Testimony of

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Good morning Mister Chairman and Members of the Subcommittee. Thank you for inviting me to appear before you this morning. As requested, I will discuss the loan packager problems identified by the Office of Inspector General (OIG) and offer some recommendations for alleviating the problems we are seeing far too often. I will also discuss lender service providers. Finally, current OIG efforts to detect and deter fraud generally in the business loan and disaster assistance loan programs will be summarized. With me today are Steve Marica, Assistant Inspector General for Investigations, and Peter McClintock, Assistant Inspector General for Auditing.

The OIG has identified three categories of individuals or entities that charge fees for their service to individuals seeking SBA loans or to lenders in the SBA loan programs: loan brokers, lender service providers, and loan packagers. The distinctions among these three categories are not always clear-cut, but generally speaking, a loan broker, or referral agent, represents the banks by searching out deals and occasionally assisting in the preparation of loan applications. Brokers are normally paid by the banks. A lender service provider may represent the interest of lenders in identifying business, servicing loans, advising on secondary market sales, and liquidating foreclosures, as well as the interest of loan applicants by rendering assistance in the application process. Brokers and service providers frequently receive fees contingent on approval of loans, and servicing fees on an ongoing basis. A loan packager assists applicants through the actual preparation of SBA loan application forms and any supporting information, such as a business plan. A packager is normally hired and paid by the applicant.

I will first summarize OIG audit work involving lender service providers and then discuss our investigations involving loan packagers. Our experience with loan brokers is limited to only two defendants whose primary activity was loan packaging. Lender Service Providers

The involvement of lender service providers in the 7(a) business loan program first came to our attention during audits of two Georgia lenders. Lender service providers are contractors that provide an array of services primarily for smaller banks that do not have employees familiar with all the requirements of the SBA's guaranteed loans. Our concern with service providers is with potential conflicts of interest that may lead to the booking of poor quality loans.

The Georgia provider obtained potential borrowers through advertising or referrals and assigned a loan packager, working as an "independent contractor," to develop the application. The provider reviewed the loan and presented it to a client lender for acceptance. If the lender rejected the application, the provider would take it to another client lender and repeat the process until the applicant obtained an SBA loan or it became clear the applicant was not going to qualify for such a loan. The packager was paid a fee by the borrower, usually one percent of the loan, and the provider was paid by the bank, usually one-half of the loan servicing fees and one-half of the premium earned on the sale of the guaranteed portion of the loan in the secondary market. In some cases, the provider and the lender would split losses on the unguaranteed portion of the loan if the borrower subsequently defaulted.

The OIG was concerned about this contingency fee arrangement, which was contrary to Agency regulations, because the provider was paid only when a loan was approved. As you can see, the provider had influence over both the manner in which the application was presented and the recommendation for approval.

The splitting of losses on defaulted loans between the bank and the provider was also contrary to regulations. The lending institution must have a full stake in the loss to give some assurance that the lender was prudent in its approval and servicing of the loan.

The special relationship between the provider and the packager clearly precluded independent representation of both the borrower and the lender. Generally, a packager represents the borrower, whereas the provider represents the bank. When the provider and the packager are affiliated, the interests of the two parties may conflict.

The practice of "shopping a loan" until a provider finds a willing lender is also troublesome. While we have no information on the extent to which loans are rejected and then presented to other lenders, this does not appear to be a prudent practice and surely not in the interest of the Federal Government. This type of loan shopping only increases the Government's risk.

In response to our audits, the SBA's Office of Financial Assistance (OFA) developed a model agreement for lender service providers, sent it to all District Offices, and asked that they require all banks to complete an agreement with their service providers. SBA received copies of agreements from 40 service providers. The model agreement prohibited splitting losses on defaulted loans, the affiliation of providers and packagers, and the sharing of servicing fees and secondary market sale premiums.

The model agreement continued to allow contingency fees that are a percentage of the loan and the shopping of loans to multiple lenders; however, fees must be commensurate with the value of the service. The provider was also required to maintain records of its costs to allow the SBA to monitor the reasonableness of the fees charged. To the best of our knowledge, the SBA has not reviewed the reasonableness of the fees of any service provider under these agreements. A scheduled OIG audit, involving a California service provider, will address this issue.

Loan Packagers

Now let me turn to the problems caused by some of the loan packagers who engage in criminal activity for personal gain, the types of fraudulent schemes used by these packagers, and some recommendations for deterring such fraudulent activity.

Over the past 5 years, unscrupulous loan packagers have played a major role in the increase in fraud in SBA's loan programs. In the 7(a) business loan program alone, criminal investigations have been initiated on 323 individuals involving loan applications that were prepared by 19 loan packagers. This figure represents 34 percent of all criminal fraud cases initiated by the OIG during this period. The potential loss to the Government, as the result of these loans, exceeds $125 million. In the disaster assistance loan program, 110 investigations have been opened involving 3 packagers with over $44 million at risk. To date, these cases have resulted in 42 indictments, 38 convictions, and over $2.2 million in fines and restitution. The OIG currently has over 200 individuals, both packagers and borrowers, under active investigation.

Loan packager cases involve a myriad of schemes designed to defraud the borrower, the SBA, the lender, or any combination thereof. These schemes include, but are not limited to, the following activities:

- submitting false or fictitious applications, including false invoices, liens, financial statements, and tax returns;
- charging excessive fees for preparation of the loan package, e.g., up to 35 percent of the loan amount;
- falsifying or omitting required fee information to SBA;
- concealing the true name of the packager by using fictitious names on SBA forms;
- requiring kickbacks from borrowers;
- requiring other incentives, such as the signing of "management agreements" or consulting contracts from borrowers;
- mis-statements to applicants, "guaranteeing" approval of loans, and alleging to have contacts inside SBA or lending institutions;
- deliberately providing false information to applicants regarding SBA regulations on use of loan proceeds;
- convincing or coercing borrowers to permit packagers to make disbursements from loan proceeds;
- charging "contingency," "advance," or "finders" fees, for which there is no provision in SBA regulations;
- illegal collusion with officials of lending institutions;
- conspiracy with borrowers to submit false loan packages; and
- bribes or gratuities to SBA or bank officials for loan approvals.

The number of loans that can be effected by a corrupt packager is a major concern. In one case alone, approximately 100 loan applications were submitted by a pair of packagers who used fictitious names on the Agency's disclosure form used to list fees paid to packagers. These individuals concealed the amount of their fees, while actually charging up to 35 percent of the loan amount. Fortunately, SBA loan officers spotted several discrepancies in some of the

applications and reported them to the OIG; however, because of the fictitious names, we could not immediately assess the extent of the fraud. Only after an arrest was made in a related case did a concerned citizen come forward and identify the packagers. So far, this particular case has resulted in 17 convictions and is still under investigation.

We have seen examples of packagers acting in collusion with bankers as well as applicants; there have also been cases where corrupt packagers have placed lenders at risk. In one case, a bank employee who was also packaging loans pled guilty to bank embezzlement by charging the lender for non-existent loan packages. In another case, the Treasury Department's Comptroller of the Currency sanctioned a bank due to poor underwriting of its SBA loan portfolio only months before the bank was closed. Court papers identified a bank employee and a loan packager as the individuals responsible for the bank's underwriting problems. It is clear from these and other case histories that corrupt packagers can indeed become a major threat to the integrity of the entire loan process.

Packagers represent a growing influence on the SBA loan programs; yet, there is no formal oversight of these individuals at the present time. The Agency lacks reliable information as to the number of packagers, the amount of fees charged, the number of packagers associated with lending institutions, or the number of individuals who received fees for brokering SBA loans. There are minimal written standards for packager competency and conduct, and there is no code of ethics specifically applicable to packagers. Also, there are no requirements for the conduct of criminal history or other character background investigations. In short, loan packaging is generally an industry with access to millions of dollars in Government funds with minimal reporting requirements and very little accountability.

Because there is no reliable estimate of the number of packagers in operation today, we can only hope that the cases involving packager corruption are a small part of the industry. Nonetheless, we must remain both skeptical and vigilant as SBA oversight resources are declining and the OIG's resources are being held static by the Congress, at a time when the SBA loan portfolio is increasing and more responsibility is being placed on the Agency's lending partners. The OIG believes this is a "sure fire recipe" for an explosion of fraud, unless tighter controls are instituted to protect the interests of the taxpayers, the Government, the lenders, and the loan applicants.

Task Force Activities

As I stated in testimony before this subcommittee last May, an SBA fraud prevention task force is addressing the loan packager problem as well as other matters of concern. The task force's loan packager committee is comprised of representatives from the Office of Financial Assistance, the OIG, SBA field offices, the National Association of Government Guaranteed Lenders (NAGGL), the packager industry, and lenders. Two courses of action are being explored to alleviate the problem of fraudulent loan packagers and ensure a high degree of integrity and accountability. First is the development of a database to track information about packagers, e.g., their geographic area of operation, the services provided, and the associated fee structure. Requirements for a packager identification number, packager training and accreditation, and adherence to a code of ethics are also being explored for their respective feasibility.

The second course of action is directed at ensuring that loan applicants receive full disclosure of the services provided by the packager, the cost of the services, and the packager's relationship to the lender and any service provider. In addition, the definition of loan packager and lender service provider is being clarified. With limited exceptions, a "two master" prohibition is being recommended, i.e., an individual or entity could not be directly compensated by the applicant to act as a packager and paid by the lender to act as a service provider on the same loan.

The loan packager committee is also proposing a mandatory lender service provider agreement that prohibits the lender and the provider from engaging in any sharing of secondary market premiums. In addition, the SBA would retain the right to require a lender to reduce the compensation paid to the provider if the compensation clearly exceeds of accepted industry standards and the excess compensation adversely affects the loan terms for the applicant.

Lenders would also be prohibited from delegating to a lender service provider any decision-making function in the making, servicing, or collection of an SBA loan that materially affects the credit risk of the loan.

The Inspector General is a member of the fraud prevention task force and members of the OIG staff participate in the work of the various committees of the task force. We believe the loan packager committee has addressed many of the problems the OIG has identified through its various audits and investigations. The OIG recommends that the following requirements be included in any regulation of loan packagers:

- Registration of packagers to practice before the SBA and participating lenders. The registration process should require the packager to demonstrate an acceptable level of knowledge of the guaranteed and disaster loan programs. One model for a registration process is the IRS enrolled agent program.
- Issuance of a certification to registered packagers. This would allow packagers to demonstrate to prospective applicants their approved participation in the SBA lending process.
- A character background check, including an FBI criminal history check, as part of the registration process.
- Development of an information pamphlet that would be included in the loan application process which would include specific information about the responsibility of loan packagers, brokers, and service providers. It could also include warnings against the submission of fraudulent information in loan applications.

We will continue to work with the Agency to promote deterrence and ensure the continued public confidence in the SBA's loan programs.

Other Current Fraud Detection and Deterrence Efforts

Finally, I would like to summarize current OIG efforts to detect and deter fraud generally in the business loan and disaster assistance loan programs. We will soon be completing an audit of Early Default of Guaranteed Loans. This audit included a review of 17 loans, originated by 5 lenders, that were transferred to liquidation within 24 months of approval. The objectives of the

audit were to determine (1) whether early defaults of guaranteed loans were based on falsified loan applications or defective loan originations, and (2) if borrowers contributed to the defaults through the unauthorized use of proceeds and business assets.

Nine of the 17 loans valued at $5.1 million were referred to the OIG's Investigations Division. Three of the 9 referrals were forwarded to the FBI, two are under active investigation by the OIG, and further information is being developed on one before a decision to investigate is made. All of these referrals were made because of misrepresentations or diversion of assets by borrowers. The balance of the referrals were closed without investigation because of bankruptcy, insufficient records, or the amount involved did not qualify under the OIG decision threshold. In only one of the nine referrals had fraud been suspected prior to our audit.

The audit specifically disclosed several procedural weaknesses that allowed misrepresentations or fraudulent borrower loan applications that were not detected:

- Repayment ability was computed using inaccurate financial information provided by the borrower. Applicants' financial statements were not fairly presented because, at the time these loans were made, SBA's procedures did not require independent review of the financial information. At the OIG's urging, the SBA now requires confirmation of financial information through IRS tax return verification.
- Lenders did not make field visits to borrowers to review financial records. On-site review of financial records was not required because SBA preferred to rely on the prudence of the lender as to when visits should be made and what to review during such visits.
- Business records for eight of the 17 defaulted borrowers were not retained or available for post review against the terms of the loan agreement. As a result, neither the OIG nor SBA could easily determine the existence of misrepresentations or fraud. The OIG had to use its power of subpoena to obtain borrowers' bank records and reconstruct their business transactions. Five cases referred did not have business records available for audit.
- Procedures for monitoring working capital were inadequate. Twenty percent or more of the loan proceeds for six loans totaling $4 million were to be used for working capital. The majority of the proceeds designated as working capital ($800,000), however, was used for non-business purposes.

We will be making appropriate recommendations to correct these problems in the audit report to the Agency.

Turning to the disaster assistance loan program, we have four auditors at the Los Angeles District Office, one in Atlanta, and one in Washington. Since February 1995, the L.A. staff has identified and referred five borrowers, with loans totaling more than $700,000, to the Investigations Division for fraud investigation and possible recovery of SBA funds. The auditors are currently developing other cases for referral to the investigative staff.

In addition to closely supporting investigative efforts, the audit staff will develop recommendations to improve SBA procedural and management controls. A review of defaulted disaster loans and servicing/liquidation activities is currently being accomplished to identify

potential fraud. Using four specific selection criteria (type of loan, loan amount, origination date, and length of time between loan approval and liquidation), the auditors have selected 55 loans for detailed review. These loans were selected from a population of more than 2,500 loans, valued at $125 million, assigned to the Los Angeles District Office for intensive servicing and liquidation. Initial results show problems with false income statements, misuse of loan proceeds, inappropriate extension of payments, and borrower disappearance.

Payment deferrals, which often result in lengthy periods after the loan approval before the first payment is due, have caused difficulties locating some borrowers and obtaining records. Subpoenas have been issued in several of these cases. The results of these audits will be consolidated into an overall report that will include recommendations for correcting systemic problems and improving the disaster assistance loan program.

The subcommittee also expressed an interest in hearing our assessment on the level of fraud in the SBA's primary loan programs. Unfortunately, the news is not good. We have experienced significant increases in the level of fraud in both the 7(a) business loan program and disaster assistance loan program of unprecedented magnitude over the past three years. In the 7(a) program, for example, we currently have over 200 open criminal fraud investigations, involving 760 subjects and over $110 million in potential losses to the Government. This is a 47% increase in cases, a 125% increase in subjects, and a 23% increase in potential Government losses from just 3 years ago when our inventory stood at 136 cases, 338 subjects, and $89 million in potential losses.

In the disaster assistance loan program, the situation is even worse. The 65 criminal cases currently open is double what it was at this juncture in 1992, when there were 27 open cases. The number of subjects has increased almost ten-fold from 45 in 1992 to 400 in 1995 and the potential Government loss in these cases has grown from $2.3 million to over $47 million.

Dramatic growth in OIG case inventory is primarily a function of the significant number of loans being made by the Agency. Our experience indicates that an increase in fraud is a by-product of loan volume; consequently, the dramatic increases in the level of loan activity in both programs has resulted in skyrocketing referrals and criminal cases. In addition, OIG integrity briefings have heightened Agency employee awareness and, we believe, resulted in an increased number of fraud referrals. The Inspector General has registered his concern to the Office of Management and Budget and the Congress, over our limited ability to react to case increases. In short, our lack of resources has resulted in a serious growth in the case inventory and limited our ability to be responsive to all the cases referred to us. For example, in FY 1995 alone, approximately 160 cases involving over $20 million in Government funds were declined for investigation by the OIG due to insufficient resources. Despite the overwhelming workload, we have still managed to increase productivity significantly. In the past 2 years, for example, we have obtained approximately 80 indictments in the 7(a) program, 40 indictments in the disaster assistance loan program, and over $10 million in court ordered fines, restitution, and civil judgments. Our due diligence efforts, which include criminal history checks and tax return verification, have resulted in the declination of over $25 million potentially bad loans during the past year alone. Additional efforts to reduce this increase in fraudulent activity include the preparation of a fraud awareness

training course for SBA loan officers and increased efforts in pursuing civil actions through the Affirmative Civil Enforcement program of the Department of Justice.

Recently we have embarked on another initiative designed to combat fraud. We have begun outreach efforts with participating lenders to facilitate increased cooperation with lenders in the future. As SBA personnel resources decline and the Agency gradually turns over more of the loan approval authority to its lenders, as well as its servicing and liquidation activities, there will be a need for increased liaison between these lenders and the OIG. Our outreach efforts are designed to familiarize the lenders with the OIG mission and responsibilities and establish lines of communication with OIG field offices. We also envision the development and presentation of fraud awareness training to bank employees, perhaps through the good offices of professional associations such as NAGGL.

Mister Chairman, this concludes my formal testimony. I would be happy to answer any questions you or the Subcommittee Members may have.