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U.S. Small Business Administration

Inspection Report

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Loan Agents and the Section 7(a) Program

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TO: Aida Alvarez
Administrator

THROUGH: Karen S. Lee
Acting Inspector General

FROM: Tim Cross
Assistant Inspector General
for Inspection and Evaluation

SUBJECT: Inspection of Loan Agents and the Section 7(a) Program

We are pleased to submit our inspection report on ***Loan Agents and the Section 7(a) Program***, which focuses on preventing loan agent fraud. Although competent and honest loan agents help small businesses gain access to capital, some agents have perpetrated fraudulent schemes which have resulted in SBA's purchase of defaulted loans. As of the end of Fiscal Year 1997, in the 7(a) program alone, criminal investigations had been initiated on 354 individuals involving loan applications handled by 18 loan agents. Twenty-eight percent of these agents had prior criminal records. Moreover, allegations involving loan agents continue to be reported to the Office of Inspector General (OIG).

Over the past few years, Agency officials have been examining ways to make loan agents more accountable. Factors affecting SBA's ability to accomplish this include the Agency's diminished staff resources and the potential for loan agents to use the Internet to commit fraud on a national scale. Accordingly, and consistent with SBA's emerging oversight role, any system to enhance loan agent accountability should emphasize fraud prevention over expensive after-the-fact remedies; avoid creating undue hardship for small businesses, lenders, and honest loan agents; monitor agents' performance to identify problems; and take into account technological change.

An important preventive tool--and one recommended by SBA's Committee on Loan Packager Reforms--is the registration of loan agents. Without an up-to-date registry, no effective accountability or controls are possible. As part of this process, loan agents should provide limited personal data so that the OIG could conduct a criminal history check. Based on the experience of some lenders, the OIG believes that the mere act of requesting verifiable information could deter dishonest individuals from involvement in the 7(a) program.

To accomplish the above without the administrative burden of fingerprinting, the OIG recommends that you propose expanding current legislation to include loan agents among those subject to National Crime Information Center criminal history checks. The OIG further recommends that the Associate Administrator for Financial Assistance establish a loan agent registration system that, among other things, creates Internet lists of registered

loan agents and those agents whose privilege to conduct business with SBA has been suspended or revoked, ensures that loan agent registration is not considered an Agency endorsement, and informs lenders that SBA is under no obligation to guarantee loans in which agents were involved after the above privilege was suspended or revoked.

Because systematic monitoring of loan agent performance can serve as an early warning system for identifying problems, the OIG recommends that the Associate Administrator for Financial Assistance establish a loan agent monitoring system that holds the lender responsible for the accuracy of data (including electronic data) originated by loan agents and transmitted by the lender to SBA, ensures that all loan data is linked to the agents involved, establishes purchase rate benchmarks that would trigger closer examination of a loan agent's performance, and centralizes the evaluation of agent performance to ensure consistency. Finally, the report discusses the possible use of lenders' bond insurance policies to help protect SBA from losses due to loan agent fraud.

The Acting Associate Administrator for Financial Assistance commented that the Office of Financial Assistance (OFA) shares the concerns identified in the report and is basically in agreement with the recommendations. She noted, however, that OFA remains somewhat less convinced than the OIG of the magnitude of the problems caused by loan agents.

The OIG inspection team appreciates the excellent cooperation received from SBA staff, other Federal officials, lenders, loan agents, and representatives from other non-governmental organizations. We would welcome the opportunity to brief you on this inspection at your convenience.

Attachment

cc: Chris Sale

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ABBREVIATIONS

CFR	Code of Federal Regulations
CLP	Certified Lenders Program
CPA	Certified Public Accountant
FY	Fiscal Year
GSA	General Services Administration
HUD	Department of Housing and Urban Development
IRS	Internal Revenue Service
LowDoc	Low Documentation Loan Program
LSP	Lender Service Provider
NAGGL	National Association of Government Guaranteed Lenders
NCIC	National Crime Information Center
NPR	National Performance Review
OCIO	Office of the Chief Information Officer
ODA	Office of Disaster Assistance
OFA	Office of Financial Assistance
OIG	Office of Inspector General
OMB	Office of Management and Budget
PLP	Preferred Lenders Program
SBA	Small Business Administration
SBLC	Small Business Lending Company
SIC	Standard Industrial Classification
SOP	Standard Operating Procedure
VA	Department of Veterans Affairs

EXECUTIVE SUMMARY

Purpose and Background

The 7(a) Program. Under Section 7(a) of the Small Business Act (Public Law 85-536, as amended), the Small Business Administration (SBA) guarantees up to 80 percent of a private lender's loan to a small business borrower who cannot obtain credit elsewhere on reasonable terms and conditions. The number of 7(a) loans approved each year more than quadrupled between Fiscal Year (FY) 1990 and FY 1997, from 10,848 to 45,288, while the number of SBA employees decreased from approximately 4,100 to 3,100.

Loan Agents. The 7(a) program involves not only SBA, borrowers, and lenders but also loan agents, who provide referral and/or loan application services for a fee. Because of the Agency's recent experience with fraud on the part of some loan agents, the Office of Inspector General (OIG) initiated this inspection to identify efficient ways to reduce the opportunities for fraud and minimize its impact on the program. The loan agent issue also highlights the problem of trying to regulate any cottage industry: how a resource-constrained agency can keep a program relatively secure while allowing access to a wide range of users and enabling private entrepreneurs to provide support services needed by some users. On the plus side, competent and honest loan agents can screen prospective borrowers for eligibility and, when appropriate, assist them in preparing application paperwork. Agents also can increase small business access to capital by reaching underserved communities.

Problems with Loan Agents. Dishonest agents, on the other hand, pose a problem for borrowers, lenders, and SBA. OIG cases have included various fraudulent schemes, such as submitting false tax returns or other financial data, charging the borrower excessive fees, using fictitious names on SBA forms, exaggerating their ability to gain loan approval, acting in illegal collusion with officials of lending institutions, and conspiring with borrowers to submit false loan packages. Such schemes have forced the purchase of defaulted loans by SBA and, ultimately, the taxpayer. As of the end of FY 1997, in the 7(a) program alone, criminal investigations had been initiated on 354 individuals involving loan applications handled by 18 loan agents. The loan volume associated with these investigations exceeded $123 million. **Twenty-eight percent of these agents had prior criminal records.** Moreover, allegations involving loan agents continue to be reported to the OIG.

Work Performed. To identify ways to reduce fraud by loan agents, the inspection team interviewed SBA central office officials, SBA district office staff, lenders in high volume/high loan-purchase districts, loan agents, program officials at other Federal agencies, and relevant staff in other OIGs. The team also obtained information from the National Association of Government Guaranteed Lenders (NAGGL) and provided input on its proposal for a loan agent registration and training process.

Because loan agents and the Agency will increasingly rely on electronic communications, team members obtained information on electronic security measures from SBA's Office of the Chief Information Officer (OCIO) and outside organizations. Finally, the team evaluated the possible use of professional liability/malpractice insurance, individual bonds, and/or lenders' blanket bond policies to ensure loan agent integrity and cover at least part of the Agency's financial position in the event of loan agent fraud.

Conclusions

Barriers to Accountability. There are several barriers to making loan agents more accountable. The most basic may be overcoming the confusion over loan agents' roles and functions, which vary widely. Second, there are few preventive measures, such as background checks, that would bar questionable individuals or firms from becoming loan agents. Third, SBA information systems presently lack reliable data on the number of active loan agents. Fourth, it is often difficult to assess the impact of loan agent activity, e.g., determining whether a loan defaulted because of agent fraud, incompetence, or reasons unrelated to the agent's actions. The final barrier is SBA's diminished staff resources, which limit the Agency's ability to monitor agent performance.

Changes Affecting Future Regulation. As SBA staffing has been reduced, the Agency's role has shifted from being directly involved in loans to monitoring and regulating lenders. While this provides opportunities, it also poses increased risks, such as lenders being less likely to report agent fraud because they fear bad publicity. In addition, many lenders are contracting out certain loan functions, raising concerns about accountability and quality control.

Changes in technology also are altering the way lenders, SBA, and related service providers do business. These include the Internet and its potential for fraudulent use, the Agency's gradual movement toward a largely paperless office environment, the strengthening of SBA's internal computer systems, the quest for secure methods of sending financial data electronically, and decreased emphasis on personal contact between a lender, loan agent, and borrower, possibly affecting the quality of credit decision-making.

A System for Accountability. Consistent with SBA's emerging oversight role, any system to enhance loan agent accountability should:

- **Emphasize fraud prevention over expensive after-the-fact remedies.**

- **Avoid creating undue hardship for small businesses, lenders, and honest loan agents.**

- **Monitor agents' performance to identify problems.**

- **Take into account technological change.**

Preventive Measures. Although the lenders and SBA officials interviewed generally agree that lenders should be held responsible for the loans they approve, regardless of whether loan agents were involved, all parties to a loan transaction need adequate preventive tools to minimize agent fraud. An important preventive tool--and one recommended by the Agency's Committee on Loan Packager Reforms--is the registration of loan agents. Registration can reduce the potential for fraud while also channeling loan agents into SBA-sponsored training and/or testing designed to ensure a standard for competence. In addition, registration can provide an accurate accounting of loan agents and a means of tracking their performance.

Recently, SBA has moved closer to developing a loan agent registration process that would require everyone who acts as a loan agent to register, including those who perform such services infrequently. A revised Compensation Agreement, which is submitted at loan closing, would trigger the registration process; training and/or testing would be conducted after an agent had been involved in a certain number of loans; and a list of registered agents would be made available to all lenders, SBA staff, and prospective borrowers. The Agency would also establish a procedure for suspension or revocation of a loan agent's privilege to conduct business with SBA consistent with the Code of Federal Regulations (13 CFR 103).

An effective registration system requires screening to prevent or deter dishonest loan agents from participating in SBA programs. Currently, all prospective 7(a) borrowers must certify whether they have a prior criminal record and provide basic personal data. In addition, the Agency has required prospective borrowers to sign a waiver allowing SBA or lenders to verify their tax returns against Internal Revenue Service (IRS) records. Some bankers have surmised that the mere act of requesting such verifiable information has deterred dishonest borrowers from proceeding with their loan applications.

Having loan agents provide limited and non-tax-related personal data would help the OIG to obtain a criminal history and could deter fraud. The simplest way for SBA to gain access to loan agent criminal histories from the National Crime Information Center (NCIC)**--without the administrative burden of requiring fingerprints--**is to expand recent legislation that allows the Agency's Administrator to verify the existence of 7(a) and other loan *applicants'* criminal backgrounds through the NCIC. The current estimated cost of such a check is between $2 and $6 per agent. **The OIG recommends that the Administrator propose expanding current legislation to include loan agents among those subject to National Crime Information Center criminal history checks.**

To avoid unnecessary delays for loan applicants, SBA could tentatively register agents prior to completing their screening. Agents who then fail the background checks would be removed from the list of registered agents and placed on publicly available lists of agents whose privilege to conduct business with SBA had been revoked or suspended

until further notice. Agents failing to register at all would also be placed on the list of agents suspended until further notice.

We believe that this registration process would be effective in curbing loan agent fraud. To give it some force and credibility among lenders, SBA should also advise all lenders that the Agency is under no obligation to guarantee loans in which agents were involved after their privilege to conduct business with SBA had been suspended or revoked. In addition, the lists could be made available promptly to prospective borrowers, lenders, and SBA field staff through the Agency's Internet Home Page. A similar process is used by the General Services Administration (GSA) to maintain lists of parties excluded from procurement and other types of programs.

Accordingly, the OIG recommends that the Associate Administrator for Financial Assistance establish a loan agent registration process that--

a) **Requires that any person or entity acting as a loan agent on any Section 7(a) business loan register with the SBA.**

b) **Ensures that each loan agent provides information, over his or her signature, that includes the Compensation Agreement, as revised, and the following:**

    - **The agent's name, date of birth, place of birth, and Social Security number.**

    - **Written authorization for the OIG to request information from criminal justice agencies.**

    - **Acknowledgment that the agent is aware of the requirements of Title 13, Part 103, of the Code of Federal Regulations.**

c) **Establishes, through the Office of the Chief Information Officer (OCIO), Internet lists of registered loan agents and agents whose privilege to conduct business with SBA has been suspended or revoked.**

d) **Ensures that SBA's loan application packages, Internet Home Page, and other media carry the disclaimer that loan agent registration is neither an endorsement by the Agency nor a guarantee that using a registered agent will result in loan approval.**

e) **Informs lenders that SBA is under no obligation to guarantee loans in which loan agents were involved after the suspension or revocation of their privilege to conduct business with the Agency.**

Monitoring Performance. Systematic monitoring can serve as an early warning system for identifying problems before they can grow. An existing Standard Operating Procedure

requires SBA to monitor third-party representatives, such as loan agents, but the inspection team found that it has not been consistently followed. Effective monitoring requires reliable data on which decisions can be made, ready access to the data by officials responsible for monitoring, and timely analysis of the data for the purpose of taking corrective action. Agency officials plan to track the performance of loan agents in the emerging Corporate Data Base, and lenders will be responsible for submitting current loan data and status updates directly to SBA through the Internet. Because SBA depends on lenders' information systems, lenders must be held accountable for any data they send to the Agency, including any originated by loan agents.

SBA also needs to review loan agent data on a regular basis to identify and correct problems. For example, it should set numerical standards that would trigger closer examination of an agent's activities if the purchase rate of loans associated with the agent exceeded a defined limit or fell outside the range of most agents' purchase rates. Given the potentially wide geographical coverage of loan agents and the inconsistencies among some district offices in their handling of the agents, the OIG believes that a single office should be responsible for handling the analysis of all loan agents and any follow-up. **The OIG recommends that the Associate Administrator for Financial Assistance establish a loan agent monitoring system that--**

a) **Holds the lender responsible for the accuracy of data (including electronic data) originated by loan agents and transmitted by the lender to SBA.**

b) **Ensures that the Corporate Data Base links all loan data to associated loan agents, including the purchase rate of such loans.**

c) **Establishes purchase rate benchmarks that, if exceeded, would trigger closer Agency examination of a loan agent's performance.**

d) **Centralizes the evaluation of loan agent performance in a single office, rather than among district offices, to ensure consistency in the monitoring and handling of loan agents.**

Blanket Bond Policies and SBA. A final issue for long-term SBA consideration is the potential use of a lender's financial institution bond insurance policy, which protects against loss resulting from dishonest or fraudulent acts committed by employees acting alone or in collusion with others. The report discusses what would be required to use such a policy to help SBA protect itself from losses due to loan agent fraud.

SBA Comments

The Acting Associate Administrator for Financial Assistance commented that the Office of Financial Assistance (OFA) shares the concerns identified in the report and is basically in agreement with the recommendations. She noted, however, that OFA remains somewhat less convinced than the OIG of the magnitude of the problems caused by loan agents.

BACKGROUND

Section 7(a) Program

Under Section 7(a) of the Small Business Act (Public Law 85-536, as amended), SBA guarantees private lenders' loans to small business borrowers who cannot obtain credit elsewhere on reasonable terms and conditions. SBA currently guarantees up to 80 percent of the face amount of such loans. The guarantee amount is generally limited to $750,000 except for Defense Loan and Technical Assistance Program, International Trade, and Pollution Control loans. In fulfillment of its guarantee to lenders, SBA currently purchases between $400 million and $450 million of defaulted 7(a) loans annually, with actual losses since 1990 exceeding $200 million per year. Annual purchases are projected by SBA to double by the year 1999 if loan demand forecasts are realized. Emphasizing the use of guarantees against borrower default reflects the Agency's shift during the 1980s from directly subsidizing credit risk to improving access to capital at the least possible cost. More than 8,000 lenders--banks, Small Business Lending Companies (SBLCs), and other credit providers--have made at least one 7(a) loan in the past five years.

The number of 7(a) loans approved each year more than quadrupled between Fiscal Year (FY) 1990 and FY 1997, from 10,848 to 45,288. Over the same time period, the number of SBA employees decreased from approximately 4,100 to 3,100. As a resource-constrained SBA increasingly relies on private sector lenders to carry out Section 7(a) program objectives, other major changes are occurring. First, lenders and borrowers are using third-party cottage industries such as loan agents to handle traditional loan functions not only in the 7(a) program but in other programs as well. Second, new technologies for loan-making and monitoring are emerging. Third, SBA's responsibilities are shifting from direct involvement in loan management to more of an oversight role.

Loan Agents Defined

The 7(a) loan program involves not only SBA, borrowers, and lenders but also various types of loan agents who conduct business with the Agency. Although the distinctions between them are not always clear, the three major types of loan agents are loan packagers, referral agents, and lender service providers. ***Loan packagers,*** according to the definitions in the Code of Federal Regulations,[1] are agents compensated by either loan applicants or lenders to prepare loan applications. ***Referral agents***--who refer either loan applicants to lenders, or lenders to loan applicants--may be compensated by either party. ***Lender service providers*** carry out lender functions in originating, disbursing, servicing, or liquidating Agency loans in return for compensation from lenders. SBA determines whether or not one is a packager or lender service provider on a loan-by-loan basis.

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[1] Title 13, Code of Federal Regulations, Part 103, Section 1 (13 CFR 103.1).

Finally, a loan agent need not be an individual. For example, Certified Development Companies and Small Business Development Centers can package loans.

Positive Contributions of Loan Agents

Competent and honest loan agents can help lenders, borrowers, and SBA by screening prospective borrowers for eligibility early in the loan origination process and, when appropriate, preparing application paperwork in a complete, consistent manner. Because loan agents know how the 7(a) program works, they also serve as a communication link among the parties to a loan. These contributions can increase loan volume and save time for borrowers, lenders, and the Agency. To avoid conflicts of interest, a good agent is careful not to work for both the lender and borrower during origination on the same loan.

Preparing a complete and understandable loan package is not a simple task. According to SBA district officials, the Agency continually is required to use additional forms even as it strives to simplify the application process. Some of these, such as the form asking if the borrower is delinquent on child support payments, may have little direct relevance to a credit decision.

Perhaps the greatest contribution of loan agents is that they can increase small business access to capital by reaching underserved communities and bringing into the program people who otherwise might not be served by SBA. Agents often bring smaller, rural banks into the 7(a) program--where one or two SBA loans can be very meaningful to a small town's economy. In short, loan agents can expand SBA program outreach at no direct cost to the Agency, thus leveraging private sector resources.

Problems with Loan Agents

Unfortunately, some agents, particularly loan packagers, have had a negative influence on borrowers, lenders, and SBA. Office of Inspector General (OIG) cases involving loan agents have included a range of fraudulent schemes.

- Submitting false or fictitious applications, including false invoices, liens, financial statements, and tax returns.

- Charging the borrower excessive fees for preparation of the loan package.

- Falsifying or omitting required fee information to SBA.

- Concealing the true name of the agent by using fictitious names on SBA forms.

- Requiring kickbacks from successful borrowers.

- Requiring other incentives, such as the signing of “management agreements” or consulting contracts from borrowers.

- Misstatements 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.

- 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.

- Bribes or gratuities to SBA or bank officials for loan approvals.

These schemes, which have been copied from one fraudulent agent to another, have resulted in loan purchases by SBA and, ultimately, the taxpayers. Moreover, before SBA initiated a “two master” rule, loan agents were able to be compensated by the borrower and the lender on the same loan--a clear conflict of interest.[2]

In some cases, one loan agent can commit a combination of crimes. For example, a packager conspired with two individuals to defraud SBA by submitting false financial statements, tax returns, and other documents to influence the Agency to guarantee a $360,000 loan. The false documents were prepared to substantiate earlier false statements that a contract for deed existed and that the packager had maintained the business’ records for years. The packager was eventually convicted on 12 counts of conspiracy, mail fraud, material false statements, and money laundering.

Sometimes agents simply exaggerate their capabilities. In one high-tech twist, a loan agent firm used the Internet to portray itself as an “SBA preferred packager,” a non-existent designation.

As of the end of FY 1997, in the 7(a) program alone, criminal investigations had been initiated on 354 individuals involving loan applications handled by 18 loan agents. The

[2] The new Standard Operating Procedure (SOP) 50-10 (4), effective December 1, 1997, describes the capacities in which an agent may work for a loan applicant or lender. For example, an agent working for the applicant as a packager may also be a referral agent for the lender on the same loan if both parties are aware of both relationships. However, an agent working for an applicant as a packager generally may not work as a lender service provider on that loan.

loan volume associated with these investigations exceeded $123 million. **Twenty-eight percent of these agents had prior criminal records.** Moreover, allegations involving loan agents continue to be reported to the OIG.

According to SBA officials and others in the small business lending community, prospective borrowers use loan agents because they have been rejected more than once by lenders. This raises questions about the quality of some of the loan applications being brought to lenders for approval.

Questions have also been raised concerning the competence of some loan agents. According to SBA officials, lenders, and loan agents, a number of loan agents lack the competence to adequately prepare loan applications. Comments about these loan agents ranged from complaints from borrowers that loan applications were not completed quickly enough to concerns from Agency officials and fellow loan agents that certain agents lacked the business skills to properly prepare a loan application.

Committee on Loan Packager Reforms

In 1994, to remedy the problem of fraud in SBA programs, then-SBA Administrator Erskine Bowles established a Fraud Prevention Task Force, which included a Committee on Loan Packager Reforms chaired by an Office of Financial Assistance (OFA) official.[3] In December 1996, the Committee made its recommendations.

- Establish a code of Standards of Conduct for loan packagers.
- Establish a loan training curriculum for packagers covering policies, procedures, standards, conflicts of interest, application package requirements, and financial information presentation.
- In conjunction with the Office of the Chief Information Officer (OCIO), establish a data base of information on packagers, including information from a registration process.
- Modify SBA Form 159, Compensation Agreement, to reflect more clearly the services provided and fees charged by packagers and loan referral agents. The form would serve as a disclosure statement for all such services and fees and would be signed by each provider, lender, and small business concern.

The Committee stated that implementation of registration and tracking depended on the development of the planned client server data base. The data base, now called the Corporate Data Base, will differ from the current systems in that the data elements of all

[3] The issue of defining the role of "packagers" is discussed later in this report.

programs will be kept in the same system, thus allowing SBA to link lenders, borrowers, and agents with any programs in which they participate. Such a data base could indicate questionable patterns of activity, e.g., a packager doing all of his/her business within one market segment, such as gas station loans. The part of the system that collects information about businesses, principals, and resource partners (such as lenders) is the Client Data Base.

Under the current plan, data will be entered by SBA's field offices. OFA's proposed data elements for loan agents include the agent's name, Social Security number, company name, employer identification number, company address and phone number, type of agent, years of experience, the lender(s) the agent works for, loan number, agent fee, loan amount, narrative fields for complaints and related matters, and information on suspensions and debarments (also known as revocations).

The Key Issue: Security vs. Access

In a broad sense, the loan agent issue highlights the fundamental problem of trying to regulate any cottage industry: how to maintain program security while allowing access to a wide range of users and enabling private entrepreneurs to provide support services needed by some of the users. More specifically, this raises the following questions:

- How can SBA assure prospective borrowers that the loan agents with whom they do business will not defraud them?
- How can SBA keep dishonest and/or incompetent loan agents out of the 7(a) program without harming the program's outreach?
- To what extent should SBA regulate professionals such as accountants or lawyers who occasionally act as loan agents?
- How can SBA minimize losses from loan agent involvement?
- How can a resource-constrained SBA regulate loan agents while minimizing the need for more paperwork and staff?

Program Surety, Not Security

Unfortunately, the only way to ensure perfect program security is to deny everyone access. A more useful concept is program surety. Program surety is risk management that balances access with security by striving to limit rather than eliminate risk, thereby conserving resources. Despite barriers to minimizing loan agent fraud and incompetence, the concept of surety offers a framework for balancing the seemingly conflicting interests identified above.

OBJECTIVES, SCOPE, AND METHODOLOGY

The issues involving loan agents are likely to reflect larger SBA challenges as the Agency changes from paper-intensive, hands-on program management to electronic-based, lender-reliant program execution. The purpose of this inspection was to identify efficient ways to reduce the opportunities for loan agent fraud and minimize its impact on prospective borrowers, lenders, and SBA.

As part of this inquiry, the inspection team sought to determine (1) what percentage of 7(a) loans involved loan agents and (2) what percentage of such loans had defaulted. Unfortunately, SBA's main data bases currently do not track whether a loan involved a loan agent, nor do the Agency's district offices consistently keep track of loan agents. Moreover, there was the problem of whether purchases could be attributed primarily to harmful loan agent behavior or to loan agents conscientiously reaching the somewhat higher risk borrowers that SBA is supposed to serve. Complicating such an analysis is the fact that most 7(a) loan defaults do not occur until three to five years after origination.

The inspection team interviewed SBA central office officials, SBA district office staff, lenders in high volume/high loan-purchase districts, and loan agents to learn their perspectives on the benefits and drawbacks of loan agents. The team also interviewed program officials at the Internal Revenue Service (IRS), the Department of Housing and Urban Development (HUD), the Department of Veterans Affairs (VA), Fannie Mae, and the Department of Agriculture to determine if their handling of third-party agents revealed methods applicable to SBA. Although this inspection focused on the 7(a) program, the team interviewed officials in SBA's Office of Disaster Assistance to learn about that program's experiences with loan agents and its planned use of paperless office technology. The team also examined OIG audit and investigative documents and contacted relevant staff in other OIGs.

In addition, the inspection team obtained information from the National Association of Government Guaranteed Lenders (NAGGL), including NAGGL's efforts to ensure loan agent competence and integrity. In response to NAGGL's request, the team submitted preliminary comments on the loan agent registration process, the draft SBA agent Compensation Agreement, the draft code of ethics, and the issue of training for use in NAGGL's proposal for agent registration and training.

Because loan agents and SBA will increasingly rely on electronic communications, team members researched the emerging challenges of a paperless environment through using the Internet and attending a conference on cyberspace fraud. Further information was obtained from OCIO staff as well as from outside organizations involved with the paperless office.

Finally, to identify private sector methods of ensuring loan agent integrity and covering at least part of SBA's financial position in the event of loan agent fraud, the team interviewed a surety association and two prominent insurance companies. One company ranks among the top 50 property and casualty insurers in the U.S., and the other was one of the first SBA preferred surety companies. The team evaluated the feasibility of using professional liability/malpractice insurance, individual bonds, and/or lenders' blanket bond policies for the above purposes. A special focus was whether SBA could hold a lender responsible for fraudulent behavior by agents acting on the lender's behalf by making a claim against the lender's blanket bond policy.

All work on this inspection was conducted between September 1996 and November 1997 in accordance with the **Quality Standards for Inspections** issued in March 1993 by the President's Council on Integrity and Efficiency. The entrance conference with program management was held in March 1997.

CURRENT BARRIERS TO LOAN AGENT ACCOUNTABILITY

Defining Loan Agents' Roles

The most basic barrier to making loan agents more accountable may be determining what a specific agent really does. Even with the definitions of the three types of loan agents, it is sometimes difficult in practice to distinguish one type from another, as was apparent from statements by agents, lending industry representatives, and some SBA officials. According to testimony by NAGGL officials before Congress in 1995, the definition of a "packager" has been a problem due to the variety of services associated with the term. To complicate matters, the term "packager" is sometimes used synonymously with "agent." Thus, a "packager" could complete paperwork for the borrower, complete paperwork for the lender, find borrowers and locate lenders for them, or locate borrowers in exchange for a lender referral fee. Moreover, the agent could work on the entire loan application process, from origination to approval, or only on a portion of it.

In 1995, an SBA 7(a) program official testified before Congress that, because of changes in the marketplace, the Agency's long-standing guidelines regarding loan packagers no longer met SBA's needs. Historically, loan packagers provided their services only to prospective borrowers. Over the years, traditional loan packagers have responded to the growth and changes in the lending industry by modifying or expanding their operations. Today, a number of packagers provide loan packaging and loan servicing functions directly to SBA's lending partners. The above 7(a) official further noted that new individuals and entities have continually entered the marketplace to provide one or more of a variety of loan packaging and lender services. Thus, a packager of one loan may be a lender service provider on another loan, depending on the activities undertaken on each loan.

Other agents simply change their specialties. For example, some agents who were strictly packagers are now lender service providers. According to an SBA district official, loan packagers may be declining in number due to the availability of new software programs that automate the loan application package process. As a result, lenders may be packaging more loans in-house, and the larger, nationwide lenders are more likely to hire loan packagers as lender service providers.

Finally, the lines between a lender and agent can be blurred. For example, in one instance an independent agent packaged loans for a bank while working out of an office within the bank. Although the agent was not on the payroll of the bank, he was given the title of vice president.

Few Restrictions to Entering the Profession

At present, virtually any individual or firm can become a loan agent. There is currently no background check on an agent before he/she conducts business with SBA program participants. Except for occasional state requirements, which are not directly related to SBA program requirements, agents may enter and leave the occupation at will.

In addition, loan agents are not restricted by geography. According to SBA district officials, loan agents are able to operate across state lines and Agency district office jurisdictions. The increasing popularity of the Internet provides another tool for agents to broaden their geographical coverage.

Lack of Reliable Data on the Number of Loan Agents

SBA cannot determine either the percentage of loans nationwide that involve agents or the total number of agents, in part because its data bases do not currently track whether loans involve agents. Field offices have differing systems for identifying loan agents, and some have not tracked them at all, despite a requirement to do so.[4] According to several SBA officials in major district offices, the current version of the Compensation Agreement (see Appendix A) is not tracked by district offices. The offices do examine, however, the fees charged by an agent to make sure they are not excessive compared to the norm for that district.

Even where documents are tracked, loan agents can easily evade oversight. For example, in one case a fraudulent referral agent's name never appeared on the loan applications because the bank packaged the loans.

Moreover, some agents do not remain in the profession long because the work is non-salaried and the cash flow is inconsistent. Thus, the number of agents is ever-changing. To complicate matters, some accountants and lawyers act as loan agents only to complement the accounting, legal, and other services they provide to their small business clients.

Determining the Impact of Loan Agents

At the district office level, it is unclear whether packaged loans have higher purchase rates than non-packaged loans. Although there was no data to determine this, some district officials believe that the purchase rate is higher for packaged loans. Even if the rates are higher, determining a loan agent's responsibility for a defaulted loan is difficult. For

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[4] SOP 50 10 3, dated August 31, 1991. SBA officials have stated that such a requirement existed before this SOP. Effective December 1, 1997, SOP 50-10(4) requires the completion of the Compensation Agreement, which is in the process of being modified.

example, a loan could have defaulted as a result of an honest agent's efforts to reach the higher risk borrowers SBA seeks to serve or for reasons unrelated to the agent's actions. Moreover, it is the borrower who is held responsible for the loan package, regardless of whether a loan agent was involved, and it is the lender's duty to exercise due diligence in deciding whether to approve a loan.

Finally, as an SBA official noted, the Agency only finds out about agent fraud at the end of the lending process, after the damage has been done. When these limitations are added to the ease of entry into the loan agent field, it is no surprise that it is difficult to know what overall impact--positive or negative--loan agents have on the 7(a) program.

SBA's Diminished Resources

As noted earlier, the Agency has experienced a significant reduction in staff resources at a time of increasing demand for its services. Because of this, some SBA officials contend that the Agency does not have the resources to regulate loan agents. Although district offices vary in their attention to loan agents, generally a prospective borrower must complain about an agent before the Agency takes action.

CHANGES AFFECTING SBA'S FUTURE REGULATION OF LOAN AGENTS

Changes in SBA's Role

As SBA's staff resources diminish, the Agency is shifting its emphasis from being directly involved in loans to monitoring and regulating lenders. This is consistent with SBA's attempts to transform itself into a leading edge financial institution by expanding its ability--through its lending partners--to provide access to credit for small businesses.

While such a transformation provides opportunities, it also poses increased risks. For example, lenders may be less likely to report fraud out of fear that bad publicity will affect their customers' and shareholders' impressions of their institutions. This has already occurred in cases of computer crime against lenders. In such an environment, Agency officials are concerned that it will be even more difficult to monitor loan agents. Moreover, there are no guarantees that the diminishing of SBA's direct involvement in loans will make more resources available to regulate its lending partners.

Changes in Lenders' Environment

SBA is not alone in relying on outside parties to carry out its work. According to industry officials, many lenders are contracting out functions to cottage industries such as temporary workers, information systems firms, and loan agents. Moreover, NAGGL officials testified in an October 12, 1995, hearing before the House of Representatives Small Business Committee that loan functions traditionally performed by lenders themselves--packaging, analyzing credit, servicing, or liquidating loans--are now being performed by outside parties that are growing in number. In 1996, outsourcing at large banks increased by 18 percent over the previous year.[5]

Outsourcing is not without its liabilities, however. Industry officials have expressed concern about accountability: as more lender functions are contracted out, protection of data and the disclosure and sharing of borrower information with outside parties may become major problems. If borrower information is compromised, lenders could be exposed to litigation and/or financial loss. There is also the question of quality control, particularly when servicing firms use new employees, each of whom is expected to become proficient in several areas simultaneously.

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[5] Moore, Michael. Biggies Seek Help Strategically. *American Banker*, April 17, 1997: 10A.

Changes in Technology

Changes in technology are altering the way lenders, SBA, and related service providers do business. With the advantages of more efficient communication and information systems come potential drawbacks. For example, the Internet allows everyone, including service providers, to reach a national audience. Unfortunately, this capability magnifies the potential for misrepresentation and, in extreme cases, financial loss. As noted earlier, one loan agent firm used the Internet to advertise itself falsely as an "SBA 'preferred' loan packager." In another instance, a different firm used the Internet to advertise "a direct channel of communications with the SBA and lenders . . . " In such situations, SBA's district office-based approach to regulation may not provide adequate geographical coverage.

Another technological change is SBA's gradual movement toward a largely paperless office environment. The Office of Disaster Assistance (ODA) has started to process disaster home loans without paper, and OFA plans to do so with LowDoc loans. Moreover, according to an Agency official, a software development company that produces a computer program for SBA loan applications has proposed a system whereby borrowers can prepare applications using its software and then transmit them electronically to lenders. Finally, the National Performance Review (NPR) has granted money to SBA to use electronic signatures with the FA$TRAK loan program.

The Agency is also strengthening its internal computer systems. As noted earlier, SBA is developing the Corporate Data Base, which will allow lenders to provide original data directly to SBA rather than have Agency staff manually enter it, thus saving staff resources.

The downside is that with the advent of electronic banking, the Internet, and other evolving technologies, the parties to a transaction need a secure means of sending financial data electronically and a reliable method for authenticating the transactions. Although digital signatures, data encryption, and electronic certification of participants' identity are still in their infancy, the pieces of electronic security are gradually coming together.

Perhaps the greatest change that new technology brings to SBA and its lending partners is not in the realm of information processing but in human relations. According to a former packager who is now a banker, a disadvantage of electronic initiatives is that they can minimize the personal contact between the lender, the loan agent, and the borrower. This, in turn, reduces the ability of lenders to develop an intuitive sense of a prospective borrower's character, upon which a large part of credit decision-making has traditionally been based. How such a change affects the quality of SBA's loan portfolio remains to be seen.

A System for Accountability

Based on the previously described barriers and changes, and consistent with SBA's emerging oversight role, any system to enhance loan agent accountability should:

- **Emphasize fraud prevention over expensive after-the-fact remedies.**

- **Avoid creating undue hardship for small businesses, lenders, and honest loan agents.**

- **Monitor agents' performance to identify problems.**

- **Take into account technological change.**

The following chapters discuss what SBA has done thus far and what still needs to be done.

PREVENTIVE MEASURES

Throughout the Federal Government, agencies are having to carry out their missions with fewer resources. One school of thought proposes two approaches to help the Government stretch its public resources: anticipatory and market-oriented. The former emphasizes preventing problems, while the latter relies more on market-based incentives than on resource-intensive command-and-control regulation.[6] Such approaches have been used successfully in areas such as economic development, environmental protection, and health care. When applied to regulating a cottage industry, an agency could prevent undesirable members of that industry from participating in a program, while making it economically worthwhile for other members to comply with the program's rules. Before SBA can apply such approaches to loan agents, however, it should be clear where ultimate responsibility lies.

Responsibility for Loan Agent Actions

As a third-party industry, loan agents are not the main beneficiaries of the 7(a) program. Instead, it is the small business seeking credit and the lender seeking profit at reduced risk. Accordingly, the SBA district officials interviewed asserted that the borrower or the lender, and not a loan agent, bears primary responsibility for a loan. The lenders interviewed were even more adamant, arguing that they should be held responsible for loans they approve, regardless of whether loan agents were involved. SBA already has the power to hold lenders responsible for the loans made; for example, the Agency can deny liability on a loan guarantee, terminate the Form 750 (Loan Guaranty Agreement), and remove Preferred Lenders Program (PLP) or Certified Lenders Program (CLP) status from a PLP or CLP lender. Moreover, SBA traditionally has viewed itself as primarily involved with lenders and borrowers, not third parties such as loan agents.

Two changes are likely to make lender responsibility more important. First, as more agents become lender service providers, i.e., under contract to lenders, the opportunities for collusion with lenders' employees are likely to increase. Poor lender due diligence may create an environment for fraud. Because the small business lending departments in some banks operate somewhat autonomously, this problem may worsen. Second, as SBA allows electronic interchange between lenders and the Agency, SBA will need some assurance that loan agents cannot access and manipulate the lenders' data.

Unfortunately, simply holding lenders responsible after the fact is not enough. Lenders, as well as borrowers and SBA staff, need adequate preventive tools to minimize the chances of agent fraud or incompetence. Moreover, such tools should be compatible with SBA's changing loan programs and technological environment.

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[6] Osborne, David and Ted Gaebler. *Reinventing Government: How The Entrepreneurial Spirit Is Transforming The Public Sector*. New York, NY: Plume, 1993, pp. 219, 223, 301, 304.

Registration of Loan Agents

An important preventive tool--and one recommended by the Agency's Committee on Loan Packager Reforms--is the registration of loan agents. Registration is both anticipatory and market-oriented because it seeks to screen out problem agents early, while also defining which agents can profit from SBA's programs. Registration can reduce the potential for loan agent fraud while channeling agents into SBA-sponsored training and/or testing designed to ensure a standard for competence. In addition, registration can provide an accurate accounting of loan agents and a means of tracking their performance--something the Agency does not have now. In short, registration is a form of indirect regulation in which the parameters and players are defined, but not regulated on a day-to-day basis.

IRS Enrolled Agent Program

Of the Federal programs that regulate agents, the most relevant is the IRS Enrolled Agent Program, which was created to improve the quality of taxpayer representation before the IRS. Although any person can be a tax preparer, only enrolled agents, attorneys, or certified public accountants (CPAs) can represent their taxpayer clients before IRS. Enrollment in the program is generally contingent on passing an examination proving competence in tax matters. Attorneys and CPAs in good standing are automatically eligible to be enrolled agents. In addition, IRS performs a limited background check, including examining the tax records of enrolled-agent applicants.

IRS officials stated that the most important factor in combating unethical enrolled agents is to place them under the authority of law, which is accomplished by registration. Moreover, IRS found that the mere act of requiring information can deter fraud. For example, when IRS required that taxpayers list dependents' Social Security numbers on tax returns, a large number of apparently phony "dependents" were no longer claimed. Yet, despite the effort in regulating enrolled agents, perhaps the most important aspect of the program is that IRS still holds the user of the agent's services--the taxpayer--ultimately responsible for the contents of a tax return, even if the enrolled agent is at fault.

Views on the Registration of SBA Loan Agents

When we discussed the idea of an SBA registration system with Agency officials, lenders, and loan agents, we found--

- Widespread support for registration, but differences as to what registration would entail and how it would be administered.

- Fear that publishing a list of registered agents could be construed as an endorsement from SBA.

- Divided opinion as to how extensive the background check should be for loan agents.

- Differences of opinion as to whether using fingerprinting to obtain complete criminal histories was necessary for screening the majority of loan agents, particularly for those who seldom handle loans.

- Concerns expressed by SBA officials about

  - ensuring full disclosure to the loan applicant of the services being provided, the costs of those services, and other relevant transactions;

  - including training and testing as part of the registration process;

  - inadvertently driving those who only occasionally act as loan agents--e.g., CPAs and attorneys--out of SBA programs, thus harming outreach to underserved areas; and

  - having problems with loan agent registration possibly delaying prospective borrowers' applications.

NAGGL and SBA Efforts at Registration

In September 1997, NAGGL's Packager Training Task Force proposed details of a registration system, based on input from its members (including an SBA official) and the OIG. The basic principles behind the system are--

- The Compensation Agreement (Form 159) should be used as a source document to monitor agents and the fees charged by agents.

- The agent code of ethics should be developed as an agreement to abide by Federal regulations.

- Training should focus on disseminating SBA requirements to agents in the form of a training manual.

- Registration should be accomplished through successful completion of a test and an SBA screening process.

- To maintain their registration status, agents should re-register every two years.

Since the NAGGL proposal, SBA has moved closer to a loan agent registration process. The following, although not final, are some of the basic components of the evolving process:

- Registration would apply to everyone who acts as a loan agent, including those who do so infrequently.

- A revised Compensation Agreement (see Appendix B for a draft) submitted at loan closing would trigger the registration process. Not only would it be the basic source document, but it would alert SBA staff to check whether a loan agent was already registered. It also might incorporate by reference any future loan agent code of ethics to be developed. Any information not collected on the Compensation Agreement form might be collected using a separate registration form and a Form 912, Statement of Personal History.[7]

- Training and/or testing would occur after an agent had been involved with a certain number of loans.

- The revised Compensation Agreement would ask what loan agents were used and the fees charged.

- A list of registered agents would be widely available to lenders, SBA staff, and prospective borrowers.

- The procedure for suspension or revocation of a loan agent's privileges would be consistent with the Code of Federal Regulations (13 CFR 103).

Screening Loan Agents

Establishing a registration system requires screening loan agents to prevent dishonest ones from participating in SBA programs. Implementing screening involves two issues. First, how extensive should screening be? Although loan agents, lenders, and SBA officials interviewed support the idea of screening, there was disagreement as to how much is necessary.

Second, when should screening take place? If an unregistered agent submits a loan package, should SBA refuse to guarantee the loan until the agent is screened and then registered? Although this would provide a market incentive for the agent to get registered, it could delay credit to the unsuspecting small business borrower. Or, should initial registration be automatic, but with the option of quickly withdrawing an agent's registration later if he/she does not pass the screening process?

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[7] The Form 912, Statement of Personal History, asks about the existence of a prior criminal record. Any person misrepresenting information on this form is subject to criminal penalty.

The Extent of Screening

The issue of how much screening is necessary applies directly to the concept of program surety, i.e., allowing access to the 7(a) program while providing reasonable assurance of security. Currently, all prospective 7(a) borrowers must certify on the Statement of Personal History whether they have a prior criminal record as well as provide personal data such as date of birth. In addition, the Agency has required prospective borrowers to sign a waiver allowing SBA or lenders to verify their tax returns against IRS records. Some bankers have surmised that the mere act of requesting such verifiable information has deterred dishonest borrowers from proceeding with their loan applications.

Having loan agents provide limited and non-tax-related personal data would help the OIG to obtain a criminal history and could deter fraud. The most comprehensive system for researching an agent's criminal history is the Department of Justice's National Crime Information Center (NCIC). The simplest way for SBA to gain access to the NCIC for administrative purposes, e.g., checking the background of loan agents, is through authorizing legislation. Recent legislation allows SBA's Administrator to verify the existence of 7(a) and other loan *applicants'* criminal backgrounds through the NCIC. [8] Expanding this legislation to include loan agents would strengthen the Agency's fraud prevention efforts at a current estimated cost of between $2 and $6 per agent. **Without such legislation, an NCIC check of loan agents would likely require fingerprinting--a major burden for all concerned.**

When Screening Should Occur

There are two ways to handle the timing of screening. The first would use screening as a prerequisite for registration: an agent would have a grace period to register so that a small business using this agent could obtain credit even though the agent was not yet registered. SBA would set a time limit for the agent to register; any loan package prepared after the limit would not be accepted. Without the limit, there would be little incentive for an agent to register. The downside of this method is that an unsuspecting borrower who uses an unregistered agent might be prevented from obtaining credit.

An alternative method suggested by SBA officials is to allow registration before screening. This would avoid harming the loan applicant who happens to use an unregistered agent. If the agent did not pass the screening process, he/she would be removed from the list of registered agents and placed on publicly available lists of agents whose privilege to conduct business with SBA had been suspended until further notice or revoked. Agents failing to register would be placed on the list of agents suspended until further notice. This method would be practicable if the following conditions were met:

[8] Small Business Programs Reauthorization and Amendments Act of 1997.

- The OIG has ready access to the National Crime Information Center for quick criminal history checks.

- SBA immediately removes an agent's name from the list of registered agents if that agent fails the screening.

- SBA vigorously moves to suspend or revoke the privilege of agents to conduct business with the Agency when appropriate.

- SBA informs lenders that it is under no obligation to guarantee loans in which loan agents were involved after the suspension or revocation of their privilege to conduct business with the Agency. Operationally, however, SBA would have the flexibility to determine whether special circumstances applied.

The Basic Registration System

To be effective, a loan agent registration system must balance security concerns, access to the 7(a) program, and administrative efficiency. The following proposed registration process incorporates ideas and concerns of SBA officials, lenders, and loan agents. It would apply to everyone acting as a loan agent, including the accountant or attorney who occasionally handles an SBA loan. The basic registration steps are--

- At the time of loan closing, SBA staff would check the Compensation Agreement to determine if a loan agent involved with the loan was registered.

- If the agent was not registered, SBA could send a letter informing the agent of the registration requirement, specifying a due date for a response, and requesting the following:

  - The agent's name, date of birth, place of birth, and Social Security number.

  - Authorization for the OIG to request information from criminal justice agencies.

  - Acknowledgment that the agent is aware of the requirements of 13 CFR 103, which by reference would make the agent subject to any applicable future code of ethics.

- Alternatively, SBA could obtain the above information via a revised Compensation Agreement.

- SBA would ensure that any known loan agent remaining unregistered would be placed on a "suspended until further notice" list, pending proceedings on revoking the agent's privilege to conduct business with SBA. The loan agent would have the right to appeal under 13 CFR 134.102 (c).

- Any required training and/or testing that SBA determines is necessary would occur after an agent passed the screening process.

Informing the Public

SBA would need to announce to the public, including loan agents, its registration requirement. The announcement could be made through policy notices sent to lenders and lobbying associations, brochures in application packages, and the Internet.

Once the registration system is in place, prospective borrowers, lenders, and SBA field staff need to know--in as close to real time as possible--which loan agents are registered and which have had their privilege to conduct business with SBA suspended or revoked. The most cost-effective way to accomplish this may be to make the lists available through the Agency's Internet Home Page. Those not familiar with the Internet could call SBA's toll-free Answer Desk, which in turn would refer to the Internet list. Establishing such lists would require changes to Title 13, Code of Federal Regulations, Part 103, and possibly Agency Standard Operating Procedures (SOPs).

Other agencies use the Internet to keep the public informed. For example, the General Services Administration (GSA) maintains lists of parties excluded from procurement and other types of programs. Moreover, HUD has issued an Internet consumer alert about "third party tracers" who track down refunds owed to citizens but may falsely represent themselves as affiliated with HUD. In such cases, the Internet's power can work in an agency's favor.

Recommendation 1. The OIG recommends that the Administrator propose expanding current legislation to include loan agents among those subject to National Crime Information Center criminal history checks.

Recommendation 2. The OIG recommends that the Associate Administrator for Financial Assistance establish a loan agent registration process that--

a) Requires any person or entity acting as a loan agent on any Section 7(a) business loan register with the SBA.

b) Ensures that each loan agent provides information, over his or her signature, that includes the Compensation Agreement, as revised, and the following:

- **The agent's name, date of birth, place of birth, and Social Security number.**

- **Written authorization for the OIG to request information from criminal justice agencies.**

- **Acknowledgment that the agent is aware of the requirements of Title 13, Part 103, of the Code of Federal Regulations.**

c) Establishes, through the Office of the Chief Information Officer (OCIO), Internet lists of registered loan agents and agents whose privilege to conduct business with SBA has been suspended or revoked.

d) Ensures that SBA's loan application packages, Internet Home Page, and other media carry the disclaimer that loan agent registration is neither an endorsement by the Agency nor a guarantee that using a registered agent will result in loan approval.

e) Informs lenders that SBA is under no obligation to guarantee loans in which loan agents were involved after the suspension or revocation of their privilege to conduct business with the Agency.

Training and Testing

SBA officials believe that training and/or testing can improve loan agents' competence and have discussed linking them with the registration process. As indicated earlier, NAGGL also supports the need for training. Although the OIG supports such efforts, it may be necessary to implement the registration process first and add testing and/or training later after the following issues are resolved:

- Who would receive training--all loan agents or just the high volume ones?

- How extensive would the training be?

- Who would provide the training--SBA or an outside entity?

- In what situations would testing be more appropriate than training?

Fortunately, SBA has a number of options. For example, even if a training/testing system were not in place, the Agency could still place basic loan agent instructions and forms on the Internet so that even inexperienced agents would have sufficient guidance.

Another option is for SBA to arrange for loan agent training to be accepted as part of CPAs' and attorneys' continuing education requirements, thus encouraging greater involvement in the 7(a) program and with underserved areas. A third option is for an open-book test to be an alternative to training, particularly in locations where training is not feasible.

Regardless of whether SBA uses training, testing, or some combination of the two, the logistics need not be labor-intensive or complex. For example, the Agency or its designee could place courses on the Internet as self-study tutorials or offer correspondence courses. Likewise, open-book tests could be handled by computer or through the mail.

MONITORING PERFORMANCE

Role of Monitoring

As SBA relies more on the private sector to carry out 7(a) objectives, effective monitoring of the performance of those involved, such as loan agents, becomes increasingly important. Systematic monitoring can serve as an early warning system for identifying problems before they can grow.

Current Status of Monitoring

As noted earlier, SOP 50-10-3, issued in 1991, required the monitoring of third-party representatives, e.g., loan agents. We found, at least among the district offices interviewed, that it has not been consistently followed. According to SBA officials, district offices at one time kept manual records of loan agents, but as the Agency became more computerized and other tasks took priority, the records were not always maintained. District offices vary in how much emphasis they place on monitoring loan agents and in how they apply rules governing loan agent behavior, e.g., fees charged to prospective borrowers. To complicate matters, some loan agents operate in more than one district, making it difficult for a single district office to know the full extent of an agent's activities.

Even if a district office had complete records, it would be difficult to analyze agents' effect on SBA programs. For example, one district official stated that many of that district's agent-packaged loans had been through the liquidation process. Without further examination, however, it is difficult to determine how much responsibility, if any, agents should bear for loan purchases or liquidations. Moreover, there is no easy way to identify unusual patterns of activity, such as an agent doing all of his/her business within one sector of the economy or one demographic group. Clearly, the Agency needs better tools for monitoring.

Systematic Monitoring

At a minimum, systematic monitoring requires--

- Reliable data on which decisions can be made.
- Ready access to the data by officials responsible for monitoring.
- Timely analysis of the data for the purpose of taking corrective action.

Reliability of Data. Agency officials plan to track the performance of loan agents in the emerging Corporate Data Base by collecting data elements such as the agent's name, Social Security number, company name, employer identification number, company address and phone number, test date and score, type of agent, years of experience, the lender(s) the agent works for, loan number, agent fee, loan amount, narrative fields for complaints and related matters, and information on suspensions and "debarments," i.e., revocations of an agent's privilege to conduct business with SBA. Some of this information will come from the revised Compensation Agreement.

According to SBA officials, the Agency will be able to link loan agents with data extracted from the loan portion of the client data base, e.g., the purchase rate and Standard Industrial Classification (SIC) codes of loans with which an agent was involved. Lenders will be responsible for submitting current loan data and status updates directly to SBA through the Internet.

The reliability of such data depends in large part on lender safeguards against unauthorized data manipulation. Given the increasing popularity of the Internet, it is likely that loan agents will provide information electronically through lenders. This is a cause for concern. According to the President's Commission on Critical Infrastructure Protection, the "price for the efficiency of networking is increased exposure of data and systems to unauthorized and anonymous access."[9] Because of this, the data upon which SBA will depend to make decisions may be vulnerable to alteration by loan agents. Currently, a dishonest loan agent can simply make false statements on a written form. An agent with a computer link to a lender could penetrate the information system to alter loan--and agent--data after a loan was approved but before the data was transmitted to SBA. Such an agent might input an alias, show lower fees than were actually charged, or even remove his/her name from a loan, thus making accountability extremely difficult.

Threats to financial institutions' information systems are far from just theoretical. In 1994, for example, computer hackers penetrated Citibank's system and stole $10 million. Because SBA is dependent on lenders' information systems, it needs to hold lenders accountable for any electronic data they send to the Agency, even if part of the data originated with loan agents. Although the draft revision of the Form 750, Loan Guaranty Agreement, would have lenders comply with a broad range of SBA requirements, there is nothing specifically covering the transmission of electronic data. Adding an electronic data transmission requirement to this document could provide a simple way to hold lenders accountable. Without such provisions, SBA could leave itself and borrowers vulnerable to the few--but potentially destructive--loan agents who use the computer to commit fraud.

Access to Data. SBA is working to make data available to as many users as possible. In the emerging Corporate Data Base, an SBA employee would be able to enter an

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[9] The President's Commission on Critical Infrastructure Protection. *Critical Foundations: Thinking Differently*. Washington, D.C.: 1997, p.17.

identification number for a loan agent, lender, borrower, or other entity and determine the programs in which the person or entity was involved. For example, not only could an SBA field employee learn which loans, lenders, and geographical areas a loan agent had been active with but also whether the loan agent was in good standing, involved in other SBA programs, or the subject of any complaints. If the data base performs as advertised, SBA will have a potent tool for monitoring and solving problems early.

Analysis of Loan Agent Data. Systematic analysis of loan agent data would enable SBA to identify and correct problems. The Agency needs to set numerical standards that would trigger closer examination of an agent's activities. According to SBA officials, a lender with a purchase rate exceeding five percent triggers closer Agency scrutiny. A similar benchmark could be established for loans associated with specific loan agents. Another option is for the Agency to compare the purchase rate of loans associated with each agent to the range into which most agents' purchase rates fall. A loan agent whose purchase rate fell outside of the range would command greater attention. SBA might discover, for example, that a significant number of defaults occurred early, possibly indicating loan agent fraud.

One of the first steps for SBA would be to determine who would be responsible for performing the analysis of loan agent data. Loan agents are not restricted to district or even regional boundaries, particularly in the era of the Internet. Moreover, given the inconsistencies among some district offices in their handling of loan agents, we believe that the most effective course is for a single office of SBA to be responsible for handling the analysis of all loan agents and any actions resulting from that analysis.

Recommendation 3. The OIG recommends that the Associate Administrator for Financial Assistance establish a loan agent monitoring system that--

a) Holds the lender responsible for the accuracy of data (including electronic data) originated by loan agents and transmitted by the lender to SBA.

b) Ensures that the Corporate Data Base links all loan data to associated loan agents, including the purchase rate of such loans.

c) Establishes purchase rate benchmarks that, if exceeded, would trigger closer Agency examination of a loan agent's performance.

d) Centralizes the evaluation of loan agent performance in a single office, rather than among district offices, to ensure consistency in the monitoring and handling of loan agents.

AN OPTION FOR LONG-TERM CONSIDERATION: BLANKET BOND POLICIES AND SBA

One approach that may help SBA protect itself from losses due to loan agent fraud is the lender's financial institution bond insurance policy, also known as a blanket bond policy. Under current regulations, SBA is released from liability on its loan guarantee when the lender's improper action or inaction has placed SBA at risk.[10] Such action or inaction could result from negligence or misconduct on the part of the lender and its employees.

Under Section 18(e) of the Federal Deposit Insurance Act, banks under Federal Deposit Insurance Corporation protection can be required to have fidelity insurance to insure certain risks containing the potential for significant loss. Other types of lenders, although not subject to such a requirement, also have fidelity insurance, without which they could not operate or stay in business.

The financial institution bond protects against a loss resulting directly from dishonest or fraudulent acts committed by an employee acting alone or in collusion with others. Such acts must be committed by an employee with the manifest intent (a) to cause the insured to sustain such loss and (b) to obtain financial benefit for the employee or another person or entity. The bond policy covers all of an institution's employees without specifically naming them. A criminal charge or indictment is not required in order to establish fraud.

A standard financial institution bond form (Standard Form 24) is used throughout the lending community. Examples of employees covered under the bond policy include an officer or other employee while employed in, at, or by any of the insured's offices or premises; an attorney retained by the insured; and a person provided by an employment contractor to perform employee duties for the insured. Additional coverage has been developed for those employees not directly covered under the blanket bond policy. This coverage is in the form of a "rider" that is attached to the bond policy, e.g., a Freddie Mac rider developed by the surety industry to protect Freddie Mac from agent fraud in the real estate industry. An agent rider would serve as an instrument that the lender and SBA could use to cover their losses from agent fraud. Covering lender service providers would be easier given the direct relationship these agents have with lenders, i.e., they are paid by the lenders.

The financial institution bond is a private agreement between the insurer (the bond company) and the insured (the lender). SBA would not be able to make a claim directly to the insurance company; only the insured, i.e., the lender, can make such a claim. Nevertheless, SBA could consider this insurance coverage during the purchase of a loan and after a loan has been purchased. After all, the purchase of a loan does not waive the right of SBA to recover any money paid on the guarantee, plus interest, as a result of fraud on the part of a lender and its employee(s).

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[10] Title 13, Code of Federal Regulations, Part 120, Section 524 (13 CFR 120.524).

Once a rider is drafted, it must be approved be each of the fifty states' insurance departments. This process can take one to two years; however, it may be possible to shorten the process because the rider would be used to protect money guaranteed by the Federal Government.

APPENDIX C (Appendix A and Appendix B (SBA Form 159 and revised SBA Form 159, respectively) can be obtained by contacting the Inspection and Evaluation Division of the OIG on (202) 205-7197 or by fax on (202) 205-6922).

US SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Date: March 31, 1998

To: Tim Cross
Assistant Inspector General
for Inspections and Evaluation

From: Jane Palsgrove Butler
Acting Associate Administrator
for Financial Assistance

Subject: OIG Final Draft Inspection Report
Loan Agents and the Section 7(a)
Program

The referenced Report, in essence, concludes with the following recommendations:

1. Expand legislation to include loan agents among those subject to National Crime Information Center criminal history checks.

2. Establish loan agent registration process that:
   a. Requires registration with SBA
   b. Ensures provision of the following specified information--
      • Name, date of birth, place of birth, and SSN
      • Written authorization for information from criminal justice agencies
      • Acknowledgment of awareness of provisions of 13CFR, Part 103
   c. Establishes lists of registered and debarred agents for Internet Home Page
   d. Ensure appropriate disclaimer re no endorsement on loan application packages, Internet Home Page, and other media
   e. Informs lenders that SBA has no obligation to guarantee loans packaged by suspended or debarred agents

3. Establish a loan agent monitoring system that:
   a. Holds the lender responsible for the accuracy of data originated by loan agents
   b. Ensures that the SBA Data Base links all loan data to associated loan agents, including the purchase rate of such loans
   c. Establishes purchase rate benchmarks to trigger examination of a loan agent's performance
   d. Centralizes evaluation of loan agent performance

OFA generally shares the OIG's concerns about agents doing business with SBA through its loan programs and has worked closely with the OIG during this effort. Of some significance is the OIG's recommendation to access the National Crime Information Center database, thereby negating the need for fingerprinting. While we share the concerns identified in the Report and are basically in agreement with the recommendations, we remain somewhat less convinced than the OIG of the magnitude of the problems and of the losses caused by fraudulent agents.

APPENDIX D
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