

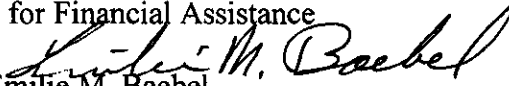


**U.S. Small Business Administration**  
**Washington, D.C. 20416**

**OFFICE OF  
INSPECTOR GENERAL**

September 30, 2003

TO: James E. Rivera  
Associate Administrator  
for Financial Assistance

FROM:   
Emilie M. Baebel  
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for Inspection and Evaluation

SUBJECT: Inspection on *Insufficient Proof of Citizenship Status for SBA Loans*

We are pleased to submit our report on *Insufficient Proof of Citizenship Status for SBA Loans*. Recent Office of Inspector General (OIG) investigations have identified borrowers who misrepresented their citizenship status in order to obtain Small Business Administration (SBA) guaranteed loans, despite the fact that non-citizens (i.e., aliens) can receive SBA loans if they meet certain requirements. Because of such misrepresentations and the effects of antiterrorism legislation, this inspection's focus was to identify the requirements for determining citizenship eligibility as well as potential vulnerabilities.

SBA and its lenders have little assurance that prospective borrowers truthfully disclose their citizenship status. The Agency cannot be reasonably certain that its loan programs benefit only eligible citizens or legal aliens because of reliance on prospective borrowers' honesty, concerns about loan origination delays, concern over the appearance of discriminatory practices, and the lack of a definitive national identification system for foreign nationals. Consistent with the USA PATRIOT Act, SBA should issue an interim directive instructing its lenders to verify the identities of new customers involved with Agency programs. SBA has promptly begun to make progress on this issue.

In addition, SBA cannot readily determine how many loans go to citizens and how many to aliens. Although the Agency's lending partners collect citizenship status information, SBA's loan databases do not contain such data. If the databases had the data, the Agency could identify potential trouble spots in its portfolio and perform programmatic research. So that the Agency can readily track which loans go to citizens and which to aliens, SBA should collect citizenship status data, including available alien registration numbers, in its loan databases.

We appreciate the excellent cooperation received from your staff and the field offices.

Attachment

**Insufficient Proof  
of  
Citizenship Status for SBA Loans**

**September 2003**

**Report No. 3-43**

**Office of Inspector General  
Inspection and Evaluation Division  
U.S. Small Business Administration**

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## ABBREVIATIONS

AAMVA	American Association of Motor Vehicle Administrators
CDC	Certified Development Company
CFR	Code of Federal Regulations
CIP	Customer Identification Program
FAFSA	Free Applications for Federal Student Aid
FBI	Federal Bureau of Investigation
FY	Fiscal Year
INS	Immigration and Naturalization Service
LPR	Legal Permanent Resident
OFA	Office of Financial Assistance
OIG	Office of Inspector General
SAVE	Systematic Alien Verification for Entitlements
SBA	Small Business Administration
SBIC	Small Business Investment Company
SBLC	Small Business Lending Company
SOP	Standard Operating Procedure

## EXECUTIVE SUMMARY

**Background.** Recent Office of Inspector General (OIG) investigations have identified borrowers who have misrepresented their citizenship status in order to obtain Small Business Administration (SBA) guaranteed loans. Non-citizens in the U.S., referred to in regulations as aliens, can receive SBA loans if they meet certain requirements. Lenders must verify the immigration status of each alien, but immigration authorities release information about an alien to a lender *only* when the alien provides a signed authorization. **However, if a borrower claims on the “Statement of Personal History” (SBA Form 912) that he/she is a U.S. citizen, the Agency does not require further verification.**

Knowing a person’s citizenship status, i.e., whether he/she is a citizen or an alien, requires knowing that person’s identity. The September 2001 terrorist attacks changed financial institutions’ customer identification responsibilities and led to the USA PATRIOT Act. The Act required new regulations in which institutions must implement procedures for “*verifying* the identity of any person seeking to open an account to the extent reasonable and practicable” [emphasis added].<sup>1</sup> Some regulations have been issued, including one for banks and similar institutions, but not for non-bank lenders as defined later in this report. **Whereas falsifying one’s identity and/or citizenship status used to be primarily a fraud issue, it is emerging as a homeland security issue. The challenge for SBA lenders is how to comply with the Act without creating undue hardships for honest prospective borrowers.**

**Objectives, Scope, and Methodology.** Because of misrepresentations of citizenship eligibility in SBA loan programs and the effects of antiterrorism legislation, this inspection’s focus was to identify the requirements for determining citizenship eligibility as well as potential vulnerabilities. The OIG examined legislation, studies, articles, Congressional testimony, and other materials on identity verification and related issues. SBA and Federal banking agency officials were interviewed.

**The Importance of Determining Citizenship Status.** Citizenship status is more than just a component of a person’s identity. There are several reasons why it is important for lenders to determine whether prospective borrowers are citizens, legal aliens, or illegal aliens. These include:

**Possible Terrorist Connections.** Several years ago, an SBA loan was approved but, according to SBA records, not disbursed to a businessman later arrested as a terrorist suspect. Moreover, an ongoing investigation of about 450 defaulted loans recently found that—thus far—approximately 100 borrowers have misrepresented themselves as U.S. citizens. Five were indicted and pled guilty, with more indictments expected. Many of these individuals are aliens from a nation subject to terrorism-related national security restrictions and have been systematically taught how to fraudulently obtain SBA loans.

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<sup>1</sup> USA PATRIOT Act, Section 326(a) (1) (2).

**Fraud.** OIG investigations have revealed other crimes related to citizenship status, such as attempted bribery to obtain citizenship papers and an individual receiving an SBA loan even though this person was in the process of being deported.

**Program Effectiveness.** Effective service delivery requires determining whether an individual is eligible for a program in the first place and, if so, learning what his/her needs are. **Despite SBA's eligibility requirements, an alien can simply circumvent them by falsely claiming to be a U.S. citizen.** For truly eligible borrowers, if citizenship status information were readily available, the Agency and its resource partners could better plan for technical and financial assistance needs, as well as make SBA programs more transparent, thereby enhancing accountability.

**New Identification Requirements for Banks and Similar Institutions.** A final USA PATRIOT Act regulation on customer identification programs (CIPs) was published on May 9, 2003, requiring banks and similar institutions to implement CIPs appropriate for their size and types of business. Regulations for various types of *non-bank* institutions have not yet been issued and are unlikely to be issued anytime soon. In the interim, such institutions are left without guidance on how to verify new customers' identities.

**Findings.** *SBA and its lenders have little assurance that prospective borrowers truthfully disclose their citizenship status.* SBA cannot be reasonably certain that its loan programs benefit only eligible citizens or legal aliens for the following reasons:

- *Reliance on prospective borrowers' honesty on the Form 912.*
- *Concerns about delays in loan origination.*
- *Concern over the appearance of discriminatory practices.*
- *Lack of a definitive national identification system for foreign nationals.*

Nonetheless, SBA and its lending partners can have a reasonable assurance of correctly identifying borrowers and their citizenship status if they bear in mind three things:

- *Keep expectations realistic, and do not expect perfection.*
- *To compensate for the current shortcomings of identification documents, emphasize "redundant" verification, i.e., the use of more than one type of verification to provide reasonable—but not absolute—assurance that a financial institution knows a customer's identity.*
- *Hold SBA lending partners to similar, if not identical, verification standards.* All lenders who benefit from SBA loan guarantees have an obligation to ensure that guaranteed funds are used as intended. Unfortunately, because it is unlikely that regulations applicable to non-bank lenders will be issued in the near future, a stopgap measure is needed.

**Recommendation 1 of 2:** *Consistent with the USA PATRIOT Act, SBA should issue an interim directive instructing SBA lenders to verify the identities of new customers involved with SBA programs. The directive should include the following elements:*

- *The directive should apply to all SBA lenders. However, because banks, savings associations, credit unions, private banks, and trust companies are subject to the recently issued USA PATRIOT Act regulation, they should already be in compliance with the SBA directive.*
- *At a minimum, a non-bank lender should require either two forms of verifiable identification, or one such form of identification combined with one type of non-documentary verification.*
- *A non-bank lender should obtain from each new customer his/her name, date of birth, address, and identification number. For a person claiming to be a U.S. citizen, the identification number should be a taxpayer identification number. For a person claiming to be an alien, it should be at least one of the following: a taxpayer identification number, passport number and country of issuance, alien identification card number, or number and country of issuance of another government-issued document demonstrating nationality or residence and bearing a safeguard such as a photograph.*
- *A non-bank lender should periodically compare any government-provided list of terrorists to its list of customers.*
- *The results of verifications of customers' identities should be part of the lender's records for future inspection.*

**SBA Comments and OIG Response.** SBA's Office of Financial Assistance (OFA) expressed concern that a directive would be redundant for many SBA lenders and offered suggestions on a proposed directive. We included *all* SBA lenders in the recommendation in part to handle ambiguous regulatory situations, such as the major bank that now owns a former non-bank lender.

Moreover, although a relative handful of lenders such as the largely unregulated Small Business Lending Companies (SBLCs) are not yet covered by a USA PATRIOT Act regulation on CIPs, SBLCs accounted for nearly \$1.7 billion of Fiscal Year (FY) 2002 Section 7(a) loan disbursements, representing over 17 percent of the program's dollar volume and an average (mean) loan amount exceeding \$570,000. This is significant exposure.

**After providing written comments, OFA was extremely responsive to OIG concerns.** It promptly drafted a procedural notice on lender compliance with Treasury requirements

for customer identification. The notice is in the Agency's clearance process for review. Once cleared, the notice should satisfy Recommendation 1.

***SBA cannot readily determine how many loans go to citizens and how many to aliens.*** Although the Agency's lending partners collect citizenship status information, SBA's loan databases do not contain such data. If the databases had the data, the Agency could identify potential trouble spots in its portfolio and perform programmatic research. Finally, readily accessible data on citizenship status would make SBA loan programs more transparent to Congress and the public. **Without this type of accountability, the Agency risks its programs not meeting public needs effectively.**

***Recommendation 2 of 2: So that the Agency can readily track which loans go to citizens and which to aliens, SBA should collect citizenship status data, including available alien registration numbers, in its loan databases.***

**SBA Comments and OIG Response.** OFA has not yet made a management decision. Given the challenges stated in this report, it is imperative that SBA collect sufficient data in its loan databases to know its borrowers' identities, including citizenship status. OFA's comments appear in Appendix A.



## BACKGROUND

Recent investigations by the Office of Inspector General (OIG) have identified borrowers who have misrepresented their citizenship status in order to obtain Small Business Administration (SBA) guaranteed loans. Non-citizens in the United States, referred to in regulations as aliens, can receive SBA loans if they meet certain requirements. Although businesses located in a foreign country are ineligible for SBA business loans, "businesses in the U.S. owned by aliens may qualify."<sup>2</sup> Moreover, according to the section of the Standard Operating Procedure (SOP) on *Businesses Owned by Persons Not Citizens of the United States*, "SBA can provide financial assistance to businesses that are owned by persons who are not citizens of the United States. However, the processing procedures and the terms and conditions will vary, depending upon the status of the owners assigned by the Immigration and Naturalization Service (INS)."<sup>3</sup> Thus, eligibility for an SBA loan depends on the individual borrower's immigration status.

The same SOP states that lenders must verify the INS status of each alien, but that INS releases information about an alien's status to lenders *only* when a signed authorization from the alien is provided to INS.<sup>4</sup> However, according to an SBA Policy Notice, **if a borrower claims on the "Statement of Personal History" (SBA Form 912) that he/she is a U.S. citizen, the Agency does not require further verification.**<sup>5</sup>

In the case of *naturalized* citizens, the Agency's directives are more complicated. For example, one SOP states, "Lenders and CDCs [Certified Development Companies] must verify the INS status of all aliens and all naturalized citizens who control or own 20% or more of any small business applicant." [bracketed notation added to quotation]<sup>6</sup> Yet, the previously mentioned Policy Notice instructs SBA employees *not* to verify the citizenship status of naturalized citizens.<sup>7</sup>

In any event, knowing a person's citizenship status, i.e., whether he/she is a citizen or an alien, requires knowing that person's identity. The September 11, 2001, terrorist attacks on the United States changed what financial institutions are expected to do to identify their customers. In October 2001, Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act. The Act required new regulations in which financial institutions must implement procedures for "*verifying* the identity of any person seeking to open an account to the extent reasonable and practicable" [emphasis added]. The new regulations must also require financial institutions to maintain "records of the information used to

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<sup>2</sup> Code of Federal Regulations, title 13, part 120, section 110 (e). [13 CFR 120.110 (e)]

<sup>3</sup> SOP 50-10(4)(E), Subpart "A," item 15.h., page 70. Note: Since March 1, 2003, the functions of INS have been performed in the U.S. Department of Homeland Security by the Bureau for Citizenship and Immigration Services and the Bureau of Immigration and Customs Enforcement.

<sup>4</sup> SOP 50-10(4)(E), Subpart "A," item 15.h. (3), p. 70-2.

<sup>5</sup> SBA Policy Notice 5000-735, dated June 7, 2001.

<sup>6</sup> SOP 50-10(4)(B), subpart "A," paragraph 8.e.(4).

<sup>7</sup> Although Policy Notice 5000-735 has an expiration date of June 1, 2002, it is still being used. See the OIG Advisory Memorandum entitled "Problems with SBA's Directives System."

verify a person's identity..." and to consult "lists of known or suspected terrorists or terrorist organizations..."<sup>8</sup> Moreover, one of the laws amended by the Act defines "financial institution" broadly enough to include the vast majority of SBA lenders, such as banks and finance companies.<sup>9</sup>

Some of the regulations derived from the USA PATRIOT Act have been issued. On May 9, 2003, the regulation for banks, savings associations, credit unions, private banks, and trust companies was published. This will be discussed later in more detail.

**Consistent with these regulations and for the purpose of clarity in this report, the term "non-bank lender" means any lender that is not a bank, savings association, credit union, private bank, or trust company.** Non-bank lenders include Small Business Lending Companies (SBLCs), Small Business Investment Companies (SBICs), and Certified Development Companies (CDCs).

Regardless of what SBA and its lending partners have done in the past, the USA PATRIOT Act requires financial institutions to exert extra effort to know their customers' identities. **Whereas falsifying one's identity and/or citizenship status used to be primarily a fraud issue, it is emerging as a homeland security issue. The challenge for SBA's lending partners is how to comply with the Act without creating undue hardships for honest prospective borrowers.**

## OBJECTIVES, SCOPE, AND METHODOLOGY

The Office of Inspector General (OIG) initiated this inspection after OIG investigations revealed misrepresentations of citizenship eligibility. Moreover, as noted earlier, antiterrorism legislation and regulations have altered what is expected of financial institutions in terms of customer identification. In light of this, the focus of this inspection was to identify the requirements for determining citizenship eligibility as well as potential vulnerabilities to fraud and misrepresentation in SBA business loan programs.

The OIG examined the USA PATRIOT Act, related legislation, applicable regulations, SOPs, and other directives. (An issue involving a specific directive led to an advisory memorandum entitled "Problems with SBA's Directives System.") Studies, articles, and Congressional testimony on identity verification for citizens and foreign nationals, identity fraud, eligibility corroboration for Federal programs, tax identification and Social Security number integrity, and terrorist financial networks were analyzed. SBA and Federal banking agency officials were interviewed, as were OIG investigators. Finally, various other materials were analyzed, such as bank examination manuals, U.S. Department of Justice notices, and press releases related to the USA PATRIOT Act and banking industry changes.

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<sup>8</sup> USA PATRIOT Act, Section 326(a) (1) (2).

<sup>9</sup> United States Code Annotated, Title 31, Chapter 53, Section 5312.

The inspection was conducted in accordance with the Quality Standards for Inspections issued in March 1993 by the President's Council on Integrity and Efficiency.

## THE IMPORTANCE OF DETERMINING CITIZENSHIP STATUS

Citizenship status is more than just a component of a person's identity. There are several reasons why it is important for lenders to determine whether prospective borrowers are citizens, legal aliens, or illegal aliens.

**Possible Terrorist Connections.** Since the September 11, 2001 attacks, the U.S. has learned how resourceful terrorist organizations can be in supporting their operations through seemingly legitimate business and fund-raising activities. Even SBA may not be immune to this problem.

Several years ago, an SBA loan was approved but, according to SBA records, not disbursed to a businessman later arrested as a terrorist suspect. Moreover, an ongoing investigation of about 450 defaulted loans in one state recently found that—thus far—approximately 100 borrowers have misrepresented themselves as U.S. citizens. Five were indicted and pled guilty, with more indictments expected. Many of these individuals are aliens from a nation subject to U.S. Department of Justice terrorism-related national security restrictions. Loan packagers are involved, as are both banks and SBLCs. Complicating the situation is evidence that the prospective borrowers had been systematically taught how to fraudulently obtain SBA loans. It is not yet clear what other illegal activities may be involved.

In addition, small businesses in general—with or without SBA assistance—are being investigated for terrorist links. For example, during 2002, the Federal Bureau of Investigation (FBI) and INS raided dozens of jewelry stores to uncover potential fronts or financial backers for terrorist groups.

When borrowers from a nation known for terrorist activities *systematically* misrepresent themselves as U.S. citizens, when a prospective SBA borrower is arrested as a possible terrorist, or when small businesses in general are investigated for terrorist links, it is no longer unimaginable that SBA financial assistance could be used—directly or indirectly—to support terrorist organizations. To what extent these situations represent greater vulnerabilities remains to be seen.

**Fraud.** OIG investigations have revealed other crimes related to citizenship status. For example, in one situation, an individual attempting to obtain two SBA loans tried to bribe a public official to obtain citizenship papers. In a separate case involving false tax returns, an individual admitted that she was not a citizen, even though she had previously represented herself as such. Another investigation uncovered an individual who had received an SBA loan, even though this person was in the process of being deported. In short, these individuals misrepresented their citizenship status in some manner for financial gain.

**Program Effectiveness.** Effective service delivery requires determining whether an individual is eligible for a program in the first place and, if so, learning what his/her needs are. In terms of eligibility, the SOP section entitled *Businesses Owned by Persons Not Citizens of the United States* discusses Legal Permanent Residents (LPRs), i.e., persons who may stay in the U.S. for life unless the U.S. government revokes this status.<sup>10</sup> For businesses *owned* by non-immigrant aliens residing in the U.S., the SOP requires that *management* have U.S. citizenship or verified LPR status, and that management must have operated the business for at least one year prior to applying for a loan. According to the SOP, “This requirement prevents financial assistance to “start-up” businesses *owned* by aliens who do not have LPR status” [emphasis added].<sup>11</sup> **Yet, an alien can simply circumvent these various requirements by falsely claiming to be a U.S. citizen.** As noted earlier, if a borrower claims that he/she is a citizen, SBA does not require further verification.

On the other hand, for truly eligible prospective borrowers, the Agency needs to know their needs and plan accordingly. SBA can readily state how many borrowers share certain characteristics, e.g., gender, race, or veteran’s status, and can tailor its programs accordingly. However, the Agency has not done so for an equally basic characteristic: citizenship status. Having such information readily available would serve two effectiveness-related functions. First, it would help the Agency and its resource partners to better plan for borrowers’ technical and financial assistance needs, particularly since legal aliens are not always eligible for the same Federal, non-SBA assistance that citizens are. Second, it would make the composition of SBA programs more transparent to Congress and the small business community, thereby enhancing accountability.

### NEW IDENTIFICATION REQUIREMENTS FOR BANKS AND SIMILAR INSTITUTIONS

To implement section 326 of the USA PATRIOT Act, the Department of the Treasury (through its Financial Crimes Enforcement Network) and other agencies published a final regulation on customer identification programs (CIPs) on May 9, 2003 that became effective on June 9, 2003.<sup>12</sup> Accordingly, part 103 of title 31 of the Code of Federal Regulations (CFR) requires banks—*broadly defined as banks, savings associations, credit unions, private banks, and trust companies*—to implement CIPs appropriate for their size and types of business.<sup>13</sup>

The CIP “must include risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable. The procedures must enable the bank to form a

<sup>10</sup> SOP 50-10(4)(E), Subpart “A,” item 15.h. (1)(b), p. 70.

<sup>11</sup> SOP 50-10(4)(E), Subpart “A,” items 15.h. (6) and 15.h. (7)(a), pp. 70-4 and 70-5.

<sup>12</sup> Federal Register, Volume 68, Number 90, May 9, 2003, pages 25090-25111. The other agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

<sup>13</sup> 31 CFR 103, Federal Register, Volume 68, No. 90, page 25090, May 9, 2003.

reasonable belief that it knows the true identity of each customer.”<sup>14</sup> A “customer” is basically defined as a person that opens a *new* account. An “account” includes a credit account or other extension of credit. *The definition of “customer” is critical, because it excludes a person who has an existing account, provided the bank reasonably believes it knows that person’s true identity.*

At a minimum, the bank must generally obtain from the customer his/her name, date of birth (for an individual), address, and identification number. For a U.S. citizen, the identification number should be a taxpayer identification number. For a “non-U.S. person,” it should be at least one of the following: a taxpayer identification number, passport number and country of issuance, alien identification card number, or number and country of issuance of “any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.”<sup>15</sup>

The CIP procedures must describe when a bank will use documents, non-documentary methods, or a combination thereof to verify a customer’s identity. Examples of non-documentary methods include contacting a customer, comparing customer-provided information with public databases or other sources, checking references with other financial institutions, and obtaining financial statements. In addition, the CIP must include procedures for determining if a customer appears on any Federally-issued list of terrorists or terrorist organizations.

The regulation allows some flexibility, with a bank’s CIP procedures to be based on an assessment of risk involving such things as location and customer base. For example, a small rural bank that is quite familiar with its customers might need little in the way of customer identification. In contrast, a large urban financial institution would need more customer identification and would likely perform some type of non-documentary verification.

Nonetheless, as one banking agency official noted, a CIP is merely “a floor, not a ceiling.” A financial institution will need to exert extra effort beyond the CIP whenever it has misgivings about a new customer.

Regulations for various types of non-bank institutions have not yet been issued. For example, the Department of the Treasury has twice delayed issuing regulations for finance companies until it better understands that type of business. Moreover, given that the final regulation for banks—which are well-understood institutions—was delayed for months, it is unlikely that regulations for finance companies and other less familiar institutions will be issued anytime soon. In the interim, such institutions are left without guidance on how to verify new customers’ identities.

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<sup>14</sup> 31 CFR 103.121(b)(2).

<sup>15</sup> 31 CFR 103.121 (b)(2)(i)

## FINDINGS

### **1. SBA and its lenders have little assurance that prospective borrowers truthfully disclose their citizenship status.**

SBA cannot be reasonably certain that its loan programs benefit only eligible citizens or legal aliens. The Agency risks serving the ineligible, possibly at the expense of the eligible, and having funds diverted from their intended purpose. The internal and external reasons for this are as follows:

***Reliance on prospective borrowers' honesty.*** By far and away, the greatest reason for SBA's lack of assurance that borrowers truthfully disclose their citizenship status is the Agency's policy of accepting—at face value—a person's assertion on the Form 912 that he/she is a U.S. citizen. As noted earlier, if a prospective borrower claims to be a U.S. citizen, SBA requires no further verification. This makes it easy for unscrupulous individuals to misrepresent their citizenship status and, as shown by the ongoing investigation mentioned earlier, to teach others to do the same.

***Concerns about delays in loan origination.*** According to SBA officials, INS had been slow to provide verification of immigration status to lenders whose borrowers stated they were aliens. In effect, such delays inadvertently penalize aliens who honestly disclose their status by possibly postponing the financing necessary to keep their businesses afloat. Moreover, verifying the citizenship status of *all* prospective borrowers, while desirable from a security standpoint, could compound the problem unless the new immigration bureaus under the Department of Homeland Security have become significantly faster at processing verifications.

***Concern over the appearance of discriminatory practices.*** Some lenders and SBA officials have expressed concern that asking *some* prospective borrowers for proof of citizenship status is inherently discriminatory. The issue is how to avoid even the appearance of discrimination. According to the U.S. Commission on Immigration Reform's testimony before Congress in 1994, "the best way to fight discrimination is to treat everyone exactly the same."<sup>16</sup> One way to accomplish this would be to verify *everyone's* citizenship status with an outside agency—something SBA has shown no desire to do.

The USA PATRIOT Act regulation published on May 9, 2003, provides a possible alternative solution. Although it distinguishes a "non-U.S. person" from a U.S. citizen, it requires identifying information from everyone. It is this universal burden that indirectly minimizes the issue of discrimination.

***Lack of a definitive national identification system for foreign nationals.*** According to a Treasury Department report required by the USA PATRIOT Act on customer

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<sup>16</sup> Testimony of Barbara Jordan, Chair, U.S. Commission on Immigration Reform, before the U.S. House of Representatives, Committee on the Judiciary, Subcommittee on International Law, Immigration, and Refugees, September 29, 1994, page 3. See [www.utexas.edu/lbj/uscir/092994.html](http://www.utexas.edu/lbj/uscir/092994.html).

identification requirements for foreign nationals, “there currently is no single, reliable system within the Federal government that domestic financial institutions could access to verify the identity of foreign nationals...”<sup>17</sup> Impediments include the wide differences in identification documents and the existence of fraudulent documents.

Even consulting immigration databases might not be effective. Such records do not reflect millions of undocumented aliens and aliens who entered the U.S. without inspection, plus thousands of Canadians and Mexicans visiting briefly. Treasury concluded that, until options for improving existing capabilities can be devised, financial institutions should use existing resources.

Yet, even existing resources have shortcomings. Driver’s licenses, birth certificates, and Social Security numbers were never intended to become universal identification documents. Their original functions were, respectively, to document the permission to drive, record births and monitor public health hazards, and aid the payment of Social Security benefits. Moreover, some states issue driver’s licenses with minimal scrutiny, duplicate and counterfeit birth certificates can be easy to obtain, and fake Social Security cards are readily available.<sup>18</sup>

#### Characteristics Of Effective Eligibility Determination

Despite the above shortcomings, SBA and its lending partners can have a reasonable assurance of correctly identifying borrowers and their citizenship status if they bear in mind three things.

**a. *Keep expectations realistic.*** Because the U.S. has no national identification card or similar tool, SBA and its lenders should not expect perfection in verifying the identities of prospective borrowers. Nonetheless, by using the types of techniques and products described below, financial institutions can dramatically improve their chances of success.

**b. *To compensate for the current shortcomings of identification documents, emphasize “redundant” verification.*** Redundancy is the use of more than one type of verification to provide reasonable—but not absolute—assurance that a financial institution knows a customer’s identity. It is a technique for managing, but not eliminating, risk.

The Department of the Treasury and the other agencies responsible for the May 9, 2003 rule on CIPs believe that redundancy enhances the value of documentary verification. Banks and similar institutions are encouraged to obtain more than one type of documentary verification as well as use a variety of non-documentary methods.

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<sup>17</sup> Department of the Treasury, “A Report to Congress in Accordance with Section 326(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act),” October 21, 2002, p. 1.

<sup>18</sup> Star Systems. “Heightened Security: Can Financial Institutions Really Know Their Customers?” September 2002, pages 14-15, 17-19.

Identifying and authenticating customers usually means gaining familiarity with something a person *has* (such as a credit card), *knows* (such as a secret password), and *is* (possibly proven by a physical signature, photograph, or fingerprint). However, it can be difficult to perform all three types of identification in a cost-effective manner.<sup>19</sup> Fortunately, the USA PATRIOT Act regulation for banks allows a flexible mix-and-match approach of documentary and non-documentary verification that can keep costs down.

In any event, according to Star Systems, a major financial services firm, no one product is likely to meet all security needs. Reducing risk requires a combination of tools. For example, financial institutions could use charts that help determine a Social Security number's validity and whether a number corresponds with a person's age. Another tool is the death master file of Social Security numbers. Other information can come from check verification vendors, credit bureaus, and vendors whose proprietary national data detects inconsistent or otherwise suspect information.<sup>20</sup>

Obviously, a determined criminal or terrorist could try to use more than one form of phony identification. But if a financial institution periodically alters the mix of documentary and non-documentary verification it requires, it lessens the chances of fraudulent misrepresentation. Moreover, a financial institution has three advantages.

First, outside organizations upon which financial institutions rely are improving the quality of their information. For example, the American Association of Motor Vehicle Administrators (AAMVA) has devised a direct link to an online database that can confirm the validity of a Social Security number and whether it was issued to the person claiming that number. To enhance information security, AAMVA is examining how to prevent insider fraud at departments of motor vehicles.<sup>21</sup>

Second, any verification effort can have a deterrent effect. Some bankers have concluded that the mere act of requesting verifiable information deters some dishonest individuals from proceeding with their loan applications.

Third, existing non-documentary verification through credit bureaus and other databases is a check on whether a customer is providing inconsistent information. Whether through a Social Security number having a sequence inconsistent with the borrower's year of birth or a neighbor's contradiction of a borrower's loan application information, any type of discrepancy is an immediate "red flag."

This is why the mix-and-match approach is promising. It is not necessarily the information itself but rather the *inconsistencies* between information from different sources that can alert financial institutions to potential trouble.

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<sup>19</sup> Star Systems, "Identification and Authentication: Challenges and Opportunities," June 2001, page 7.

<sup>20</sup> Star Systems, "Heightened Security: Can Financial Institutions Really Know Their Customers?" September 2002, pp. 25-27.

<sup>21</sup> Star Systems, pp. 14 and 16.



**c. Hold SBA lending partners to similar, if not identical, verification standards.** All types of lenders can be vulnerable to fraud or terrorist activity. Equally important, all lenders who benefit from SBA loan guarantees have an obligation to ensure that guaranteed funds are used as intended. Regardless of the type of lender, it is ultimately taxpayer dollars providing the final protection if lenders' losses were to mount dramatically.

SBA's non-bank lenders provide services and receive public benefits comparable to those of banks and similar institutions. It would be inherently inequitable to hold banks to a significantly higher customer identification standard than, say, SBLCs. Unfortunately, for reasons discussed earlier, it is unlikely that regulations applicable to non-bank lenders will be issued in the near future. In the meantime, a stopgap measure is needed.

During this inspection, we examined various verification alternatives. For example, we considered using the INS-originated Systematic Alien Verification for Entitlements (SAVE) program, in which government agencies can obtain immigration status information to determine whether an applicant is eligible for a public benefit. Likewise, we considered citizenship verification techniques such as the U.S. Department of Education's match of its Free Applications for Federal Student Aid (FAFSA) against the Social Security Administration for applicants claiming to be U.S. citizens and against the INS' successor agencies for applicants claiming to be non-citizens.

Whatever the merits of these approaches, a government agency still must employ limited staff resources. More important, the USA PATRIOT Act places responsibility for verifying customers' identities on financial institutions. It is the financial institution that is closest to the customers, making it the first line of defense against identity and citizenship fraud. Finally, because SBA lenders receive a government benefit, they bear responsibility for knowing their borrowers.

In terms of verifying customer identity and citizenship status, a USA PATRIOT Act regulation already covers banks, savings associations, credit unions, private banks, and trust companies. Until regulations are issued for non-bank lenders, the challenge is how to ensure that such lending partners are reasonably sure of new customers' identities without creating an undue burden on legitimate small business borrowers.

Under current conditions, verifying all borrowers' citizenship status with an immigration bureau or another agency would likely create unacceptable delays for many small business borrowers. Likewise, although it would be desirable for non-bank lenders to have detailed customer verification procedures in place until new USA PATRIOT Act regulations are issued, this could mean a great deal of work for what hopefully should be only an interim period.

Instead, SBA could proactively issue a relatively simple directive consistent with both the intent of the Act and the basic substance of the regulation for banks. In line with the flexibility allowed under the Act, SBA could simply require non-bank lenders to use redundant verification for new customers' identities. If performed at the same time that

other paperwork is prepared, such verification need not slow down the loan origination process and would provide the non-bank lenders with reasonable assurance that they indeed know their prospective borrowers.

**Recommendation 1 of 2:** Consistent with the USA PATRIOT Act, SBA should issue an interim directive instructing SBA lenders to verify the identities of new customers involved with SBA programs. The directive should include the following elements:

- The directive should apply to all SBA lenders. However, because banks, savings associations, credit unions, private banks, and trust companies are subject to the recently issued USA PATRIOT Act regulation, they should already be in compliance with the SBA directive.
- At a minimum, a non-bank lender should require either two forms of verifiable identification, or one such form of identification combined with one type of non-documentary verification.
- A non-bank lender should obtain from each new customer his/her name, date of birth, address, and identification number. For a person claiming to be a U.S. citizen, the identification number should be a taxpayer identification number. For a person claiming to be an alien, it should be at least one of the following: a taxpayer identification number, passport number and country of issuance, alien identification card number, or number and country of issuance of another government-issued document demonstrating nationality or residence and bearing a safeguard such as a photograph.
- A non-bank lender should periodically compare any government-provided list of terrorists to its list of customers.
- The results of verifications of customers' identities should be part of the lender's records for future inspection.

## **2. SBA cannot readily determine how many loans go to citizens and how many to aliens.**

In recent years, the Office of Management and Budget has sought to make government programs more accountable and transparent to the public. To some extent, SBA's loan databases accomplish this by containing data on borrowers' race, gender, veteran's status, and other characteristics. Yet, despite the fact that the Agency's lending partners collect citizenship status information and alien registration numbers on the Form 912, SBA's loan databases do not contain such data.

This is puzzling, particularly since citizenship status is a basic characteristic of any government program beneficiary. By not having such data in its databases, SBA is missing opportunities for better program oversight, performance, and transparency.

If SBA's databases contained citizenship status data, the Agency could identify potential trouble spots in its portfolio. By taking a sample of loans of self-identified citizens and aliens, SBA could uncover borrowers misrepresenting their citizenship status. Database analysis could determine what factors the borrowers had in common, e.g., the same lender, loan packager, or geographic area. This could prevent future fraud or losses.

Even without the fraud detection aspect, having borrowers' citizenship status in the databases would provide opportunities for analyzing economic activity. For example, by having citizenship status in the database and using purchase rates on defaulted loans as a performance indicator, SBA could:

- Identify concentrations of loans and defaults to aliens in terms of industry, geographical area, types of lenders, etc.,
- Compare loan purchase rates by various characteristics such as geographical area, and
- Determine in which industries aliens appear to be more successful than citizens, and vice versa. Follow-on research from this could identify institutional or other barriers to access to certain industries.

Finally, and most important, readily accessible data on citizenship status would make SBA loan programs more transparent to Congress and the public. **Without this type of accountability, the Agency risks its programs not meeting public needs effectively.**

**Recommendation 2 of 2:** So that the Agency can readily track which loans go to citizens and which to aliens, SBA should collect citizenship status data, including available alien registration numbers, in its loan databases.

## SBA COMMENTS AND OIG RESPONSE

Regarding Recommendation 1, SBA's Office of Financial Assistance (OFA) expressed concern that a directive would be redundant for the "over 99 percent" of SBA lenders already covered by the USA PATRIOT Act regulation on CIPs. OFA also offered suggestions on how to write a directive for lenders currently subject to the regulation and lenders who are not.

We included *all* SBA lenders in the recommendation in part to handle ambiguous situations. For example, one major bank now owns a former non-bank lender, making it unclear whether this former non-bank lender is subject to the regulation on CIPs. A directive that includes *every* type of SBA lender would cover virtually all situations.

Moreover, although a relative handful of lenders such as the largely unregulated Small Business Lending Companies (SBLCs) are not yet covered by a USA PATRIOT Act regulation on CIPs, SBLCs accounted for nearly \$1.7 billion of the Section 7(a) loans disbursed during Fiscal Year (FY) 2002. This represented over 17 percent of the program's dollar volume. Even more telling, the average (mean) SBLC loan amount exceeded \$570,000. This is significant exposure.

After providing written comments, OFA was extremely responsive to OIG concerns. It promptly drafted a procedural notice on lender compliance with Treasury requirements for customer identification. The notice is in the Agency's clearance process for review. Once cleared, the notice should satisfy Recommendation 1.

Regarding Recommendation 2, OFA has not yet made a management decision. Given the challenges stated in this report, we believe it is imperative that SBA collect sufficient data in its loan databases to know its borrowers' identities, including citizenship status.

OFA's comments appear in Appendix A.



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

**DATE:** September 11, 2003  
**TO:** Emile M Baebel  
Assistant Inspector General for Inspections  
**FROM:** James Rivera,  
Associate Administrator For Financial Assistance *JER*  
**SUBJECT:** Reply to Draft Report on Insufficient Proof of Citizenship

The Office of Financial Assistance (OFA) takes this opportunity to comment on the Final Draft Report on Insufficient Proof of Citizenship from the Office of Inspector General (IG) before it becomes final, so that the two offices can work together to assure ourselves that the best possible customer identification practices are being complied with when a loan is supported by a guaranty from SBA.

The Report on Insufficient Proof has two principal recommendations. The first is for SBA to issue a directive to all participating lenders saying they must verify the identities of all new customers involved with SBA programs. The second is that SBA develops and maintains a computer data base that lists the alien status of every owner of 20% or more of every business that applies for an SBA 7(a) or 504 business loan.

OFA finds that the first recommendation is not the most prudent way to address the issue of making sure those few lenders that SBA regulates establish their own Customer Identification Program (CIP). With the May 9, 2003, issuance of regulations from the Department of the Treasury and other organizations that regulate lender activity, (31 CFR 103.121) over 99 percent of all the lenders who participate in SBA's loan guaranty programs are already required to implement their own CIP program beginning October 1, 2003. It would be redundant for SBA to issue a directive to these same lenders saying they need to verify the identities of their new customers when Treasury already has regulations that say the same thing. With such a directive SBA may inadvertently imply that the lender may need to do something for their SBA loan applicants that they do not do for their own new customers.

However the first recommendation could be altered so that it says a directive should be written that will (a) remind the regulated lenders that loans with an SBA guaranty are not exempt from the CIP requirements of Treasury et. al., and (b) that any participant not required to initiate a CIP program under Treasury requirements must follow these same requirements and implement their own CIP program by order of SBA.

The non-regulated lenders should be given the same ability to develop their own CIP program as the Regulators gave the regulated lenders.

Regarding the second recommendation for the creation of a computer data base OFA has this under consideration and does not have a management decision at this time.

**Appendix B**

**CONTRIBUTOR TO THIS REPORT**

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