, Office of Special Guarantees, still considered this bulletin to be effective, 75 percent (three out of four) of the surety bond officers we contacted considered it to be expired.

In addition, SBA has no systematic method for identifying program graduates or obtaining current information on inactive contractors. Although most SBA officials believe that contractor graduation was limited, SBA could not provide reasonable estimates of the number of contractors graduated from the Surety Bond Guarantee Program. SBA therefore cannot assess its effectiveness in graduating contractors into the standard bonding market.

CONCLUSIONS

The Surety Bond Guarantee Program is not significantly contributing toward graduating contractors into the private bonding market. Our review of contractors who had not participated in the program during the last 2 years showed that only about 6 percent had graduated from the program. In addition, we found that many active contractors had successfully participated in the program for several years.

The lack of program graduates may result in part because neither SBA nor the surety companies encouraged graduation. Our review of 273 randomly selected files showed only one instance where SBA formally questioned whether a contractor should remain in the program and encouraged him to obtain bonding without the SBA guarantee. In addition, the surety companies writing most of the program's bonds will write few, if any, bonds without SBA's guarantee; so these companies have no methods or incentives to graduate contractors. Furthermore, the absence of current SBA procedures and guidelines

regarding contractor graduation contributes to this inadequate emphasis on graduation.

RECOMMENDATIONS

We recommend that the Administrator, SBA, establish graduation criteria and procedures for formally encouraging and assisting contractors to obtain private bonding. The Administrator should, for example, establish guidelines requiring Surety Bond Guarantee Program personnel to evaluate a contractor's progress periodically based on such factors as length of time in program, number of bonds guaranteed, and financial and managerial capabilities. If the contractor appears to meet standard market qualifications, SBA should notify the contractor to seek private market bonding within a reasonable period of time, and SBA should assist the contractor in locating a surety company, if necessary.

We also recommend that the Administrator place incentives on contractor graduation. The Administrator could, for example, annually increase the contractor's fee to SBA after being in the program 2 years. He also could annually decrease the percentage guarantee to surety companies after the contractor has participated in the program for 2 years.

In addition, we recommend that the Administrator:

- Refrain from doing business with sureties that refuse to offer bonding to qualified contractors without an SBA guarantee in order that contractors may have a reasonable opportunity to graduate.
- Develop a system for determining the program's success in attaining its goal of placing contractors into the standard bonding market.

SBA COMMENTS, SURETY COMPANY COMMENTS, AND OUR EVALUATION

SBA and one surety had several comments regarding the section on contractor graduation. Both SBA and the surety state that graduation is not a formal goal of the Surety Bond Guarantee Program. SBA states that imposing rules of graduation upon the sureties, which in turn would impose similar rules on contractors, would be an inappropriate imposition of Government rules on the free enterprise system. While SBA opposes rules of this nature, it points out that it has provided written instructions for its employees and surety people to encourage graduation. Finally, SBA disagreed with our recommendation requiring specialty surety companies

to also provide bonding to qualified contractors without the SBA guarantee in order that contractors may have a reasonable opportunity to graduate. SBA stated that it does not have the regulatory or statutory authority to place this requirement on specialty sureties. We have clarified this recommendation in response to SBA's comment, although we have not modified its meaning or intent.

We believe that contractor graduation is an intended objective of the Surety Bond Guarantee Program because prior congressional and SBA reports have reiterated this objective. A 1970 House of Representatives report (H.R. 91-1556) on the program's authorizing legislation, for example, states that

"The Committee expects that long-run advantages will be gained from the overall program by helping the disadvantaged contractors enter the mainstream of the economic system and thereby be able to establish the required 'track record' of successful performance ordinarily required by private surety companies."

In addition, a 1976 report by the House Subcommittee on SBA Oversight stated that

"* * * it is expected that contractors participating in the program will eventually 'prove' themselves, join the mainstream of bondable contractors, and will no longer need this SBA assistance. The end product of this movement into the standard surety market is commonly called 'graduation.'"

Finally, a 1977 SBA study of the Surety Bond Guarantee Program points out that

"A fundamental and inherent objective of the program is to increase the bondability of participating contractors so they can make the transition to the regular bonding system without supporting guarantees."

Regarding graduation instructions, page 31 of the report recognizes that SBA has written graduation instructions. However, as pointed out, these instructions expired on June 1, 1977, and 75 percent of the Surety Bond Officers we contacted did not consider them to be in effect.

We believe that SBA has the statutory authority to refrain from doing business with sureties which only offer bonding with an SBA guarantee. We also believe that this

policy would further the legislative intent of the Surety Bond Guarantee Program regarding contractor graduation. We maintain that in order for contractors to have a reasonable opportunity to graduate, the sureties in this program must offer bonding to qualified contractors without an SBA guarantee.

CHAPTER 5

SBA DOES NOT PROVIDE MANAGEMENT

ASSISTANCE TO SURETY BOND

GUARANTEE PROGRAM CONTRACTORS

Although SBA is responsible for providing technical and management assistance to small firms, it does not identify the need for management assistance or provide it to the Surety Bond Guarantee Program contractors. SBA relies on the contractor or surety companies to recognize the need for management assistance and request it from SBA when applying for a bond guarantee.

The SBA Management Assistance Program is designed to foster the establishment, growth, and success of small business. Available management assistance resources include SBA's own business management specialists, volunteer groups such as the Active Corps of Executives, and paid outside consultants.

Our review of 273 randomly selected contractors showed only five instances where management assistance was requested. Two of the contractors were actually requesting specialized assistance from an agent rather than SBA, and SBA believed that one other request was a mistake. Another contractor obtained management assistance through another SBA program. The fifth contractor did not receive any assistance from SBA.

Some program officials believe that contractors are reluctant to request management assistance because they feel that (1) a request for management assistance could cast doubt on their managerial skills and result in the bond guarantee being denied and (2) SBA management assistance is inadequate. In addition, some program officials expressed reservations about the quality of SBA management assistance.

CONCLUSIONS

We believe that adequate and timely management assistance could minimize defaults or significantly enhance a contractor's ability to obtain subsequent bonding in the private market. Management assistance to the contractor, for example, could prevent some defaults by providing information regarding cost estimating, cash flow, and company workload capacity. In addition, assistance regarding basic accounting, audits, and controls could help a contractor in qualifying for standard market bonding.)

RECOMMENDATIONS

We therefore recommend that the Administrator, SBA, (1) develop a method for identifying the management assistance needs of Surety Bond Guarantee Program contractors and (2) provide timely and adequate management assistance to them. The Administrator could, for example, require more indepth analysis of contractor financial positions and management resumes and, if necessary, discussion with contractors. The Administrator should consider approving certain bond guarantees only if the contractor is willing to accept SBA management assistance.

SBA COMMENTS, SURETY COMPANY COMMENTS, AND OUR EVALUATION

SBA stated that it will review our recommendation in further detail and determine those measures deemed appropriate to provide management assistance.



U.S. SMALL BUSINESS ADMINISTRATION
SURETY BOND GUARANTEE UNDERWRITING REVIEW

SBG No. with Suffix

PART I SURETY'S REVIEW

SURETY COMPANY	CONTRACTORS TRADE NAME & ADDRESS (Inc. County & Zip)
<p>NOTE: Items 1-17 are to be completed on each guarantee submission to SBA including the initial and all subsequent submissions</p>	

THIS FORM IS MANDATORY. NO SURETY SUBSTITUTE WILL BE ACCEPTED BY SBA.

1(a). JOB DESCRIPTION AND LOCATION (Including obligee):

SUBCATEGORY CODE(S) OF CONTRACT TYPE _____ (APPENDIX 5 SOP 50 45)

1(b). CONTRACTOR IS SUB-PRIME OR CONTRACTOR	ON THIS JOB	1(c). TYPE OF CONTRACT <input type="checkbox"/> CONSTRUCTION <input type="checkbox"/> SERVICE <input type="checkbox"/> SUPPLY <input type="checkbox"/> OTHER (Specify)
2(a). CONTRACT AMOUNT \$	2(b). <input type="checkbox"/> NEGOTIATED <input type="checkbox"/> BID	2(c). IF BID WHAT IS 2ND LOW BID? \$ % <input type="checkbox"/> N/A
3(a). BOND AMOUNT (Bid) \$	PERFORMANCE \$	PAYMENT \$
3(b). IF PENALTY CLAUSE AMT/WORKING OR CALENDAR DAY \$	4. PRESENT PROJECT SIMILAR TO PREVIOUS WORK PERFORMED? <input type="checkbox"/> YES <input type="checkbox"/> NO	5. BOND REQUIRED BY ORIGINAL CONTRACT DOCUMENT? <input type="checkbox"/> YES <input type="checkbox"/> NO
6(a). SCHEDULED STARTING DATE	6(b). SCHEDULED COMPLETION DATE	6(c). CONTRACTOR STARTED JOB YET? IF "YES" DATE IF "YES" ATTACH BOND BENEFICIARY REPORTS <input type="checkbox"/> YES <input type="checkbox"/> NO

7. WORK IN PROGRESS

7(a). WORK IN PROGRESS STATUS REPORT ATTACHED IF NO, REVIEW YOUR FILE AND ATTACH YOUR REPORT OR SBA FORM 994F <input type="checkbox"/> YES <input type="checkbox"/> NO	7(b). VERIFIED BY OBLIGEE'S? <input type="checkbox"/> YES <input type="checkbox"/> NO	7(c). HOW MANY?	7(d). OF HOW MANY?
7(e). HAS SURETY CHECKED W/SUPPLIERS? <input type="checkbox"/> YES <input type="checkbox"/> NO	7(f). HOW MANY?	7(g). OF HOW MANY?	7(h). PAYABLES CURRENT? IF NO PROVIDE SPECIFICS <input type="checkbox"/> YES <input type="checkbox"/> NO

8. FINANCIAL STATEMENT

COPY OF CURRENT FINANCIAL STATEMENTS (Company & personal) ATTACHED OR ALREADY ON FILE W/SBA

NOTE: THESE STATEMENTS MUST BE SIGNED AND DATED BY PRINCIPALS

8(a). DATE OF FINANCIAL STATEMENT	8(b). FISCAL YEAR ENDS	8(c). FINANCIAL STATEMENT PREPARED BY WHOM?
8(d). F/S SHOW DISCLAIMER? <input type="checkbox"/> YES <input type="checkbox"/> NO	8(e). TYPE OF FINANCIAL STATEMENT SIMPLE <input type="checkbox"/> COMPLETED <input type="checkbox"/> % OF COMPLETION <input type="checkbox"/> OTHER (Specify) <input type="checkbox"/> <input type="checkbox"/> CASH <input type="checkbox"/> ACCRUAL <input type="checkbox"/> CONTRACT	
8(f). NET WORTH \$ COMPANY: \$ PERSONAL \$	8(g). NET QUICK ASSETS \$ COMPANY: \$	8(h). WORKING CAPITAL \$ COMPANY: \$

8(i). WORKING CAPITAL SUFFICIENT? <input type="checkbox"/> YES <input type="checkbox"/> NO	IF "NO" HOW MUCH IS NEEDED? SOURCE:	
9(a). SCHEDULE OF AGED PAYABLES & RECEIVABLES ATTACHED? <input type="checkbox"/> YES <input type="checkbox"/> NO	9(b). VERIFICATION OF PAYABLES? <input type="checkbox"/> YES <input type="checkbox"/> NO: % OVER 60 DAYS	9(c). VERIFICATION OF RECEIVABLES? <input type="checkbox"/> YES <input type="checkbox"/> NO: % OVER 60 DAYS

10. BANK RELATIONS

10(a). SURETY VERIFIED BANK BALANCE? <input type="checkbox"/> YES <input type="checkbox"/> NO	10(b). AVERAGE BANK BALANCE \$	10(c). CONTRACTOR HAVE BANK LINE OF CREDIT? <input type="checkbox"/> YES <input type="checkbox"/> NO	10(d). HOW MUCH? (Gross) \$
10(e). WITH WHOM?	10(f). HOW MUCH PRESENTLY OWING \$	10(g). HOW MUCH L/C PRESENTLY UNUSED? \$	

11. BONDING AVAILABILITY

11(a). CONTRACTOR HAVE SURETY BONDING LINE? <input type="checkbox"/> YES <input type="checkbox"/> NO	11(b). IF YES WHAT AMOUNT? \$	11(c). SURETY BONDING LINE WITH?
11(d). INDEMNITIES POSTED? (Company and personal) <input type="checkbox"/> YES <input type="checkbox"/> NO	IF "NO" ATTACH EXPLANATION	IF "YES" ATTACH COPIES OF INDEMNITY AGREEMENTS AND PERSONAL FINANCIAL STATEMENTS ON ALL INDEMNITORS (Including those of third parties unless previously submitted to SBA)

12. HAS SURETY REQUIRED EXTRA SECURITY i.e. A CD OR CASHIERS CHECK FROM CONTRACTOR

YES NO IF YES: WHAT TYPE INSTRUMENT: _____ AMOUNT \$

13(a). SUBCONTRACTORS INVOLVED IN THIS JOB? <input type="checkbox"/> YES <input type="checkbox"/> NO	13(b). IF YES PARTICIPATION %	13(c). PRINCIPAL SUBCONTRACTOR BONDED? IF YES, AND BY YOUR COMPANY THROUGH THE SBG PROGRAM ATTACH SPECIFICS <input type="checkbox"/> YES <input type="checkbox"/> NO
--	-------------------------------	--

14. DOES SURETY RECOMMEND FINANCIAL/MANAGEMENT/TECHNICAL ASSISTANCE BY SBA? YES NO IF YES, WHAT TYPE & WHY

15. CHECKLIST OF REQUIRED ITEMS

CONTRACTOR APPLICATION FEE CONTRACTOR PROCESSING FEE SBA FORM 994 SBA FORM 990 SBA FORM 912 SBA FORM 994F OR SUBSTITUTE COPIES OF BONDS IF SPECIAL CONDITIONS ADDED

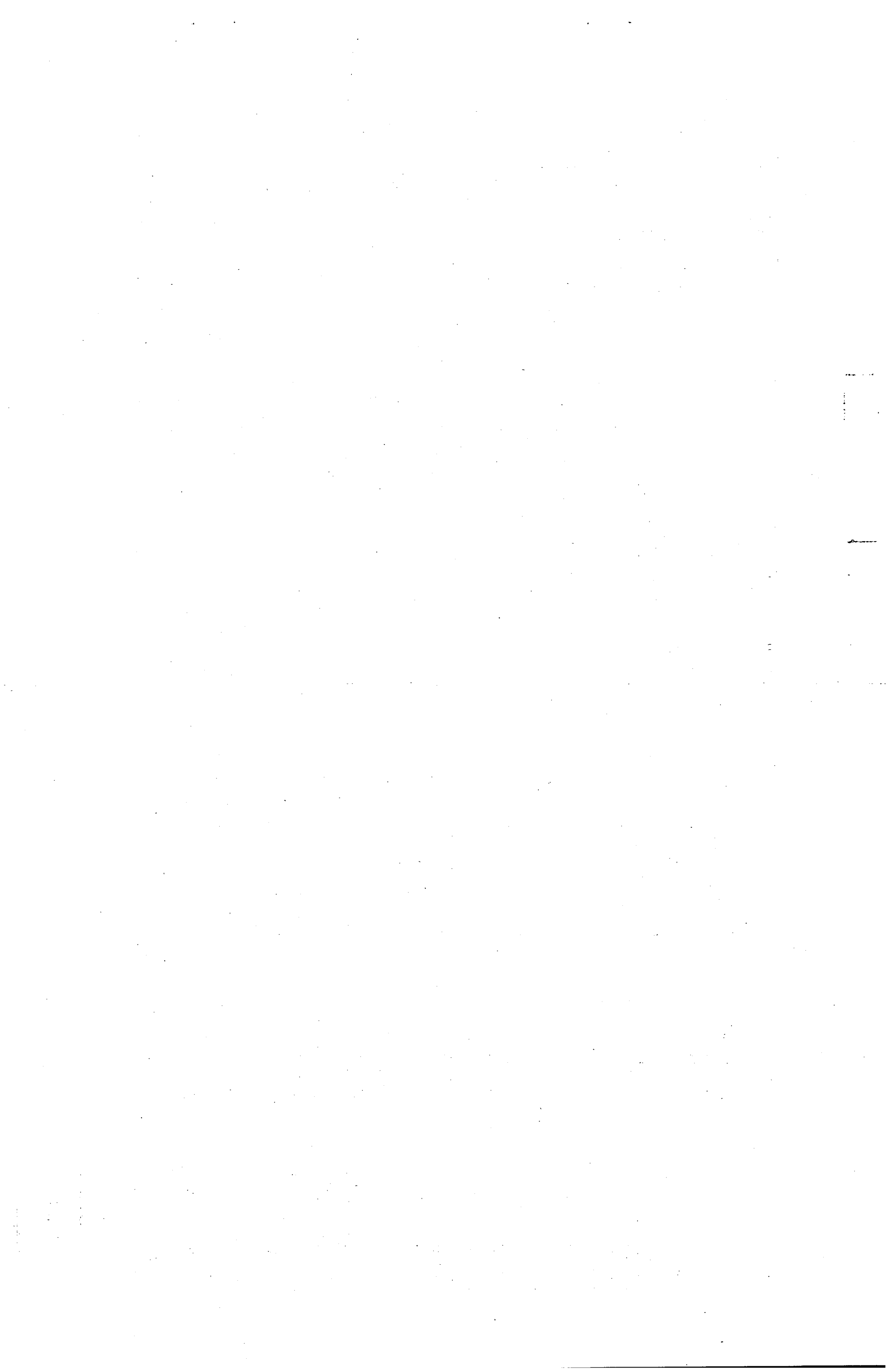
16. CONTINUATION SHEETS ATTACHED? YES NO

17. REMARKS/CONCLUSIONS. (Please specify why this contractor must have SBA's bond Guarantee Assistance and when you anticipate his no longer needing this help.)

Items 18-28 are to be completed on the initial submission and its annual update as requested by SBA

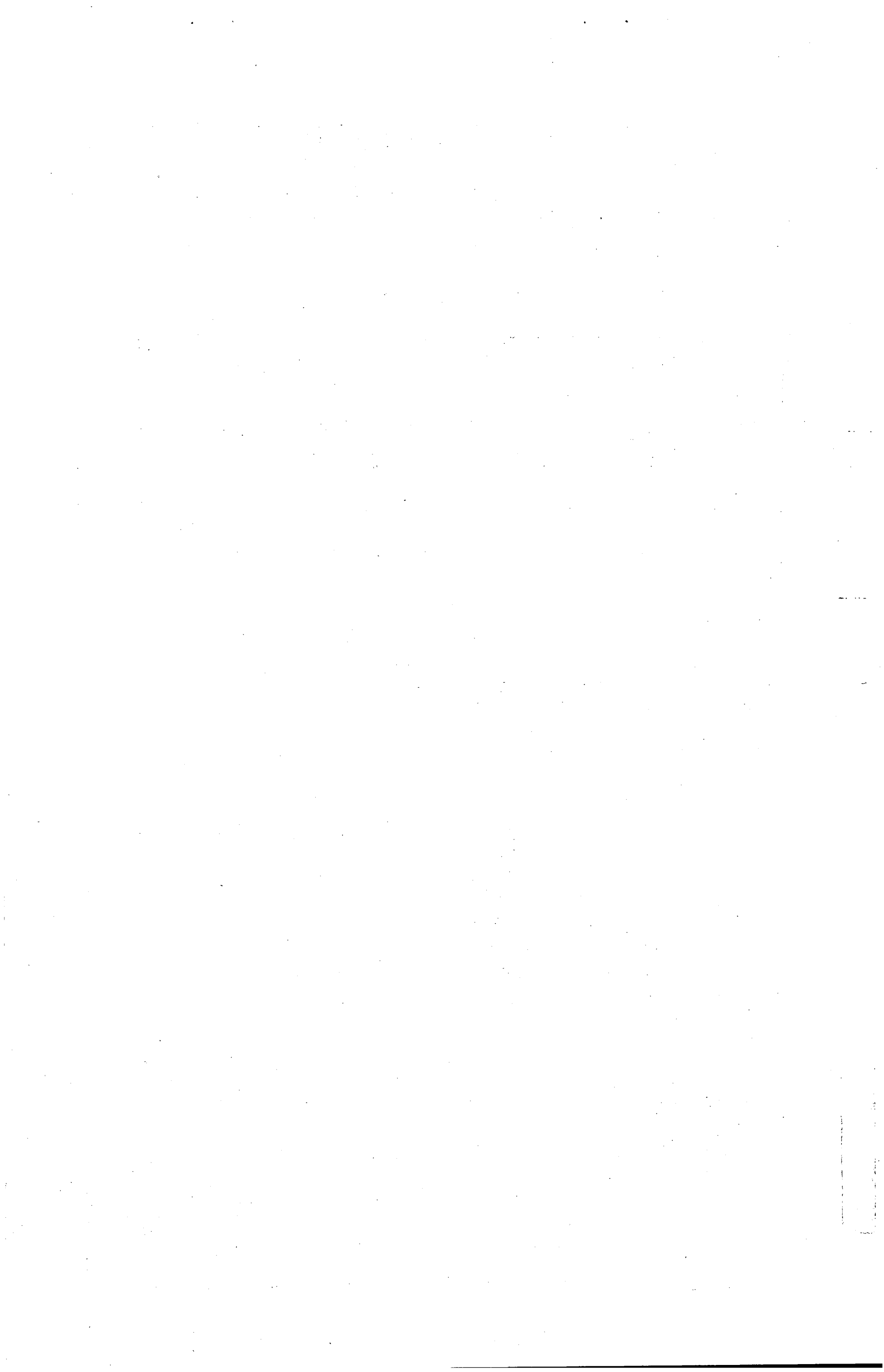
18. TYPE OF CONTRACTUAL WORK THIS FIRM HAS DONE PREVIOUSLY

19(a). LARGEST PREVIOUS CONTRACT UNDERTAKEN? \$	19(b). LARGEST PREVIOUS WORK PROGRAM UNDERTAKEN? \$ # OF JOBS	20(a). ANY DISPUTES? IF "YES" ATTACH DETAILS <input type="checkbox"/> YES <input type="checkbox"/> NO	20(b). ON SCHEDULE? IF "NO" ATTACH DETAILS <input type="checkbox"/> YES <input type="checkbox"/> NO
---	---	---	---



21(a). CONTRACTOR EVER FAILED TO COMPLETE JOB? <input type="checkbox"/> YES <input type="checkbox"/> NO IF "YES" ATTACH SPECIFICS		21(b). HAS CONTRACTOR EVER DEFAULTED ON A CONTRACT FORCING A SURETY TO SUFFER A LOSS? <input type="checkbox"/> YES <input type="checkbox"/> NO IF "YES" ATTACH SPECIFICS	
22(a). CONTRACTOR HAVE ADEQUATE EQUIPMENT? <input type="checkbox"/> YES <input type="checkbox"/> NO		22(b). OWNED? <input type="checkbox"/> YES <input type="checkbox"/> NO	
23. CONTRACTOR TAXES CURRENT? IF "NO" ATTACH SPECIFICS <input type="checkbox"/> YES <input type="checkbox"/> NO		24. CONTRACTOR INSURANCE COVERAGE SUFFICIENT? <input type="checkbox"/> YES <input type="checkbox"/> NO	
25(b). LARGEST AMOUNT BONDED? \$ _____ JOB: \$ _____		25(c). WITH WHOM? WORK PROGRAM	
25(d). IF CHANGE OF SURETY, WHY?			
26. ATTACHED RESUME(S) OF OFFICERS, OWNERS AND/OR KEY EMPLOYEES <input type="checkbox"/> YES <input type="checkbox"/> NO			
27(a). MANAGING AGENCY OF SURETY (If applicable)		27(b). MANAGING AGENCY'S EMPLOYER (IRS) I.D.	
28. REMARKS/CONCLUSIONS			
IN OUR OPINION THE PRINCIPAL APPEARS TO HAVE THE FINANCIAL/MANAGEMENT/TECHNICAL ABILITIES TO SUCCESSFULLY COMPLETE THIS CONTRACT, HOWEVER, WE FEEL THIS CONTRACTOR FALLS BELOW THE NORMAL UNDERWRITING STANDARD OF OUR COMPANY, AND WE WILL NOT ISSUE BONDS TO THIS CONTRACTOR WITHOUT THE SBA GUARANTEE.			
SIGNATURE OF UNDERWRITER		DATE	
TYPED NAME		TELEPHONE NO. (Inc. Area Code)	
TITLE OF UNDERWRITER		AGENCY NAME (If applicable)	
ADDRESS OF UNDERWRITER		CITY	STATE ZIP
DATE RECEIVED BY SBA		BY: (Initials)	
PART II SURETY'S REVIEW TO BE COMPLETED BY SBA			
1. MEETS SBG SIZE STANDARDS <input type="checkbox"/> YES <input type="checkbox"/> NO		2. FINANCIAL/MANAGEMENT/TECHNICAL ASSISTANCE REQUESTED OR RECOMMENDED <input type="checkbox"/> YES <input type="checkbox"/> NO	
2(a). BY WHOM?		2(b). WHAT TYPE?	
2(c). SBA ACTION TAKEN			
3(a). IF NECESSARY ASSISTANCE IS NOT READILY AVAILABLE IN GOVERNMENT HAVE YOU REFERRED APPLICANT TO FUNDED ASSISTANCE PROGRAMS, i.e. MINORITY CONTRACTORS ASSISTANCE PROJECT (MCAP), ETC.? <input type="checkbox"/> YES <input type="checkbox"/> NO			
3(b). IF YES NAME THE PROGRAM(S):			
4. BASED ON THE UNDERWRITING DATA SUBMITTED:			
4(a). THERE <input type="checkbox"/> IS <input type="checkbox"/> IS NOT REASON TO EXPECT SUCCESSFUL COMPLETION OF THE CONTRACT		4(b). THE COSTS <input type="checkbox"/> DO NOT <input type="checkbox"/> DO APPEAR TO BE REASONABLE IN ACCORDANCE WITH STD. SURETY INDUSTRY PRACTICES	
5. IT HAS BEEN DETERMINED THAT THE REQUESTED BOND(S) <input type="checkbox"/> IS <input type="checkbox"/> IS NOT NECESSARY, REQUIRED BY THE CONTRACT DOCUMENT'S TERMS, AND THE SURETY HAS INDICATED THAT IT WILL NOT ISSUE THE BOND(S) WITHOUT THE SBA GUARANTEE. FURTHERMORE, NO ADVERSE DATA CONCERNING THE SURETY'S PREMIUM/FEE SCHEDULE WAS REVEALED IN THE CONTRACTOR'S APPLICATION (SBA Form 994)			
6. ATTACHMENTS (Check appropriate boxes)			
<input type="checkbox"/>	CONTINUATION SHEETS	<input type="checkbox"/>	INDEMNITY AGREEMENT(S)
<input type="checkbox"/>	CONTRACTOR'S CURRENT BUSINESS FINANCIAL STATEMENT	<input type="checkbox"/>	PERSONAL FINANCIAL STATEMENT(S)
<input type="checkbox"/>	RESUMES OF PRINCIPAL(S) OWNER(S) AND OR KEY EMPLOYEES	<input type="checkbox"/>	SBA FORM 990
<input type="checkbox"/>		<input type="checkbox"/>	SBA FORM 994
<input type="checkbox"/>		<input type="checkbox"/>	SBA FORM 912
<input type="checkbox"/>		<input type="checkbox"/>	SBA FORM 994F
7. REMARKS/CONCLUSIONS			
8. PRINCIPAL'S TRADE NAME			
9. RECOMMENDATION/ACTION			
APPROVE	DISAPPROVE	SIGNATURE	TITLE DATE
<input type="checkbox"/>	<input type="checkbox"/>		
<input type="checkbox"/>	<input type="checkbox"/>		
<input type="checkbox"/>	<input type="checkbox"/>		

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

OCT 17 1979

Mr. Henry Eschwege
Director
Community and Economic
Development Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

The Draft report of the General Accounting Office represents the results of a comprehensive examination of the Surety Bond Guarantee program conducted over a period of approximately one year. The report identifies four areas which GAO feels need improvement.

Prior to responding to specific findings and recommendations, three points need to be raised in order to establish foundations from which debate of the four GAO findings can be judged. No attempt will be made in this review to argue about facts contained in given case files or direct quotes attributed to various people interviewed. However, the degree of importance which is attached to any given observation can vary widely depending upon the background and experience of the interested party. In this regard, the GAO team should be complimented for having started in July of 1978 with virtually no background in surety, and to have concluded their fact gathering in late June of 1979 with a much improved level of appreciation for some of the issues involved.

First, the reason SBA is involved in surety bonding is that, after extensive hearings between 1965 and 1970, the Congress recognized that bonds were simply not available to certain segments of the business population. There are no substitutes for a surety bond when statutory language, in existence since 1935, requires prime contractors to furnish surety bonds in favor of the Government when the job involves new or rehabilitative work on Government-owned facilities. The straight-forward objective of the Surety Bond Guarantee program is, therefore, to make bonds available thru the use of an up to 90 percent guarantee to a qualified surety against loss.

The second point is to make clear that the fee or premium structure of the surety business is not related in any sense to actuarial computations related to loss, as is the case in insurance. Surety is not

Mr. Henry Eschwege

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insurance. One of the most basic reasons that bonds are not available to small and minority contractors stems from the fact that there is barely enough premium to pay for the administrative costs of issuing bonds, much less enough to establish significant reserves for losses.

The third and most important point is the productivity and cost effectiveness of the Surety Bond Guarantee program. This subject was either overlooked or ignored completely by the GAO. While the report acknowledges that 50 SBA employees in 19 offices have assisted small business in obtaining over 91,000 bonded jobs worth \$6.3 billion, the report fails to indicate that an additional 90,000 guarantees were extended to contractors who were not low bidders. Likewise, no mention is made that response time, a vital aspect, is normally one day, and very rarely, more than three days from receipt of the surety's guarantee request.

With these three points established for reference, the remainder of this response will deal with the four GAO-identified issues.

SURETY BOND GUARANTEES ARE OFTEN

BASED ON UNRELIABLE DATA AND SUPERFICIAL REVIEWS

We believe that adequate guidelines (guidance) are provided to both SBA field offices and sureties in the Surety Bond Guarantee Underwriting Review, the form attached as Appendix I of the report. The form is not intended as a crutch or substitute for decisionmaking. Upon careful examination, it will be found that the form and all of its blocks lead an underwriter thru the various steps encountered in determining credit and capacity of a contractor. Character aspects are accomplished by use of SBA's standard form 912. Program results indicate a very high degree of success without the use of a detailed underwriting manual or other such explicit instructions. Such suggestions to develop those type books or manuals have been rejected before primarily because such precision, to whatever degree, would adversely affect SBA's efforts to assist minority contractors whose needs are greater and whose balance sheets, assets, and experience are generally much weaker.

We will undertake to insure that agents and sureties exercise more diligence in the preparation of the form.

Mr. Henry Eschwege

page 3

The need for indepth reviews in certain instances is appropriate. As a result of GAO's comments and our own reviews, we know that SBG clients of long term and those which undertake larger than average jobs need periodic indepth review. We will take steps to implement this recommendation.

The final recommendation indicates that the GAO team possibly missed the fact that sureties themselves screen out many applicants without ever going to SBA. The figure is probably twice to three times the number actually forwarded to SBA. Declines by SBA represent about 3 percent of applications received. We will not attempt to suspend agents who are under contract with sureties. We will continue, however, to inform sureties, as we have in the past, of poor performers and let sureties take appropriate action. Failure on the part of surety to take corrective action can trigger action by SBA to punish the surety. Statutory language exists to support this approach.

SBA AND SURETY COMPANIES

ARE NOT MINIMIZING LOSSES

Throughout the GAO Draft are references to the use of attorneys for default handling by the specialty companies, the use of various people or resources to provide and produce more or better paper documentation, and the use of unlimited manpower resources to monitor and oversee contractors in hopes of somehow preventing defaults. Whether those manpower resources are from the private sector or the public sector, the costs of providing such services would be enormous. There should be no mistake that either the Government must pay for these costs or they will be borne by the contractors we have an obligation to assist. The last full paragraph on page 15 of the report grossly misrepresents what a standard surety uses the bond fee for, and suggests that it is used to handle defaults. GAO quoted a line from a booklet prepared by the Surety Association entitled "Unseen Services." What that quote means is that the fee is used to eliminate all risks before the bond is issued. [See GAO note, p. 45.]

We believe that the recommendation is not practical or cost effective.

Likewise, we believe that the next recommendation is unrealistic and impractical because its consequences to small and minority contractors would be extremely adverse.

Mr. Henry Eschwege

page 4

The last recommendation is reasonable. Some months prior to the issuance of the Draft report, a similar initiative was instituted by SBA. Depending upon the definition of "in-depth verification" and upon the availability of either internal or external audit resources, this effort will be carried out. Previous support from the Office of Inspector General has been valuable and timely, and continued support as required will be forthcoming.

THE PROGRAM IS NOT GRADUATING
SIGNIFICANT NUMBERS OF CONTRACTORS

We believe that the term "graduation" originated with GAO's many reviews of the SBA's 8(a) program. Less than three percent of the bonds guaranteed by SBA can be attributed to the 8(a) program. Approximately 20 percent of the total results of the SBG program relate to contractors who have some other connection with SBA, primarily through its loan programs. That the other 80 percent have no need for other SBA services, including management assistance, is their business, not SBA's. But to impose rules of "graduation" upon the sureties, which in turn would impose similar rules on contractors, would be, in our opinion, an inappropriate imposition of Government rules of the free enterprise system. While we oppose rules of this nature, the GAO team is aware that many efforts are exerted in this regard, that SBA does have written instructions in the hands of its employees and surety people to encourage "graduation," and that new ideas and new efforts are welcomed if they are rational. A recent suggestion, although inherently unfair, will be given careful consideration. It proposes that SBA deliver a list of successful contractors involved in the SBG program periodically to the major sureties (who write less than five percent of SBA's business). Armed with this information, agents for the major companies would seek out those contractors and attempt to capture the account away from the sureties which do not write bonds without SBA guarantees. It should be recognized that good surety customers contribute significantly to reducing losses and costs incurred by unsuccessful contractors, whether in or out of the SBA program.

The SBA has no regulatory or statutory authority to require sureties to write bonds without SBA's guarantee. That kind of corporate decision is made company by company for sound financial reasons. With one

Mr. Henry Eschwege

page 5

exception, all of the sureties which have participated in the SBG program have been qualified and approved by the U. S. Treasury Department and appear on that Department's annual publication in the Federal Register, entitled "Surety Companies Acceptable on Federal Bonds."

We will consider the final recommendation to develop an information system for measuring the program's success in graduating contractors, Please note the omission of the word "goal" because this is not a formal goal of the program.

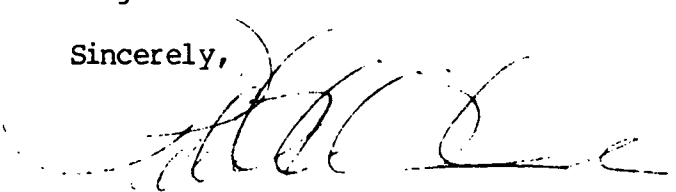
SBA DOES NOT PROVIDE MANAGEMENT

ASSISTANCE TO SURETY BOND CONTRACTORS

We will review this recommendation in further detail and determine those measures deemed appropriate to provide management assistance.

This concludes our response. We may wish to provide further details or clarifications on any of the subject areas covered at a later date.

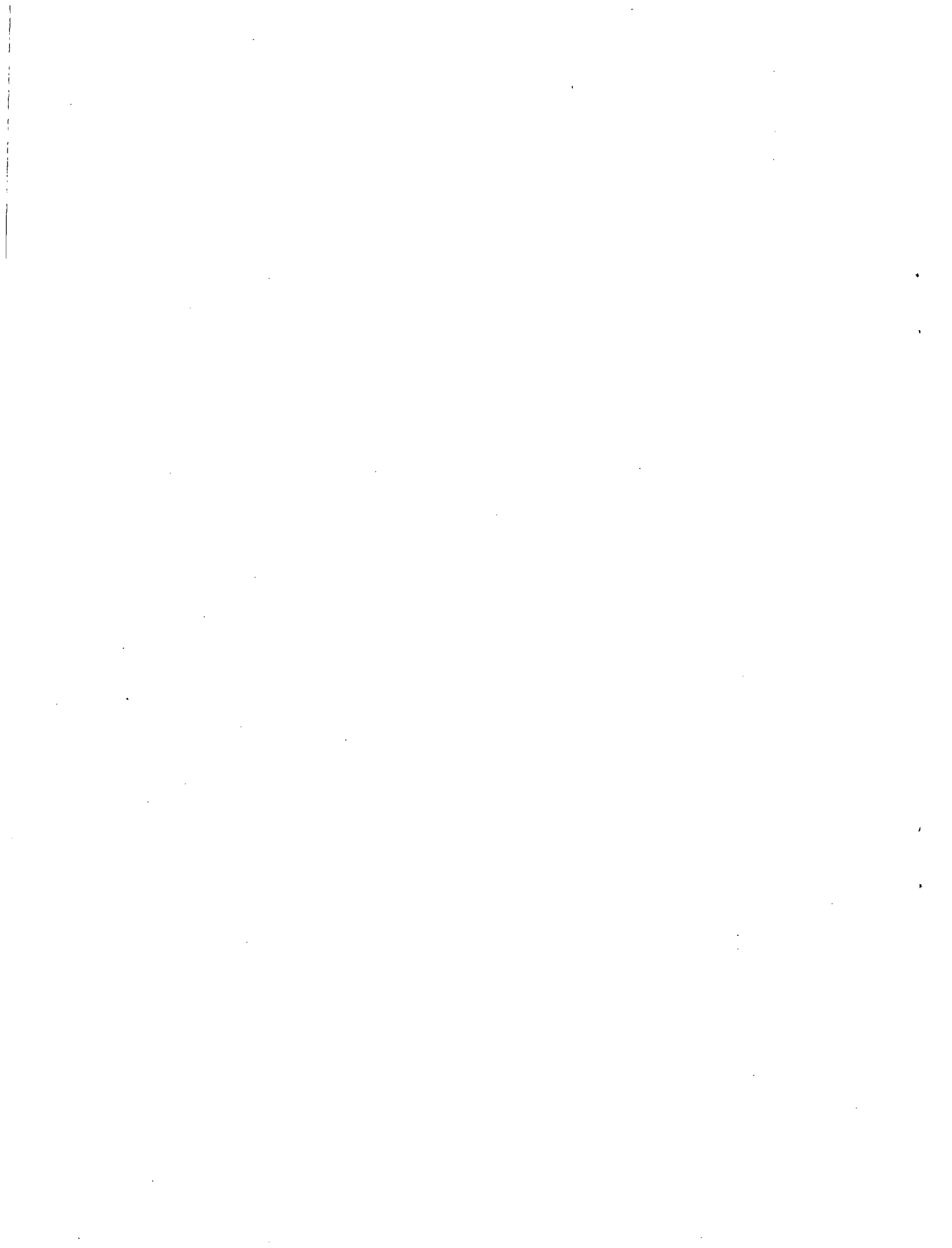
Sincerely,



Peter F. McNeish
Acting Associate Administrator
for Finance and Investment

GAO note: Page number references in this appendix may not correspond to page numbers of this report.

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