

STATEMENT OF

ERIC M. THORSON, INSPECTOR GENERAL
U.S. SMALL BUSINESS ADMINISTRATION

BEFORE THE

COMMITTEE ON HOMELAND SECURITY,
SUBCOMMITTEE ON MANAGEMENT,
INTEGRATION AND OVERSIGHT,
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING A HEARING ENTITLED:

“FEDERAL 9/11 ASSISTANCE TO NEW YORK:
LESSONS LEARNED IN FRAUD DETECTION,
PREVENTION, AND CONTROL”

JULY 13, 2006

Introduction. Chairman Rogers, Ranking Member Meek, distinguished Members of the Subcommittee, thank you for inviting me here today to discuss the efforts by the Small Business Administration (SBA) Office of Inspector General (OIG) in connection with the SBA's response to the September 11th terrorist attacks. September 11, 2001, was a day in American history that we can never forget. Beyond the tragic loss of life, the terrorist attacks disrupted the economy of the United States. The SBA responded to the economic downturn by providing guaranties on loans made by private lenders through the Section 7(a) Loan Guaranty program, and by making loans directly to affected small businesses under the Disaster Loan program. My testimony today addresses the OIG's efforts to review the efficiency and management of these 9/11 assistance programs and to prosecute wrongdoers who took advantage of this national tragedy by obtaining loans through fraudulent means.

Overview of the OIG's Audit of the STAR Loan Program. In January 2002, Congress authorized SBA to provide financial assistance to small businesses that were affected by the 9/11 attacks and their aftermath through what is known as the Supplemental Terrorist Activity Relief or "STAR" loan program. Newspaper articles in the Fall of 2005 raised questions as to whether borrowers obtained STAR loans even though they had not been affected by the terrorist attacks. As a result, Senator Snowe, who chairs the Senate Small Business and Entrepreneurship Committee, and the SBA Administrator asked the OIG to review this program. The audit objectives were to determine if STAR loan recipients were appropriately qualified to receive STAR loans and if SBA established and implemented proper administrative procedures to verify STAR loan recipient eligibility. However, before getting into the results of our review, let me provide a short background on the STAR loan program, which was administered under the Section 7(a) Loan Guaranty program.

Overview of 7(a) Program. Under the Section 7(a) of the Small Business Act, SBA may guaranty up to 85 percent of a loan made by an authorized lender to a small business. This program is known as the "7(a) program." In 1983, SBA implemented the Preferred Lenders Program (PLP) which allows designated lenders to process, service, and liquidate SBA-guarantied loans with reduced SBA oversight and, as SBA's budget for salaries and expenses has shrunk over the past decade, the Agency has increasingly delegated this authority to lenders.

Loans made under the 7(a) program that go into default are individually reviewed by SBA to determine whether the lender complied with the Agency's lending requirements. Generally, this review is the primary means that SBA uses to determine lender compliance with Agency regulations and requirements. If it is determined that the lender did not comply materially with SBA's regulations, SBA can negotiate a settlement of the guaranty amount or deny payment of the guaranty entirely.

The STAR Loan Program. Under the STAR loan program, SBA was authorized by Congress to charge lenders reduced fees for guaranties on loans made to small businesses which were deemed "adversely affected" by the September 11th terrorist attacks and their aftermath. Although the term "adversely affected" was not defined, Congressional staff and SBA program managers appear to agree that Congress intended the program to benefit not only those businesses that were directly impacted by the attacks, i.e., firms located near the World Trade Center or the Pentagon, but also businesses across the country that were harmed by the economic

consequences of the attacks. Congress appropriated \$75 million for the STAR loan program, which provided authority for SBA to guaranty up to \$4.5 billion in loans. Funds were available from January 11, 2002, through January 10, 2003.

SBA Guidance on the STAR Loan Program. SBA issued guidance on the STAR loan program that defined an “adversely affected small business” as any business that “suffered economic harm or disruption of its business operations as a direct or indirect result of the terrorist attacks” Qualifying businesses were not limited to a “particular geographic area or to any specific type of business.” SBA procedures required lenders to determine that the loan applicant was adversely affected by the terrorist attacks and to prepare and maintain in its loan file “a write-up summarizing the analysis and its conclusion that the loan is eligible for the STAR program.” The guidance made clear that a lender would be deemed not to have met its responsibility for determining that a borrower was adversely affected if the lender did not provide a narrative justification demonstrating the basis for its conclusion. Borrowers were permitted to use STAR loan funds for any purpose authorized for 7(a) loans. Lenders also had authority to reclassify loans made under the regular 7(a) program as STAR loans if the borrower was eligible.

Our review found that lenders were initially reluctant to use the STAR loan program due to concerns that SBA would second guess their justifications and deny payment of the loan guaranty. Congressional staff expressed concern about the lenders’ lack of interest in the program and urged SBA to promote the use of the program. SBA reacted by vigorously promoting the program through articles in trade journals, speeches at lender conferences, and by directing its district offices throughout the country to contact local lenders to persuade them to approve STAR loans. SBA advised lenders that a very large percentage of small businesses could qualify for STAR loans and assured lenders that SBA would not second guess their justifications.

OIG Audit of the STAR Loan Program. The OIG conducted an audit of a statistical sample of 59 STAR loans from the universe of 7,058 STAR loans approved between January 11, 2002 and January 10, 2003, to determine whether loan recipients were eligible to receive the loans. There were 27 lenders included in the sample. Using accepted statistical methodology, the audit results could be projected with 95 percent certainty. For 50 of the 59 borrowers (85 percent) in the sample, we were unable to determine from the lenders’ loan files and discussion with available borrowers whether the borrowers were adversely affected by the 9/11 attacks and their aftermath, as required for STAR loan eligibility. For these 50 loans, the required justification was either (1) missing – 5 loans; (2) merely a conclusion with no support – 4 loans; (3) based on the adverse affects suffered by the business being purchased with a STAR loan rather than the “loan applicant” and SBA procedures did not specify whether such loans could qualify – 11 loans; (4) contrary to documentation in the lender’s loan file or borrower statements – 21 loans; or (5) vague and neither contrary to nor supported by documentation in the lender’s loan file or borrower statements – 9 loans. Although these results do not necessarily show that the 50 borrowers were ineligible for the program, they indicate that lenders failed to prepare adequate justifications and obtain supporting documentation to determine eligibility.

Further, of 42 borrowers that we were able to contact, only two stated they were aware that they had received a STAR loan. Thirty-six borrowers said they were not asked, or could not recall if they were asked, about the impact of the attacks on their businesses. We concluded that, in many cases, funds appropriated for guaranties on loans to small businesses adversely affected by the terrorist attacks may not have been used for that purpose.

Inadequacy of SBA Program Controls. In trying to establish the reasons behind these findings, we determined that SBA did not implement adequate internal controls and oversight to ensure that only eligible borrowers obtained STAR loans. Although SBA established guidance for the program requiring lenders to prepare and file written justifications showing borrower eligibility, senior SBA officials, in order to encourage the use of the STAR loan program, broadened the scope of program eligibility. Public statements made by senior SBA officials conveyed SBA's expansive interpretation of the term "adversely affected" and that SBA believed that virtually every small business had suffered some direct or indirect adverse impact and could likely qualify for a STAR loan. Further, SBA officials reassured lenders that the Agency would not second guess their eligibility justifications. SBA also did not require lenders to provide their justifications to the Agency, either at the time a loan was made or at the time that a lender requested SBA to honor the guaranty on a defaulted loan.

I should note that, although the SBA guaranties may not have been used for appropriated purposes, we did not find that any businesses legitimately affected by the 9/11 attacks were precluded from obtaining a STAR loan. Indeed, when the STAR loan program appropriation expired in January 2003, funds for the program were still available and were transferred to the regular 7(a) loan program. Therefore, it does not appear that eligible businesses were prevented from receiving STAR loans due to a lack of funds. Furthermore, the default rate for STAR loans does not appear excessive in comparison to similar SBA-guarantied loans. As of September 30, 2005, only 8 percent of disbursed STAR loans approved between January 11, 2002, and January 10, 2003, had been transferred to liquidation status, while 10 percent of the 7(a) loans approved during the same time period had been transferred to liquidation status.

Lessons Learned. What were the lessons learned from this review? For future special programs where 7(a) loans are used for nationwide disaster relief, the OIG recommended that SBA: (1) require loan applicants to justify how the business was harmed by the disaster; (2) require lenders to obtain supporting documentation to verify applicant claims of injury and provide detailed justifications showing applicant eligibility; and (3) implement effective internal controls and program oversight to ensure borrower eligibility and lender compliance. Specifically related to the STAR loan program, the OIG recommended that the Agency: (1) implement procedures to require lenders to submit STAR loan justifications when seeking SBA's purchase of a STAR loan guaranty; (2) establish criteria to provide more definitive guidance and examples for purchase reviewers to use in determining what constitutes an inadequate justification for STAR eligibility; (3) for future purchase requests, determine whether STAR loans that contain inadequate justifications can be reclassified as 7(a) loans or whether SBA can deny lender requests for purchase of the guaranties under SBA regulations; and (4) review guaranties the Agency has already paid under the STAR loan program to determine whether lenders were paid despite the absence of adequate borrower eligibility justifications. If

there is inadequate justification, we recommended that the Agency determine whether SBA should reclassify the loan as a 7(a) loan or seek recovery of the guaranties from the lenders.

Disaster Loans for Businesses Hurt by 9/11. The Small Business Act also permits SBA to make direct loans to victims of declared disasters. Disaster loans, which are available to businesses and to homeowners, can be used to fund repairs of physical damage to homes and businesses, and to provide working capital to disaster-impacted businesses to allow them to pay their bills or otherwise fund operational needs. These latter loans are known as Economic Injury Disaster Loans (EIDL). These loans are made at a low interest rate, generally less than 4 percent, with generous repayment terms, which can last up to 30 years. In order to make Federal assistance available to more businesses that were impacted by the September 11th terrorist attacks, and not just those located in the declared disaster areas, SBA expanded the EIDL program to assist small businesses located outside the declared disaster areas. SBA disbursed over \$1.1 billion in 9/11 disaster loans.

9/11 Disaster Loan Fraud. In 2003, the OIG began a proactive review of defaulted 9/11 EIDLs to assess whether there was fraud involved in obtaining or using loan proceeds. Inevitably, some of these disaster loans involved fraud due to loan transactions being expedited in order to provide quick relief to disaster victims. The OIG's Auditing Division screened a sample of defaulted 9/11 loans to identify indicators of fraud. Where indicators existed, these loans were then examined further by investigators. Based on these referrals, as well as those from other sources such as OIG Hotline, Office of Disaster Assistance, other law enforcement, etc., the OIG's Investigations Division opened 51 cases on loans valued at approximately \$20 million. Thus far, 37 cases have been closed, and 14 cases are in an open status at various stages of investigation. There have been 10 indictments, 10 convictions, and over \$1 million in restitution and settlements.

The types of fraud schemes we identified in these cases included individuals and businesses claiming losses even though their companies were not located in the disaster area, false claims related to personal property or equipment damage, misuse of the disaster loan proceeds, and false statements concerning financial status. For example, in one case, the president and the managing partner of a business received an SBA disaster loan by falsely claiming that their company had been located at the World Trade Center. In fact, the business was not located there on September 11, 2001, and the individuals were salaried employees of another company at the time. They were sentenced to incarceration and ordered to pay a combined total of \$618,000 in restitution.

OIG Finding Regarding SBA Collection of 9/11 Disaster Loans. While the auditors were screening defaulted loan files, it became apparent that SBA was not always pursuing collection timely. Therefore, the OIG conducted a review to determine if delinquent 9/11 disaster loans were serviced appropriately. As of September 30, 2004, 1,495 of these loans, valued at \$208.8 million, were delinquent. The Office of Management and Budget (OMB) requires that agencies promptly act on the collection of delinquent debts, using all available collection tools to maximize collections. Since 1993, SBA has employed the issuance of demand letters as an important part of the loan liquidation process.

The OIG reviewed a sample of delinquent loans and found that SBA sent pre-demand or demand letters to only 4 of the 17 borrowers who should have received them. We found that insufficient staffing of SBA's liquidation center prevented personnel from following proper collection methods. Instead of properly issuing pre-demand and demand letters to collect delinquent loan funds, personnel were used to service bankruptcies, collateral activities, and/or borrower initiated offers of compromise.

OIG Recommendations on Proper Debt Collection. The OIG recommended that the Agency revise its procedures to direct servicing centers to send timely pre-demand and demand letters to delinquent borrowers and to maintain copies of these letters in loan files. Additionally, we recommended that the Agency ensure that sufficient staff resources are devoted to liquidation center activities to fulfill the debt collection responsibilities required by OMB. Attention to the collection of funds when a loan is delinquent must be part of SBA's most basic responsibilities.

Conclusion. Thank you for the opportunity to comment. I look forward to answering any questions that you may have.