Testimony of

Robert F. Tannenhauser
Chairman of the Board
Business Loan Express, LLC

Introduction

Chairman Kerry, Ranking Member Snowe, and Members of the Committee, thank you for inviting me here today. I am Robert Tannenhauser, currently Chairman of the Board and formerly President and CEO of Business Loan Express, LLC ("BLX"), a national non-bank lender with approximately 250 employees in more than 40 offices across the country.

BLX has been a leading participant in the Small Business Administration's ("SBA") loan programs, having made more than 9,000 SBA loans totaling more than $3.6 billion since 1994, when I joined the company. Over the past 13 years, we have partnered closely – and successfully – with the SBA to meet its goals of promoting entrepreneurship and providing access to capital to qualified borrowers ignored by traditional lenders, particularly women, minorities, veterans and other underserved groups. We are proud of our track record of helping thousands of small businesses grow and giving thousands of people an opportunity to become successful entrepreneurs and to live the American Dream.

Yet, we are here today because we know that concerns have been raised in light of the misconduct that has now been admitted by a former employee in our Detroit office. It is important both to recognize the gravity of this former employee's fraudulent activities and to put those activities into the larger context of our past and present. While this misconduct affects less than one percent of the SBA loans originated during my time with the company, I want to be clear that any fraud in the loan process is unacceptable and is something we take very seriously.

That is why we responded decisively on two fronts. First, we voluntarily committed – before any definitive finding of wrongdoing was made – to make the SBA whole for any losses sustained as the result of fraud by current or former BLX employees. Second, to guard against this kind of fraudulent conduct, we took a number of proactive steps to strengthen our already extensive internal controls and fraud-prevention practices in light of what we learned from this incident.

The fact is that what this former employee did victimizes everyone in the SBA lending process: it undermines the SBA's mission of expanding opportunities for entrepreneurship; it makes it that much harder for deserving borrowers – especially women, minorities, veterans, and other underserved groups – to get access to much-needed capital; it caused severe financial losses for BLX; and it unfairly tarnished the efforts of the hundreds of dedicated BLX employees who do their jobs well and with pride.

We are committed to working with Congress, the SBA, the National Association of Government Guaranteed Lenders, and our employees to do what it takes to prevent this kind of fraudulent activity from jeopardizing the SBA's mission. We support this Committee's efforts, through the recently introduced "Small Business Lending Oversight and Program Performance Improvements Act of 2007," to foster transparency in the SBA's oversight process, to facilitate evaluation of lenders' and borrowers' successes with consistent, reliable, and appropriate performance measures, and to guard against fraud in the SBA loan process.

I. BLX Plays a Critical Role in Furthering the SBA's Mission

Over the past 13 years, BLX has been a steadfast partner in fulfilling the SBA's mission to provide vital capital to the small businesses that are the economic engine of this country.

In response to the dynamic small business lending market, BLX has changed with the times and responded to new challenges. When I joined BLX in 1994, the company had seven offices with minimal annual loan volume, and it was not recognized by the SBA as a preferred lender. By 2000 – after restructuring, obtaining financing, and focusing on high-yield, real estate collateralized lending – BLX had become the tenth largest SBA participating lender, with preferred lending status in 67 SBA offices and an annual volume of approximately $160 million. In 2001, BLX expanded its product offerings with non-SBA ("conventional") real estate collateralized business loans and further diversified in 2004 by offering investment real estate loans.

While conventional loan originations now constitute the majority of BLX's production, and the company has recently made a strategic choice to focus in a more concentrated way on real estate loans, BLX has been a major participant in both the SBA's 7(a) Guaranteed Loan Program and the Community Express Loan Program.

A. BLX's Participation in the SBA 7(a) Program

The 7(a) program – which is specifically designed to aid borrowers who cannot obtain credit from traditional sources – is the most widely used of the SBA's business loan programs. Lenders structure their loans in accordance with SBA requirements, and, in exchange, the SBA guarantees up to 75% of the loan, with the lender retaining a minimum risk of 25%.

The SBA has given BLX permission to operate under its Preferred Lenders Program ("PLP") nationwide. The SBA grants PLP status to lenders that have established a highly successful loan record in the market and a thorough understanding of the SBA process. Likewise, to maintain PLP status, a lender must substantially exceed minimum standards, including satisfactory ratings from annual SBA audits conducted by the Farm Credit Administration. Under the PLP program, the SBA delegates loan approval, closing, and most servicing and liquidation authority to approved lenders like BLX, enabling those lenders to provide better, more efficient service to clients.

The PLP program has two critical elements that create incentives for lenders like BLX to originate successful, performing loans and to prevent fraud. First, the lender and the SBA share the risk that a borrower will not be able to repay the loan in full. More specifically, because BLX retains a stake (generally 25%) in the face value of every loan it originates under the 7(a) program, if a loan goes into default, BLX suffers a loss along with the SBA. To minimize that risk of loss, BLX has a strong interest in ensuring quality underwriting.

Second, the SBA's financial interest is protected against fraud that the lender failed to prevent or detect, but the lender's is not. If a PLP loan defaults, the SBA performs its own credit determination based on the same documentation the lender used. If the SBA finds that the lender was deficient in exercising its delegated credit-approval duties, it has the right to hold the lender responsible for the SBA-guaranteed portion of the loan. As the SBA's website notes: "The guaranty is a guaranty against payment default. It does not cover imprudent decisions by the lender or misrepresentation by the borrower." *See* http://www.sba.gov/services/financialassistance/sbaloantopics/7a/index.html. Thus, a lender like BLX has no financial incentive to condone or ignore potential fraud, and, in fact, it has every incentive to avoid it.

B. BLX's Record of Serving Underprivileged Communities

BLX has a proven track record of assisting the core borrowers the 7(a) program was designed to help: those who show promise but cannot get conventional credit. For more than a decade, BLX has gone into communities and neighborhoods ignored by other lenders to provide access to credit – and therefore opportunities for entrepreneurship – to historically underserved populations. Indeed, in certain distressed and underserved communities, including parts of Alabama, Alaska, Florida, Georgia, Hawaii, Indiana, Mississippi, Montana, North Carolina, Oklahoma, South Carolina, Tennessee, West Virginia, and Wyoming, BLX is one of the leading small business lenders providing desperately needed credit that is simply not otherwise available. Moreover, approximately 77% of BLX's SBA loans since 2001 have been made to minorities, women, veterans, and borrowers in low to moderate income areas. That translates into approximately 5,620 loans to these otherwise underserved populations. I am proud to be able to say that BLX has made a real difference in real people's lives.

Beyond simply providing loans, BLX also has taken a leadership role in working to identify and address the specific challenges that members of typically underserved groups such as women, minorities, and veterans face in starting and maintaining a small business. For example:

- <u>Ethnicity & Gender Research</u>. BLX underwrote a survey on Access to Capital conducted by the US Chamber of Commerce's Statistics & Research Center and its diversity initiative. The study of more than 1,000 small business owners provides comprehensive funding information and identifies unique financing differences and challenges based on ethnicity and gender.

- Minority Access to Franchising. BLX developed and monitors a website for minorities interested in becoming franchisees (www.franchisediversity.com) and is a founding member of the Franchise Diversity Initiative with the Metropolitan Business Collaborative/Urban Entrepreneurial Partnership and the IFA Education Foundation.

- Resources for Veterans. BLX is a sponsor and participant in the Syracuse University/Burton Blatt Institute's "Entrepreneurship Boot Camp for Veterans with Disabilities," which is designed to provide training and resources to assist disabled veterans in becoming business owners.

C. BLX's Record of Strong Performance

BLX has a robust performance record, even though SBA 7(a) lending is inherently higher risk than traditional lending because the borrowers – by definition – cannot obtain credit from traditional lenders.

First, despite serving populations with a greater risk of default, BLX has consistently maintained loss rates well below SBA industry averages because its loans are collateralized by real estate – which limits loss if a loan defaults. Based on data obtained from the SBA, BLX's 10-year average loss rate through 2007 was 1.64%, less than half SBA industry averages from 1989 through July 2004.

Second, BLX has a low repair rate, meaning that the SBA has only very rarely demanded that BLX reimburse it for the guaranteed portion of a defaulted loan. Since 1994, the SBA has denied the guarantee on only 6 of BLX's more than 5800 7(a) loans and has required a repair for only 11 such loans.

Third, BLX is subject to annual audits by multiple third parties, including senior lenders, rating agencies (Moody's and S&P), and warehouse lenders. In addition, for the past six years, BLX has been audited annually by the SBA (under contract with the Farm Credit Administration ("FCA")), and the SBA has taken into account the results of those audits when deciding to renew BLX's PLP status.

II. BLX Renews Its Commitment to Preventing and Remedying Fraud

In January 2007, indictments were unsealed by the United States Attorney's Office for the Eastern District of Michigan charging five individuals – one of whom had been employed in BLX's Detroit office – with fraud in originating SBA-guaranteed loans. Also in this group was a former assistant vice president from Huntington National Bank who was indicted for providing false verifications of loan applicants' account balances and unpaid bank checks to be used at loan closings. To date, approximately fifteen individuals – mostly borrowers who were involved in fraudulently obtaining loans, as well as the Huntington National Bank official – have been convicted or pleaded guilty to fraud in connection with loans originated by BLX's former Detroit office. Last month, the former BLX employee, Patrick Harrington, pleaded guilty to one count of conspiracy to originate fraudulent loans and one count of perjury.

It is an understatement to say that this has been a difficult chapter in BLX's history and that I am personally saddened by and disappointed in Mr. Harrington's conduct. I certainly wish we had become aware of Mr. Harrington's activities earlier, but the truth is that BLX did not stand still in the face of questions about lending activities of the Detroit office. In fact, in 2004, BLX engaged a nationally-known law firm to conduct an internal investigation of the issues in Detroit. Our decision to commission an independent investigation shows that BLX did not turn a blind eye.

In addition, in October 2005, well before the indictments, our Portfolio Surveillance Group – which is charged with monitoring our portfolio and identifying potential negative trends – discovered weaknesses in the Detroit office portfolio; in response, we made a business decision to stop originating new gas station loans in the Detroit market. Around the same time, we moved Mr. Harrington out of originating loans entirely. In August and September 2006 – five months before Mr. Harrington's indictment was announced – we closed the Detroit office and severed our relationship with Mr. Harrington. For the past year, we have been cooperating actively in the government's ongoing investigation.

A. BLX Agrees to Make the SBA Whole

BLX responded promptly and forcefully to the fraud that Mr. Harrington had gone to great lengths to conceal. When the indictments were announced – and before any definitive finding of wrongdoing was made – BLX pledged to reimburse the SBA for any losses sustained as a result of alleged fraudulent activity by current or former BLX employees. As soon as the agreement was signed, BLX made an immediate payment of more than $8 million to the SBA for losses already incurred with respect to specific loans named in the Harrington indictment and related criminal complaints. In addition, BLX placed another $10 million in escrow to reimburse the SBA for any other losses determined to be the subject of fraud by any current or former BLX employee. In total, BLX committed approximately $18 million to ensure that the SBA is made whole.

B. BLX Suffers Losses Arising From Mr. Harrington's Scheme

I am here to tell you that while BLX is deeply concerned about the conduct that Mr. Harrington has now admitted, BLX is a victim – not a perpetrator – of Mr. Harrington's fraudulent scheme. It is important to remember that BLX incurs significant losses of its own on the unguaranteed portions of each and every SBA loan that defaults. And looking at the complete picture, in connection with the Detroit office, BLX already has had to write off $9.8 million in losses on loans that the government asserts were fraudulently originated by Mr. Harrington, including $8.7 million on SBA-guaranteed loans. In fact, BLX has been submitting victim impact statements in cases against the borrowers detailing the company's losses as a result of the fraud, and several of those borrowers have been ordered to pay restitution to BLX. Finally, to the extent that Mr. Harrington's actions jeopardize BLX's PLP status, his scheme cuts to the very heart of one of BLX's most important assets.

C. BLX Enhances Anti-Fraud Procedures

BLX today is a very different company than the one in which Mr. Harrington was able to originate fraudulent loans. Having invested millions of dollars and countless hours, we now have the benefit of a host of upgrades BLX has made to its internal control systems over the past several years, both before and after the indictments. Both unilaterally and in conjunction with more specific guidance from the SBA, BLX took a number of specific steps to enhance its fraud prevention capabilities and increase the rigor of its lending controls:

- We strictly separated the origination function from the underwriting function to provide an additional independent check on the loan file contents and to prevent loan originators from hiding misrepresentations.

- We implemented financial incentives for our employees to originate higher-quality, more creditworthy loans.

- We created a blacklist of brokers who referred bad loans and with whom we would not do business.

- We imposed a requirement of prompt and thorough post-closing audits of every loan.

- We created a Portfolio Surveillance Group to analyze and identify potential risks and negative trends in our portfolio.

- We implemented quality initiatives based on data collected using Six Sigma methodology.

- We made major investments in our information systems, allowing for improved loan tracing and collection of portfolio data.

- After the indictment of Mr. Harrington, a major outside consultant extensively reviewed our policies and procedures; concluded that they were adequate and that we had a high compliance rate; and made a number of recommendations for enhancements, which we have implemented or are in the process of implementing.

- As part of our agreement with the SBA, BLX agreed to have its newly originated loans reviewed by an independent third party selected by the SBA and paid for by BLX.

III. The OIG Report Is Inaccurate and Incomplete

Although the OIG is to be commended for its contribution to uncovering Mr. Harrington's fraud, I am disappointed that it has issued a report focused on BLX (Report 7-28, entitled "SBA's Oversight of Business Loan Center, LLC") that is fundamentally inaccurate, both as a matter of process and as a matter of substance.

With respect to procedure, the report has two significant flaws. First, several portions of the OIG Report should be redacted under laws that protect a lender's confidential information that is provided to the SBA. The confidentiality requirement is designed to enhance regulatory oversight by providing a mechanism for lenders to disclose full and accurate information to the agency for candid review, while having assurances that the lender will be protected from the competitive harm that would result from public disclosure of that information. Second, the Report purports to be an "audit" – a term with a particularized, technical meaning in the financial services industry. In fact, the OIG did *not* conduct its own "audit" or review of BLX but instead simply reviewed BLX's quarterly risk ratings and the annual reports of audits of BLX conducted by the Farm Credit Administration ("FCA") on behalf of the SBA.

Most importantly, as to substance, the OIG Report ignores the primary findings and ultimate conclusions of the FCA audits on which it purports to rely. The Report meticulously excludes the central, overall conclusions of the auditors – which support the SBA's decision to renew BLX's status each year – while selectively highlighting a smattering of subsidiary comments. Because of criminal laws that prohibit lenders such as BLX from disseminating the contents of FCA audit reports, we cannot be more detailed, in this forum, about the mischaracterizations of the OIG Report. In letters to the OIG – which is not bound by those prohibitions – we have, however, provided specific references to each of the FCA audit reports that demonstrate that the OIG Report inaccurately portrays both BLX and the SBA's oversight efforts. We remain confident that an objective, side-by-side comparison of the OIG report and the FCA audits will reveal that the OIG has not fairly or accurately summarized what the FCA auditors found.

Conclusion

I appreciate the opportunity to testify today. Integrity is a core value of our business, and I want to assure you in the strongest terms that BLX is committed to preventing loan fraud. We are continually looking for ways to improve, and we welcome engagement with the Congress and our regulators in that process.