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SBA LENDER OVERSIGHT: PREVENTING LOAN FRAUD AND IMPROVING REGULATION OF LENDERS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

NOVEMBER 13, 2007

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SBA LENDER OVERSIGHT: PREVENTING LOAN FRAUD AND IMPROVING REGULATION OF LENDERS

TUESDAY, NOVEMBER 13, 2007

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS
AND ENTREPRENEURSHIP,
Washington, DC.

The Committee met, pursuant to notice, at 10:32 a.m., in room 428–A, Russell Senate Office Building, the Honorable John F. Kerry (Chairman of the Committee) presiding.

Present: Senators Kerry, Cardin, and Snowe.

OPENING STATEMENT OF THE HONORABLE JOHN F. KERRY, CHAIRMAN, SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, AND A UNITED STATES SENATOR FROM MASSACHUSETTS

Chairman KERRY. Good morning. This hearing of the Small Business Committee will come to order. I thank everybody for being here and I thank you for your patience. We had a vote, obviously, but we thought it was more important to begin the hearing after the vote rather than interrupting the hearing, and so I appreciate everybody's indulgence. This way, we will be able to go straight through because there are no more votes until after lunch, and therefore, we can have an uninterrupted hearing, which is what both Senator Snowe and I prefer to do.

Let me emphasize a couple of things about this hearing. I know there have been some questions from some parties about why we should have a hearing like this. Senator Snowe and I and all the Members of this Committee manage a Committee that works in a very bipartisan way and try very hard to keep the politics off the table.

The bottom line is that the Congress—as a separate and co-equal branch of government, which sometimes people have to be reminded of—has a major responsibility as to how we spend the taxpayers' money, as to what happens to the programs we put into law, and we are often the critical oversight arm in making certain that those laws are carried out, that the intent of Congress is, in fact, the intent of the American people—it is not our intent. It is who we represent, and we have the responsibility to make sure that intent is, in fact, carried out and that we are presenting the American people with the best governance possible. That is what we owe them. And sometimes this city has an ability to get up on

an arrogant high horse and forget why we are here and who puts us here and what our obligations are.

So the purpose of this hearing is not politics. The purpose of this hearing is not "gotcha." The purpose of this hearing is to figure out how—with the help of the SBA's Office of Inspector General, which was created in order to have transparency and accountability and effectiveness—how the SBA's lending partners and our committee can improve the agency's lender oversight and prevent fraud in the SBA's small business lending programs.

No one is here to suggest that this is somehow pervasive or that it is more—we don't know that situation. We are here to explore the one situation that we know and those things that have been talked about by the Inspector General over the course of time.

And the timing of this hearing, frankly, couldn't be more important. Everybody is aware of what is happening in the economy. Everybody understands the difficulties with the subprime lending and mortgages and what is happening to credit as a consequence. And the whole purpose of the SBA is to help small businesses access credit and be able to move in the marketplace and get capital.

So we see now a credit crunch, somewhat caused by the mortgage subprime crisis and people in the country losing their homes. Small businesses, therefore, feel the impact from that in a lot of different ways, and many get their credit from their homes. At least one in three small business owners say that they are now being adversely impacted by this credit crisis.

Secondary market premiums are down 25 percent, so banks are tightening up their loans for everyone, including entrepreneurs. That means that the government-backed loans, the very rationale for the existence of the SBA and the very rationale for 7(a) and 504 programs and so forth are even more important right now, much more important.

SBA loans provide capital to small firms that can't access credit through the normal channels, and if all of a sudden people start to have doubts about that marketplace, you can have a problem, a cascading kind of problem, and we want to avoid that. We also want to make sure that we are reaching those people who we have always tried to target, who are the minorities and women and veterans and others for whom the SBA has a particular mission.

So we are here today to discuss SBA lender oversight and, you can't avoid some discussion of the fraud scheme that was carried out by a bad actor from Business Loan Express in their Troy, Michigan branch and a small group of people. I emphasize we don't know the depths. It is obviously important because it resulted in $76 million in fraudulent SBA loans. So we need to know what happened. We all need to know this. We need to know how it happened. We need to know what is being done to prevent it in the future.

The hearing is not intended to hurt Business Loan Express nor any other entity, but that is not to say also that there isn't a legitimate standard of accountability, because people need to answer for their employees. That is just a normal course of business and this should be no different.

We need to understand how no one noticed or reported a high number of bad SBA loans coming out of the branch, and today's

hearing is an opportunity for the company to tell its side of the story, including their rationale for cutting back on small business lending, which they announced recently.

And let me just say, I greatly regret the loss of jobs that is going to go with the company's announcement. The SBA lending community is a close-knit community, and I know this has created concern within that community, even some regret in some parties. We obviously hope that everybody lands on their feet in this judgment that has been made and what happens.

Another aspect of today's hearing is the SBA Inspector General's report generated by its audit of the lender oversight procedures and resources. SBA requested that much of the IG's report be redacted before it was made public, including most of the IG's recommendations. It is hard to understand why those recommendations and the agency's plans to address the IG's findings were redacted. Frankly, this is highly unusual. The SBA and BLX have based their requested redactions on claims of trade secret protections, the deliberative process privilege, and the bank examination privileges, which can be legitimate reasons for redactions if applied correctly.

However, even if SBA had the legal right, I question whether all of the information blacked out needs to be redacted. It seems like an overreach and has probably created more problems than it has solved. So I think in the interest of having more transparency of SBA's oversight activities, not less, Mr. Administrator, we have been very complimentary of you throughout the process and very encouraging for the initiatives that you have brought, but I think SBA could have handled this particular issue more effectively. I think the agency needs to improve its oversight with more transparency.

Let me also comment, the BLX report is not the only report relevant to the SBA's oversight. In the past 5 years, the SBA IG has issued more than 60 reports on general lender oversight issues and SBA procedures related to justified payments of guarantees on defaulted SBA loans. Also, the IG has examined the transfer of the purchase responsibility from the 69 district offices to the Herndon Center.

Now, some of the problems we are going to discuss here today demonstrate that the agency may have been excessive or harsh or even irresponsible in dismantling the loan functions in the district offices so quickly. They didn't have the Herndon Center adequately established to take on centralization and they underestimated the necessary staff and training requirements. It also came at a personal cost to almost 200 people who lost their jobs or were uprooted in haste. From what at least we hear, and I am open to evidence to the contrary, but certainly from what we hear, that has contributed to low morale in some quarters. It has created unnecessary instability over the last couple of years for lenders on liquidation and purchases of loans.

Furthermore, the Administration's budget request—and I think this is felt by most Members of, I think unanimously, on the Committee—the budget requests have simply been insufficient and unreasonable for staffing and funding the centralized offices and district offices. Simple logic says that you can't go from a budget of

almost $1 billion to $600 million, while nearly doubling your loan portfolio from about 51,000 loans in 2002 to almost 100,000 loans in 2006 and still claim to have the labor-intensive personal oversight necessary to know what those loans are doing, unless you have created some new magical virtual system, which we have yet to understand.

You are not saving money, if by scrimping on staff responsible for loan oversight, you end up enabling sloppy lenders to do poor underwriting and allow the agency to make improper and inaccurate payments on defaulted loans. In fact, an audit by the IG, issued in May, states that the SBA's lax review of purchase requests of defaulted loans resulted in $36 million in erroneous payments on unjustified purchases on bad loans.

To round out the discussion, we are going to hear from Jim Baird and Tony Wilkinson representing the 504 Certified Development Company lenders and the 7(a) lenders. These lenders have a stake in this process, and they ought to be part of the discussion, and part of that discussion involves information sharing.

As the SBA tries to predict and identify problem loans, they should share with the lenders which ones they deem to be at risk, so that they can take action to prevent a default, or even a lapse in currency.

Senator Snowe got a lot of these issues right in the lender oversight legislation that she introduced recently, and I very much appreciate her work and her knowledge with respect to this. I was glad to join her in introducing that, and with that, I turn to Senator Snowe.

OPENING STATEMENT OF THE HONORABLE OLYMPIA J. SNOWE, A UNITED STATES SENATOR FROM MAINE

Senator SNOWE. Thank you very much, Mr. Chairman, and also thank you for holding this hearing to conduct oversight over the Small Business Administration's ability to detect and prevent fraudulent loans. Your longstanding leadership is certainly critical at this juncture, and as you said, this hearing couldn't be more timely given the economic situation that we find ourselves in in this country and the degree to which small businesses do depend on the Small Business Administration for loans, and ultimately, the creation of jobs.

I also want to thank Administrator Preston and Inspector General Thorson for being here and all the other witnesses. I appreciate their willingness to help us better understand the challenges that the Small Business Administration is confronting with respect to the SBA's loan monitoring and lender oversight activities.

As Ranking Member of this Committee, I find the SBA's history of SBA's lender oversight issues unacceptable. It is my hope, this morning, that we will probe how and why the Government has inappropriately allowed loan fraud and poor loan underwriting to occur at the Business Loan Express Corporation, BLX, Innovative Bank, and in 44 out of 45 of the Small Business Express and Community Express loan files reviewed by the Office of Inspector General.

These three cases reveal the ineffectiveness of the SBA's current oversight activity. I fear that unless the SBA is able to dramati-

cally improve its lender oversight, escalating losses and fees will drive lenders and borrowers away from these key loan programs. This will seriously hamper and harm the ability of small businesses to access capital to grow, but also—regrettably—it would reverse the very mission of these programs.

Currently, the SBA has $80 billion in outstanding loans issued to small businesses, many of which are new startup companies without longstanding credit histories. When they apply for an SBA loan, the loan officer must determine if the company meets the needs to obtain an SBA loan, including having a sufficient cashflow to repay the terms of the loan.

Unfortunately, as the IG report demonstrates, a number of loan officers have failed to perform their due diligence and have improperly underwritten loans without verifying that loans can be repaid and that borrowers can meet all the criteria necessary to qualify for an SBA loan. It is an irrefutable established truth that poor loan underwriting directly leads to loan defaults, fraud, and other deficiencies. This is a reality that we need to address here at the hearing today.

Although the SBA has recently undertaken a number of efforts to improve its lender oversight activities—these are steps in the right direction—they are no substitute for the strides that are absolutely an imperative. Simply put, not enough is being done by the SBA, and that must change.

To enhance its oversight in the performance of the 7(a) and the 504 loan portfolios, it is incumbent upon the SBA to improve the quality of lenders' underwriting and to make doing so a fundamental and absolute priority. That progress should begin with three things: First, effectively and thoroughly auditing lenders' loan files during onsite reviews; second, harnessing technology to help lenders meet the SBA's underwriting requirements; and finally, streamlining the initial application loan review process.

Mr. Administrator, today I hope we can hear from you about your clear and concise plan to work with the SBA Inspector General and immediately improve the SBA's lender oversight process. As I mentioned earlier, there is a history of problems within the SBA. Now, I know much of it occurred before your tenure, but nevertheless, there has been a long history of lender oversight difficulties. We have had numerous hearings and numerous reports—as the Chairman cited—and yet we still find ourselves at this juncture where we are finding fraudulent loans to the magnitude and degree of millions and millions of dollars. Just with BLX alone, it was more than $200 million.

Additionally, the SBA must increase the transparency of its oversight activities and measurements. The SBA has failed to provide participating lenders with much of the criteria the agency uses to determine whether portfolios are sound or substandard. Again, this is an issue that we heard repeatedly from lenders with respect to the failure of the SBA to present the criteria and the standards by which the Agency measured lenders' portfolios. It goes without saying, this lack of transparency hinders the SBA's oversight capability and encourages participating lenders to be justifiably critical of the agency's ability to accurately assess portfolio quality and conduct effective oversight.

That is why, earlier this month, Chairman Kerry and I introduced legislation that I hope will codify the SBA's standards for portfolio quality and enhance the transparency of measurements that the SBA must use to evaluate lenders. This is timely legislation. Hopefully, Mr. Chairman, we in the Committee can mark this up this year so that we can address these issues as effectively and efficiently as possible.

Finally, I am also concerned by the large redactions within the SBA Inspector General's report that were done at the request of the Small Business Administration. It seems to me, at this point, given the amount and the totality of fraudulent loans with BLX—there have been, in fact, 76 fraudulent BLX loans worth $76 million—it underscores the necessity for both SBA and the Inspector General to work in a collaborative fashion. We need a report that doesn't have the kind of redactions that we are facing here today.

The SBA cannot stifle the SBA's Inspector General's critical voice, or hide from the public's view suggestions on how to improve lender oversight. Given the history of the SBA on this very question, there has to be an urgency and an imperative on the part of the Small Business Administration to address these issues; more importantly, to correct them and to prevent this kind of catastrophic event from reoccurring. Ultimately, these types of failures can impinge upon the ability of small businesses to access needed loan guarantees. Ultimately, this can hurt our economy as small companies will or will not create jobs, depending on small businesses' ability to secure those loans. If you think about SBA being the net creator of jobs in this country, then clearly the effectiveness of the SBA's lender oversight has a direct consequence and correlation to small businesses' access to loans.

I hope we can address all of these issues here today, Mr. Chairman.

Chairman KERRY. Absolutely. We hope to and I thank you for that important statement. Thank you very much.

Senator Cardin, do you have any opening statement you want to make quickly before we start? I want to try to——

OPENING STATEMENT OF THE HONORABLE BENJAMIN L. CARDIN, A UNITED STATES SENATOR FROM MARYLAND

Senator CARDIN. Mr. Chairman, let me just thank you and Ranking Member Snowe for your comments and convening this hearing. I concur with the comments that have been said.

Let me just make a very quick point to Administrator Preston. I am not satisfied by the manner in which the agency has conducted oversight or outreach when dealing with the fraudulent loans that we are talking about today, but also outreach to make sure we have the right quality of loans against those groups that have been denied the opportunity historically and the need for capital, the minority businesses, first-generation businesses, and women-owned businesses.

So, I think we are not only concerned about the oversight to make sure the fraudulent loans don't have any place, but that the capital is available to help small businesses grow and produce the jobs that are critically important to our economy, and I look forward to today's hearing. Thank you.

Chairman KERRY. Thank you, Senator Cardin.

As we begin this—and this will apply to each of the panels—I mentioned the issue of the redactions and the question of the assertion of a legal privilege with respect to them. While we are looking at and examining thoroughly the question of their appropriateness, I nevertheless will respect if somebody here feels that some answer is going to tread on the assertion of those privileges, and declines to respond. We certainly will respect that here, and I simply ask you to tell us what you believe the basis of your claim is, and we will proceed forward from there.

So Administrator Preston, thank you for being here. You have served in your role since July of 2006, and you have come to this job with about 25 years of experience in financial operational leadership, so we look forward to your observations and hopefully continued progress.

STATEMENT OF THE HONORABLE STEVEN C. PRESTON, ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC

Mr. PRESTON. Great. Thank you. Thank you, Senator Kerry. Thank you for setting that context for the hearing, Ranking Member Snowe, as well, Senator Cardin. Obviously, we are here to talk about a very important——

Chairman KERRY. Let me just say, if I may interrupt you for a minute——

Mr. PRESTON. Yes.

Chairman KERRY.I know you had asked maybe to testify afterwards, et cetera. What I would like to do—and I put the others on notice, because we are here to get information and facts, not to provide just a platform for everybody—so after Administrator Preston testifies, I asked him if he would stay around, listen to the other testimony; and I am going to give him the privilege of inserting himself into the dialog at any point that he deems it necessary, and we will have a good discussion.

Mr. PRESTON. Well, what I plan to do is leave my head of Capital Access, as well as our General Counsel here, who are much more familiar with the details of the redactions and those sorts of things than I am.

Chairman KERRY. Is your microphone on?

Mr. PRESTON. Yes, it is. Can you hear me OK?

Chairman KERRY. Yes.

Mr. PRESTON. All right. Well, thank you very much. Obviously, this is an important topic. We have about $67 billion worth of 7(a) and 504 loans in the marketplace. Our guarantee represents about $53 billion. Obviously, that number has grown significantly, especially just in the last 5 or 6 years.

A I listened to your comments, I think it is very important for us to look at the historical context in terms of the issues we are talking about, when they occurred, and the progress the agency has made. I hope we will be able to make some progress in talking about that because, I think we have made a lot of progress, although I do think we have a lot more to make.

As you are aware, we administer our 7(a) loan guarantee program through participating banks, credit unions, and through other

lenders, many of whom get varying levels of delegated authority to make those loans. We are responsible for oversight of about 5,000 lenders, but about 674 have preferred lender authority.

In 2003, the GAO reported that the SBA had made significant progress in developing lender oversight, but that much more was necessary. In particular, the GAO recommended that SBA measure the financial risk of lenders' portfolios, qualitatively assess the lenders' performance, and clarify its enforcement authority.

Since that report, SBA has established extensive credit risk management programs that cover both onsite and offsite portfolio review. Those are a very significant change from our prior review process. The offsite review and monitoring program features sophisticated risk rating measurements developed by a nationally recognized provider of commercial credit scores and performance models. The information allows SBA to compare lenders within a peer group, while helping lenders monitor their performance within our portfolio. SBA also provides a risk rating based on the consolidation of individual loan credit quality and overall portfolio performance information, which is an indicator that allows the lenders to take corrective action where necessary.

The onsite process is qualitative analysis of credit administration, policies, procedures, and controls that relate to the SBA loans, as well as portfolio performance conducted to provide more in-depth reviews of individual loans and verify the lender adherence to our policies.

For our supervised lenders, we contract with an independent examiner, the Farm Credit Administration, for detailed safety and soundness and portfolio performance evaluations. These reviews are just part of our increased oversight activities. In addition, we conduct post-purchase reviews to inspect loan files after SBA has honored its guarantee to ensure all procedures and documentation are correct. SBA has developed a more independent supervision and enforcement process. A new lender oversight board, which includes the Deputy Administrator, the CFO, as well as the AA for Capital Access, regularly review our enforcement actions to make sure that they follow our guidelines and that performance standards are being met.

The Office of Credit Risk Management also has numerous tools available to enforce its performance standards. It can reduce the length of the PLP and other delegated authorities to mitigate risk. It has the ability to conduct more frequent onsite reviews. We work with management to resolve deficiencies through correction action plans, through required quarterly monitoring, and obviously in the more severe circumstances, we can pull their PLP status or their authority to make SBA loans at all.

I think our progress shows that we are taking responsibility seriously. We appreciate our responsibility for portfolio performance and also our desire to reduce fraud. Fraud usually occurs by exception, but we nonetheless are taking measures to prevent that occurrence. We are working cooperatively with our lending partners to ensure that they have in place policies and procedures to identify and prevent fraud. We are also considering other analytical tools that will support our ability to detect it and refer it more effectively.

With respect to the proposed regulation, we are certainly not resting on our efforts to improve oversight. On October 31, we published in the Federal Register a proposed comprehensive lender oversight rule to enhance the roles and responsibility of our Office of Credit Risk Management. The rule would codify many of the existing processes for on- and offsite reviews as well as risk ratings. It also provides new enforcement actions, oversight processes, controls, especially for SBA supervised lenders.

The proposed rule addresses recommendations from the GAO report and Inspector General on clear policies and procedures for enforcement and will specify how lenders have to maintain satisfactory portfolio performance. In addition, the proposed rule will enhance reporting for SBA lenders to aid SBA in monitoring and assessing their performance.

Recently, the IG issued a report regarding SBA's credit risk practices focused on BLX. We appreciate the efforts of the IG to help SBA continue to improve its processes and procedures with regard to credit risk management and to reduce fraud. My written testimony submitted for the record and my letter to you, Mr. Chairman, fully detail our concerns regarding that report.

The Committee is likely to hear some issues relating to our lender review and examination fee from the industry partners today. I do want to point out that those fees enable us to perform onsite and offsite risk management of the portfolio. The amount is charged at a reasonable progressive—based on a reasonable progressive system linked to the size and relative risk of those portfolios. In addition, the fees simply cover the cost of the reviews. As such, many of our lenders will not be charged any fee, and when assessed, the fees are modest compared to other financial regulators. We would be happy to provide you with analysis to show that.

For offsite reviews, we will be charging a simple annual fee of $73 per million in the portfolio. These reviews provide information on portfolio performance and the bulk of the information is shared with the lender. We also provide lenders with the factors that comprise the risk rating calculation and their individual component ratings, as well as their peer group ratings and their portfolio averages of the components. That is one of the many tools that we use to oversee the portfolio.

We are particularly sensitive to the need to minimize fees whenever practical. The fees are fully detailed in our notices that reflects the actual cost of the agencies and do not substitute for administrative costs.

We have made significant progress to improve and increase lender oversight. As I mentioned before, I think that will continue to improve. It is an evolving process. That oversight will support a strong portfolio and I believe it will increase our ability to reach more small businesses. We believe that a strengthened management is crucial to the operation of our portfolio in an evolving marketplace.

So thank you for the opportunity to discuss our oversight and I look forward to your questions.

[The prepared statement of Mr. Preston follows:]

TESTIMONY OF

ADMINISTRATOR STEVEN PRESTON

United States Senate

Small Business and Entrepreneurship Committee

Tuesday, November 13, 2007

Chairman Kerry, Ranking Member Snowe, distinguished members of the Committee, thank you for inviting me here today to discuss the Small Business Administration's ongoing efforts to assist entrepreneurs throughout the country through the Agency's various lending and investment programs. In particular, I would like to discuss SBA's efforts in the area of credit risk management and the important responsibility we have in managing program credit risk, monitoring lender performance, and enforcing lending program requirements. I will also discuss SBA's requested redactions to a recent Inspector General audit report.

SBA manages a portfolio of over $80 billion, a portfolio that has grown significantly through the PLP program and since the expansion of the SBA Express program. This growth demonstrates SBA's success in reaching more small businesses and presents challenges with regard to our risk management responsibilities. We have made significant progress in putting measures into place to oversee risk in the loan programs, while increasing the number of small businesses that we are able to assist through these programs.

Background

SBA administers its 7(a) loan guarantee program through participating banks, credit unions and other lenders including, for example, Small Business Lending Companies (SBLCs). These lenders receive varying levels of delegated authority from SBA to make 7(a) loans. For example, under the Preferred Lender Program (PLP), SBA delegates loan approval, closing, and most servicing and liquidation authority and responsibility to PLP lenders. This program was established by Congress to streamline these processes. SBA is currently responsible for oversight of approximately 5,000 7(a) lenders, 640 of which have PLP authority.

In 2003, a Government Accountability Office (GAO) report noted that SBA had made significant progress in developing its lender oversight program, but that more effective oversight was necessary, particularly of PLP lenders. In particular, GAO recommended that SBA adequately measure the financial risk to SBA of lenders' SBA portfolios, that SBA perform qualitative assessments of lenders' performance and lending decisions, and that SBA clarify its enforcement authority and specify enforcement conditions.

Since the issuance of the 2003 GAO report, SBA has taken important steps to put into place a comprehensive credit risk management program for its loan programs. These steps include:

- Implementing a comprehensive off-site review/monitoring program which features sophisticated risk rating measurements developed by a nationally-recognized provider of commercial credit scoring solutions;
- Instituting a risk-based on-site review/examination program that includes qualitative analysis of a lender's credit administration, SBA operations management, and loan portfolio performance data;
- Drafting proposed lender oversight and enforcement regulations; and
- Developing a coordinated and more independent supervision and enforcement process.

These actions are just a part of SBA's ongoing process of increased and expanded portfolio oversight that SBA began implementing in the last several years. A more detailed discussion of our progress follows.

Oversight

To monitor portfolio problems, SBA relies on both on-site and off-site reviews of the lenders. To facilitate off-site reviews, SBA has contracted with a nationally-recognized provider of commercial credit scoring solutions and predictive performance models. This provider has a strong track record within the financial services industry. The information they provide on a lender is compared with other lenders of similar size and portfolio makeup. Information is shared with the lender, and provides the lender with a peer group understanding of their performance and status within SBA's portfolio. SBA also uses this information to assign lenders with a risk rating based on the individual loan information and overall portfolio information, as indicator of portfolio performance. This enables SBA to take corrective action.

SBA on-site reviews are conducted with lenders to provide more in-depth reviews of individual loans, pulled at random, and checks on lender adherence to SBA policies and procedures. In the case of those lenders supervised primarily by SBA (SBA Supervised Lenders), SBA contracts with an independent examiner, the Farm Credit Administration, to provide in-depth on-site safety and soundness and portfolio performance evaluations.

In addition, SBA can reduce the time period between renewals of delegated lending authority. Shortened renewals are another means of mitigating SBA risk. SBA also has the ability to conduct more frequent on-site reviews, and the ability to work with the lenders' management to resolve deficiencies. Corrective action plans can include quarterly monitoring. In addition, a wide range of data is collected that provides SBA with continual updates on lenders' progress. These are substantial reforms that allow lenders to remedy deficiencies in their loan portfolios while continuing to serve the small business community.

When deciding which corrective measures to take for under-performing lenders, SBA seeks to efficiently meet programmatic objectives while first and foremost, protecting the taxpayer.

The progress that we have made in lender oversight demonstrates that SBA is taking its responsibility very seriously. In addition to our responsibilities for general oversight, we are considering how to lessen the likelihood of fraud in our loan programs. While fraud occurs generally by exception, SBA nevertheless is taking measures to prevent its occurrence. To that end, SBA is working cooperatively with its lending partners to ensure that they have in place policies and procedures to identify and prevent fraudulent activity. In addition, SBA is working to identify irregularities in lenders' portfolios and to bring these to the attention of SBA's Inspector General (OIG). SBA relies on SBA's OIG and the Justice Department's experts in fraud to investigate and prosecute fraud related activities. While we have processes and policies in place to deal with these issues, SBA is considering what other analytical tools SBA can add to facilitate fraud detection.

Proposed Regulation

On October 31, 2007, the Agency published a lender oversight proposed rule. This proposed rule would further establish the roles and responsibilities of SBA's Office of Credit Risk Management, while codifying more comprehensive and coordinated oversight regulations for participants in SBA's loan programs.

While this proposed rule would codify many of the processes that SBA has already developed, especially in the area of on-site and off-site reviews/examinations and risk ratings, it also provides for new enforcement actions available to SBA, new oversight processes, and the implementation of new controls, especially for SBA Supervised Lenders. The proposed rule also would address GAO's recommendation to provide clear policies and procedures for taking enforcement actions against lenders in the event of continued noncompliance with SBA requirements. In addition, it would more precisely specify that 7(a) lenders must maintain a level of satisfactory portfolio performance.

In addition, the proposed rule would enhance reporting requirements for SBA lenders, especially SBA Supervised Lenders (specifically SBLCs and Non-Federally Regulated Lenders). This would greatly assist SBA in monitoring lenders and assessing lender performance.

SBA is awaiting comments on the proposed rule from interested members of the public. We will carefully consider any comments we receive in developing a final rule that thoughtfully implements SBA's lender oversight responsibilities.

IG Report

As you know the Agency has moved quickly to recover any losses stemming from the loan fraud investigation involving BLX's former Michigan office manager that was uncovered by the U.S. Secret Service, the U.S. Attorneys Office in Detroit and our Inspector General's Office. That action included a written agreement with BLX that provided SBA with compensation for known losses stemming from the fraud and an additional obligation to cover any losses revealed in the future. It also provided for the retention by the Agency at BLX's expense of a large accounting firm experienced in forensic accounting to review all BLX PLP loans prior to their sale into the secondary market and, if there is a default in one of their loans once it is in that market another review by the accounting firm before SBA pays on its guarantee.

Recently, the Office of the Inspector General issued an audit report regarding SBA's credit risk practices, which focused largely on BLX. The OIG has provided this Committee with an un-redacted copy of the report. The OIG has also made a copy in redacted form available on its website. The needs for the redactions have been detailed in my letter to the Committee of November 6, 2007. Briefly stated, the redactions are the necessary result of the delicate balance SBA must strike between full public disclosure and protecting the integrity of the Agency's duties as a financial regulator. The public disclosure of such information would severely damage the Agency's ability to obtain sensitive or adverse information from its lenders. Keeping such information confidential is standard practice among financial regulators. Indeed, the legend placed on audit reports of SBA lenders by our contract auditor, the Farm Credit Administration, warns of criminal penalties for violation of the confidential nature of such reports. Furthermore, Congress and the courts have recognized the there is a need in government for protecting the confidentiality of information that comes under the bank examination privilege, the deliberative process privilege and the matters exempt from disclosure under the Freedom of Information Act.

Review/Examination Fee

SBA realizes that as the Agency modifies and strengthens its oversight activities, our industry partners will have questions and concerns. For instance, when SBA first instituted our lender oversight fees some lenders objected. However, the purpose of the fees was fully described in our proposed regulation and industry comments were carefully considered and addressed in the final rule. These fees enable SBA to perform on-site and off-site risk management on the 7(a) loan portfolio. The amount of the oversight fees charged to the lender is a progressive system linked to the size of the lender's portfolio. As such, many of our lending institutions have portfolios that are so small that they will not be charged any fee. This structure considers the amount of risk SBA is exposed to relative to the lender's activity in the 7(a) program. For those financial institutions regulated and examined by other banking regulators, the SBA fees are modest in comparison. For SBA Supervised Lenders, the SBA fees are critical to ensuring that proper safeguards are in place and they are commensurate with the examination fees charged by banking regulators generally.

For the off-site review, SBA charges an annual fee of $73 per million dollars in portfolio size. Through these reviews, SBA receives information on the lenders' SBA portfolio performance and is able to share the bulk of the information with lenders. We have provided lenders with the factors that comprise the risk rating calculations and their individual component ratings. We also have provided them with peer group and portfolio averages for the component ratings. The information obtained through the off-site review is but one of many tools that SBA uses to oversee its loan portfolio and its participating lenders.

SBA is particularly conscious of the regulatory burdens placed on small businesses and as such is sensitive to the need to minimize fees whenever practicable. However, the fees charged to lenders are necessary for protection of the taxpayers. The oversight fees charged to lenders are fully detailed in the Lender Review Fee notices that SBA has published. The notices provide a breakdown of how on-site and off-site review fees are calculated. This breakdown shows that the fees are based on the actual costs to the Agency, and are not a substitute for the administrative costs of the program.

Finally, through SBA reviews and examinations, we expect to decreases risk and can improve portfolio performance, however it is conceivable that unexpected factors such as change in the loan mix and other factors could increase risk..

Mr. Chairman, SBA has made significant progress over the past several years to improve and increase the oversight we perform on our guaranteed loan portfolio. SBA believes this strengthened management is crucial to the operation of a modern guarantee portfolio.

I would like to thank the Committee again for the opportunity to discuss progress in SBA's credit risk management program and I look forward to continuing to work with the Committee to assist our Nation's small businesses.

Chairman KERRY. Thank you, Mr. Administrator. Why don't we start with a 7-minute round and we will obviously probably go around a couple of times.

Let me start with the larger picture first. I mentioned in my opening statement the issue of the overall budget and manpower, which concerns the Committee a lot. Is it not a handicap to have a doubling of your loan capacity and a reduction in oversight personnel?

Mr. PRESTON. Well, I think the reduction in personnel primarily occurred in the field at the SBA, and many of those resources were moved to centralized activities——

Chairman KERRY. Right, but isn't the field where you get an opportunity to be able to interact and really take a group of loans at the local level and get a sense of what is happening to them?

Mr. PRESTON. I think at the field level, we do a lot in outreach. We can get a sense of local lenders. But people in field offices were actually processing loans and making credit decisions which basically left us in a situation where we had a broadly dispersed set of credit activities taking place around the country, rather than having them be located in a single facility or a single set of facilities, which provide for much more standardization of practices, much greater ability to audit those standards, and a much better ability to institute quality standards.

Chairman KERRY. What about—I mean, that might in theory work, but what about the complaints and the observations that it has never been adequately staffed and has not been able to deal with a centralized burden?

Mr. PRESTON. Well, I think those are very valid criticisms of the agency.

Chairman KERRY. Isn't that personnel related and budget related?

Mr. PRESTON. Senator, I think it is—the challenges in that operation are well beyond just personnel issues. I think when the agency centralized those activities, the standards were not put in place. I don't think the processes were efficient to the degree that they need to be. And I don't believe that we put in place metrics, performance standards, or communication back to other lenders to help them understand what was happening.

That is all stuff we are in the process of doing, and in fact, I spoke in front of hundreds of lenders at the National Association of Government Guaranteed Lenders Conference last month, and I have spoken with hundreds across the country directly to talk specifically about the challenges we have in that operation. We have a very clear pathway forward that hits on—I won't bore you with the details, but a number of issues that we think will dramatically improve the responsiveness, the speed of execution, the support of lenders, and the interaction with our field network.

Chairman KERRY. Well, that is welcome news, and I think it is terrific that you have that kind of a comprehensive——

Mr. PRESTON. We would be happy to come by and brief you all on the details of that.

Chairman KERRY. I think it would be good for the staff to get a sense of exactly where that implementation process is. In the meantime, let us assume you had those standards and you have

the sort of centralized operational initiatives in place that you just listed. I think there were three or four of them. Do you have enough personnel to carry that out?

Mr. PRESTON. Yes, I believe we will have enough personnel to carry that out.

Chairman KERRY. You believe you do?

Mr. PRESTON. I believe we do. We have looked at our staffing levels. You all were good enough to increase our budget last year. We have hired people in our processing centers with the additional budget we received from Congress, and at this point, we believe it is adequate. But certainly, this is not an area that I am interested in skimping in at all.

Chairman KERRY. Well, also you mentioned in your testimony—it just caught my ear—the issue of pulling the authority from a lender in circumstances. Have you ever pulled the authority completely?

Mr. PRESTON. Oh, yes. I think last year, somewhere between 6 and 7 percent of our PLP lenders did not have their authority reviewed.

Chairman KERRY. Can you give us, maybe in writing, we can get a little background on those——

Mr. PRESTON. Yes.

Chairman KERRY [continuing]. Circumstances and numbers. And in your testimony, you talk about the SBA's oversight as a whole, and we have just been discussing it a little bit. You described implementing the offsite monitoring through Dun and Bradstreet that forecasts whether a loan is at risk of default. Witnesses on the third panel will testify that that program collects data already available from the lenders and the agency's loan servicing contractor, and it arrives at currency and default rates that differ greatly from the lender's actual performance, and that is not transparent. And then once it predicts that loans will go bad, SBA doesn't tell the lenders which loans could be in trouble so that they could proactively move on those and try to mitigate against the potential of default.

So when you say the system, and this is your quote, "enables the SBA to take corrective action," it is a corrective action that reacts to the default rather than proactively moving to prevent it. I wonder, don't you think SBA would be better off moving proactively and altering that?

Mr. PRESTON. Well, yes, I think it is important to understand that the decisionmaking process and the rating criteria is much more complex than any one score we get from one place. We look at a handful of things. We look at predictive scores based on widely available information on individual lenders, and we kind of look at that in an aggregated basis and that sort of provides a predictive quality. In addition, we look at historically what is happening in people's purchase rates. We look at changes in those rates to see if there are more recent trending issues to face.

All that information is provided to people, to lenders, on a portal called the Lender Portal. They get information on all of those areas so they understand how they are doing, not only in a vacuum, but how they are doing relative to similar institutions. So they get a significant amount of information.

I think the issue with the lending community right now is primarily that we don't go down and actually pull individual credit scores on their individual loans and then give it to them. Those are widely available tools in the industry. Contractually, we don't have the ability to do that with a third party. We would certainly look at potentially providing that for people in the future.

Chairman KERRY. Is that really the heart of what I asked? I mean, isn't the question more, if you have been given a very specific prediction that a loan is going to go bad through this loan contracting, loan servicing entity, why would you not then have the transparency that relays that to the lender so the lender could get involved directly?

Mr. PRESTON. Yes. I think the way it works is if you have hundreds of loans in your portfolio, based on the relative weighting of different credit qualities in that portfolio, it comes out with a macro estimate of the percentage of loans that are likely to go bad, given how many loans are kind of in a lower tier or a higher tier or middle tier. So I don't think we would go down to the individual level and say, these four loans are expected to go bad. It more looks at the blend of credit scores.

Chairman KERRY. Is that a warning bell? I mean, can you segregate those that are at the lower end?

Mr. PRESTON. Oh, absolutely. I mean, you could get a list of companies—yes. This is what I was saying, you could get a list of companies in that lower credit tier and those are just based on, like I said, there are many kind of firms out there that do these types of ratings, most of which may not very dramatically. We don't have the ability right now to provide that detailed data to the lenders.

Chairman KERRY. Why?

Mr. PRESTON. We don't have the ability to do it contractually right now, but we would look at doing that in the future if they would like those lists.

Chairman KERRY. Isn't that what you would want to do with an onsite review?

Mr. PRESTON. Well, an onsite review, I think, you know, we really are——

Chairman KERRY. That is a more in-depth review, correct?

Mr. PRESTON. Yes. We are pulling credit files. I know some people don't think we do that. Under the new processes, we pull credit files. We look at their management practices, whether or not they are complying with policies, so that is a different kind of review.

Chairman KERRY. Why has the IG suggested and others, even the lenders have suggested that that, quote, "in-depth review" is actually nothing more than a kind of paper check-off process? That is their perception from——

Mr. PRESTON. Well, I think there are a couple of things. Number one, I think this process has evolved over time. I am not aware of the IG making that claim, but if he has, I would be happy to understand that better. I would also be happy to have our head of Capital Access come up and walk you through fully what we do on the onsite process.

Chairman KERRY. Well, there is a contention here, and I think it will be stated here today, that the SBA has a need to verify the

borrowers' financial claims and to make sure the collateral is legitimate and the equity injection is legitimate and so forth.

Mr. PRESTON. Yes. Those things all contribute to credit quality, obviously. They have made those injections. If we look at the collateral, if we look at the credit quality. Now, that having been said, Senator, I would be the first one to say, especially if it is coming from the industry, if people are coming forward and saying, we are looking at your new process, what you are doing onsite, and we think you should bolster it in one way or another. We would love to understand that in more detail, and so I think we welcome that kind of input.

Chairman KERRY. Senator Snowe.

Senator SNOWE. Thank you, Administrator Preston, for your comments here this morning. I think it is a real question of, a sense of urgency about implementing an oversight strategy. This has been a historical problem with the Small Business Administration and ultimately can have such negative consequences for both the SBA and those small firms who depend on SBA loans guarantees. After reading the IG's report, I think it is important to make sure that their recommendations are implemented. If they are not implanted, we need to know why in a timely fashion.

Mr. PRESTON. Yes.

Senator SNOWE. I am concerned. We objected to the Herndon Center consolidation. I did as Chair of this Committee and Senator Kerry did, as well. I think all of us did because of the concern that it was going to lead to serious problems, which it did. At that time, we objected to the understaffing of SBA that has ultimately led to many of these problems. Another pressing issue has been that the Small Business Administration has placed an emphasis on loan growth and not overseeing the quality of those loans. I realize why this is all being done, because obviously we want to help small businesses. Yet at the same time, we have a public interest obligation that we must uphold here.

BLX underscores one of the questions and issues that I have. Why didn't you take remedial steps with respect to BLX? I mean, why weren't there any remedies or any penalties? Why didn't you revoke their preferred lender status, for example? Because as the Inspector General's report indicates, there doesn't seem to be very few terminations or revocations. This enables lenders to essentially ignore SBA's delegated lending authority requirements because they do not suffer any material consequences.

What are the SBA policies for imposing penalties? Where is the accountability? What is the standard for accountability when we have the magnitude of the failures we are talking about? They are broad with respect to BLX. The fact that the SBA would repurchase more than $270 million of potentially bad loans from BLX, on top of everything else, I think is serious and consequential. So why aren't you setting forth policies on the issue of what penalties for lenders who fail to meet specific and clear requirements? These types of policies would clearly be a disincentive for bad behavior.

Mr. PRESTON. Yes. Let me just make one comment before I jump into that. You should know that I am very directly personally engaged in the Herndon issues we have and the reengineering. I am personally on calls every week, going through the project plans,

going through the progress, talking to lenders about it. So this is something, I think is going to be a good news story for us in the coming months, and I feel very good about that.

On the BLX, you are asking more of a question about policy, and so let me take a step back and say when we have an issue with a lender, we have a lot of things that we can do. First of all, obviously, we look at credit quality. If credit quality goes down, we take a very hard look at the policies in place, the practices, the credit administration, what they are doing onsite.

The kinds of things we can do over time, first of all, I think we begin to do more frequent, more intensive reviews when we see these situations. Number two, we put in place very specific corrective action plans. We try to look at what the root causes at a lender and put in place corrective action plans. Then at some point, if things don't work out, we have the ability to pull the PLP status.

The other thing we can do is at the back end. If we are looking at the loans that we purchase, because of our guarantee if a loan has gone delinquent. We look at those loans to ensure that they have followed our policies and our procedures and that those loans have been done correctly. And if they haven't, we can withhold all or a portion of that guarantee.

What the new regulations do, and it gets right to your point because I think you are onto something very important, is we have to have clear standards in place. We have to have clear enforcement opportunities in place. And in Herndon and in those facilities where we purchase those loans, we also have to have clear policies and practices and procedures in place that are enforced and get those things to work together.

I think that a lot of what we saw with this particular lender happened, you know, a few years ago. I think even during that period of time, since then, we have made a good deal of progress and I think we have made a good deal of progress in the last year. I really think in the next year to 18 months, we will make a good deal more progress.

Senator SNOWE. Why can't it be sooner than that? I just don't understand why it can't be sooner.

Mr. PRESTON. Well, let me just give you an example. I know one of the criticisms of the industry has been that we haven't done enough onsite reviews, which I think is valid. A few years ago, we had the ability—the lenders paid for those reviews. We went a couple of years where there were no charges and that was a budgetary issue. Now that we can charge again, we will be going through onsite reviews every 2 years. So what we will see—and we have already kicked that up so that the engines are kind of geared up to do those more intensive reviews to provide that better oversight. The analytical information is better, and then the enforcement actions will be clearer under the new regulations.

Senator SNOWE. Well, so how many lenders have had their status revoked?

Mr. PRESTON. Last year, it was about 7 percent—between 6 and 7 percent of the lenders that had that delegated authority. In reference to Senator Kerry's request, we would be happy to provide you a list and you can get the numbers.

Senator SNOWE. Well, no, I think it is important to revoke preferred status because it provides a disincentive, you know, for this kind of behavior. When you look at the extent of problems with BLX—and BLX was over a period of time, I mean, it wasn't a limited period of time, it was over many years, between 2001 through 2006—there were $76 million worth of fraudulent loans, 27 arrests, multiple convictions, and SBA purchase of up to $272 million worth of questionable loans.

Mr. PRESTON. Yes, let me comment on a couple of those things. I think it is real important for us to understand the difference as well as the connection between broad loan portfolio quality, which just has to do with the ongoing quality of the credit decisions you are making, and fraud. Certainly in the case of BLX there was a highly sophisticated group of people within that institution, in a bank among borrowers. Obviously, high levels of fraud can affect credit quality, but those are two very different sets of activities and need to be treated as such.

Senator SNOWE. Well, I understand that, but on the repurchases, why isn't the SBA documenting and verifying the information prior to the loans being made? I mean, that is one of the critical issues here. I mean, we have heard too much of it. We have had 15 reports over this last year-and-a-half regarding many issues, and I would like to have the Committee be informed in exactly how many of those recommendations in those SBA IG reports the SBA has followed. I think that is absolutely critical.

Mr. PRESTON. Yes.

Senator SNOWE. We need to know. These IG reports are done for a reason. Now, I am not saying that every recommendation is essential and there may be some problems with some of the recommendations. But clearly, they have got to be considered in a manner that is more than lip service.

Mr. PRESTON. We would look forward to coming up and working on that.

Senator SNOWE. And so that is the concern. We have 15 reports—I just think it is important to understand that—in this last year-and-a-half, with a number of recommendations that have, I think, yet to be implemented on lender oversight activities by the Small Business Administration. So I think it is important. So I would like to see exactly what the SBA has done to follow up on those recommendations.

And the last issue, because I know my time is running out, is on the projected repurchase rate, the rate of defaults the SBA projects will occur in lenders' portfolios over the next year. Now, for this last quarter that ended in September, the SBA projects that repurchases in lenders' portfolios will increase by as much as 167 percent, potentially. Now, that 167 percent is a decrease from the previous quarter where the SBA projected that defaults would increase within lenders' portfolio by 240 percent. How does the SBA justify those predictions?

Mr. PRESTON. I am not sure what you are referring to, Senator. Is that—are you talking about a particular lender, or——

Senator SNOWE. No, the SBA's analysis of predicted loan repurchase rate.

Mr. PRESTON. OK. I am not——

Senator SNOWE. This last quarter, the SBA projected that repurchase rates would increase between 9 to 167 percent——

Mr. PRESTON. Yes. I would have to look at that. We have generally, in the last several years, seen our credit performance actually much better. We are beginning to see some trends come out of the current credit markets which are a little concerning, but generally over the last several years, our credit performance has been pretty good.

Senator SNOWE. OK. Again, this is based on the SBA's projected default rate. If loan default increased dramaatically, what will you do to address the defaults on this high number of loans that could be in this category? So we would like to have an answer to that, as well.

Mr. PRESTON. Great.

Senator SNOWE. OK. Thank you.

Chairman KERRY. Thank you, Senator Snowe.

Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman.

Administrator Preston, your response to Senator Kerry's question about having adequate resources in order to conduct oversight review of loans seems to be at odds with the Inspector General's testimony, and I just really want to give you a chance to respond. I know you said that you will stay here during the hearing, but the Inspector General states that SBA has had a 25 percent reduction in personnel since 2001, while loan production has increased by more than 100 percent over that same period. SBA's Office of Credit Risk Management, formerly the Office of Lender Oversight, has not had a significant staff increase and is currently operating with less than its authorized number of personnel.

As a result, it cannot perform the type of analysis that might detect fraud schemes and isolate high-risk situations, or investigate lenders with high default rates, and the Inspector General goes on to state the sheer volume of guaranteed purchase requests that the agency must process with current staffing levels, combined with the agency's goal of paying lenders in a timely manner, has resulted in the careless purchase reviews that fail to identify loan deficiencies.

Now, Senator Kerry asked you specifically as to whether you had the staff necessary, and your——

Mr. PRESTON. I think I said yes, right? Didn't I say yes?

Senator CARDIN. You disagree with the Inspector General?

Mr. PRESTON. Well, I think the Inspector General is looking at a historical set of events. I can comment on any of those statements that you would like. We had a 25 percent reduction that primarily hit the field offices. We are talking about centralized loan purchasing activities. So some of those people were moved from the field to a centralized activity. I think that is what Senator Snowe was talking about. The process of moving them from the field to the center and setting up that center provided the agency with a tremendous number of challenges. That was done 4 or 5 years ago. That has led, in part, to the backlog and some of the challenges in these purchasing activities.

Senator CARDIN. Would you take issue with the fact that you cannot detect fraud schemes because of personnel shortages and

that you have a careless purchase review system to identify loan deficiencies because of staff deficiencies?

Mr. PRESTON. Yes. I think the careless purchase review issue gets to the same issue of that centralization process and that is what we are addressing right now. Where you had loan review activities having taken place around the country, those are being brought into a centralized facility. The process of that centralization, a number of years ago, was not done in a way—I believe, and I am sure our IG believes—that provided the right kind of oversight practices, policies, training, all the stuff you need to do to make sure it is a tight process. That is very much what we are all about addressing right now. So I think the IG is current on some very important issues, but I also believe they are the issues we are addressing.

The other thing I would mention is our reviews. Our onsite reviews of these banks, are performed through a third party, so they are not dependent on our personnel levels. For example, the Farm Credit Administration does the onsite reviews for small business lending institutions. So that is not dependent on our staffing level. The staffing issue has to do with when we get all these purchases in and all these loans get sent to us for review; we need to review them at the back end. I think we have made a tremendous amount of progress in addressing that, but we are not there yet. I think it is going to take us another 6 to 8 months to get there.

Chairman KERRY. Senator Cardin, if you will permit——

Senator CARDIN. Sure.

Chairman KERRY [continuing]. This will not come out of your time, but while we are on the topic, I just want to come back. The Inspector General's report of May 8, 2007, specifically says, "Staffing problems and an overly aggressive emphasis on expediting and increasing purchase production at the (Herndon) center"—now we are talking about the center—"has adversely impacted the quality of purchase decisions.

For example, the high rate of staff turnover in 2006 left the center with unfilled vacancies and largely inexperienced loan officers to review purchase requests. Because supervisor vacancies were not filled, the center had 3 individuals to perform supervisory oversight of nearly 3,000 purchase reviews. Consequently, supervisors either did not review purchase requests performed by inexperienced loan officers or did not identify deficiencies the officers missed.

The level of erroneous payments will likely increase given that SBA has not fully resolved staffing issues at the center and has launched a major initiative to grow the 7(a) portfolio by 15 percent in 2007. Increasing the loan guarantee portfolio without identifying how the existing and additional workloads will be accommodated places Government funds at increased risks."

Mr. PRESTON. Yes.

Chairman KERRY. It seems to——

Mr. PRESTON. I think there are either some mistakes—yes, there are some mistakes in those comments. First of all, there is no 15 percent goal for 2007. We, with concurrence in the field, provided a 15 percent goal for a 2-year period, 2007 and 2008, which was

later reduced to roughly 10 percent, working through it with the field.

Chairman KERRY. So it is a 10-percent increase, not 15?

Mr. PRESTON. It was originally 15 percent over 2 years——

Chairman KERRY. Right. Now it is——

Mr. PRESTON. Now it is about 10 percent over 2 years, roughly speaking.

Chairman KERRY. I think the same——

Mr. PRESTON. In addition——

Chairman KERRY [continuing]. Issue still applies, and we can quibble on the percentage of the increase——

Mr. PRESTON. But you know, Senator, it is so important in looking at this to understand where the breakdowns were and why. I think we have had some real challenges, and I think the IG has noted these in that Herndon operation. It has not been functioning well. There are backlogs out there and it is something that——

Chairman KERRY. But you have been asked if you have adequate staff. I mean, I am not trying to have a——

Mr. PRESTON. It is not a staffing—we have added staff.

Chairman KERRY. You had adequate staffing levels?

Mr. PRESTON. We have added—we are hiring staff. We will have adequate staff. It is much more an issue of process efficiency, consistent standards, good communication with our banks, which we have not had in that facility. In addition, most of the purchases—and I think this is the issue the IG was looking at—most of those packages that come in from banks come in wrong. There is a tremendous amount of rework. We don't have the paperwork. We have not done our job in going to banks and communicating to them how they need to do these packages, getting them right at the front end, and turning that around quickly.

So there are a lot of—that is why I hesitate to get into the detail here because we went into a lot of issues. There are a lot of very classical—I hate to say it that way—business sort of engineering challenges that have been in place here and I think we are addressing them. But like I said, I would be happy to get up here periodically. We can come up every month and show you the progress.

The other thing I do want to say is we have been very transparent about this issue. I have spoken to the industry. I have spoken widely to our people about it. We have gotten the numbers out there as sort of a rallying cry to get this thing fixed.

Chairman KERRY. Let me yield back to Senator Cardin. I appreciate——

Senator CARDIN. No, that was very helpful, Mr. Chairman. I just point out that the Inspector General indicates that because of staffing deficiencies, the backup to analyze whether these purchases of guarantees were proper or not is not there. So it seems like you don't have the information necessary to make the right judgments because of the personnel levels, at least that is what the conclusion of the Inspector General is.

I would feel more comfortable with your response if I just hadn't completed a hearing in Maryland where we were going over your outreach efforts, your personnel that you have in the field that you now say you are bringing back. When you look at the procurement center representatives, and I understand you are going to increase

those numbers modestly, but we need a significant increase in services in the field if SBA is going to be able to carry out its principal function to facilitate small businesses in dealing with Government procurement and elsewhere because we are not meeting our goals. We haven't met any one of our goals, as your reports point out, on Government procurement.

So if you are taking resources away from the field, I am not exactly sure we are going to be able to meet the needs there. I can tell you, by the additional procurement offices, centers that you are scheduled to open, if every one of them opened in Maryland, I would be satisfied. But I understand that is for nationwide.

We are in desperate need of help in our small business community from SBA, and I have been told over and over again that a significant part of the problem is the resources that you have within your agency, and it seems to me I would like to have the Administrator advocating for the type of services needed to our small business community and I am concerned as to whether you have the adequate resources to carry out and correct the failure of our agencies to meet procurement goals, let alone oversight of the loan activities. It seems like this is a continuing problem within the agency.

Mr. PRESTON. Right. Well, there are a couple of things, I think, to mention here. The reduction in staff that I think Senators Snowe and Kerry were talking about was a centralization process that ended a couple of years ago. I have increased our staff in the field by 50 people in this past year. We promoted another 50 people. We have accelerated the hiring of PCRs in the field by 15 to 18 percent. Unfortunately, we have had some retirements and movements that have kind of moved us in the other direction.

But what I would tell you is my allocation of resources to the field last year and this year have, for the first time in a while, turned us toward that growth trajectory now in the field. The field has reacted very, very favorably toward it.

The other thing we are doing is, which we haven't done, is we are significantly increasing training, specifically in procurement to support our ability to be effective in helping those small businesses in the contracting picture, providing greater tools to other Federal agencies to find those small businesses. And I will also say—a little advertisement here—the scorecard we put out there, the new recertification rule we had issued, and a number of the other measures we have taken are raising the bar for Federal agencies and they are reacting by coming our way saying, how can we meet our goals? It has been very helpful for us.

So I think we are seeing a higher degree of interest across the Government to engage with small business and we have—there is a little bit of a lag when you authorize these positions and you get them in the field, but we have begun adding those positions in the field.

Senator CARDIN. Thank you, Mr. Chairman.

Chairman KERRY. Thank you very much, Senator Cardin. I appreciate it.

In relation to the BLX case, Mr. Administrator, the Committee has been told that the SBA paid about $28.4 million on guarantees, loans underwritten by one loan officer. Is that unusual? Is that a

red flag in and of itself in any way, that one loan officer in one branch in Detroit, Michigan—it seems like a lot of money for one loan officer in a branch——

Mr. PRESTON. I don't know. That authority was delegated to them as a PLP lender, so the credit decisions——

Chairman KERRY. Do you know what the average is or what the expectation would be per loan officer? Is there any kind of measurement or metric on that?

Mr. PRESTON. That would be within the bank institution if there were a metric.

Chairman KERRY. SBA wouldn't have an oversight? I mean, aren't there some red flags for irregularities?

Mr. PRESTON. I think there are red flags for irregularities. The number of loans made by a loan officer, I don't know if that would be an irregularity. Especially in a lot of these lending institutions, people are very active in obviously extending capital. So I don't know.

Chairman KERRY. Maybe that is something you might want to look at and make some judgment about. I mean, I think it would be interesting to know what that norm is or whether that is, in fact, a red flag that ought to be established. But can you tell the Committee what value Dun and Bradstreet provides that can't be obtained by the SBA working with the FDIC, or the Office of Comptroller of the Currency, the National Credit Union Administration, or Federal Reserve Board?

Mr. PRESTON. Yes. First of all, we would love to be working with those agencies more.

Chairman KERRY. Say that again?

Mr. PRESTON. We would love to be working with those agencies more. We would love to partner with them more effectively. I think it would reduce some of the burden to the lenders.

What I would tell you is most—when a bank regulator comes into a large institution with a broad portfolio, they are looking at safety and soundness, they are looking at capital adequacy. Obviously, they do look at the loan portfolio. Typically, we are a relatively small subset of that portfolio. We go in, we specifically look much more deeply at the SBA loan portfolio, their adherence to our regulations, and their practices and procedures specifically relating to eligibility and those types of things.

So there is both the issue of our concentrating more heavily on our pool of loans, as well as making sure that they comply with unique standards as a Government guarantor rather than them as an independent lender.

Chairman KERRY. With respect to the BLX situation, I mean, obviously both BLX and SBA consider themselves victims of the fraud, and on some levels that is obvious and true. But to what degree might there have been signs that BLX should have picked up on and/or SBA? I mean, can you sort of share with us what the SBA knew and when it began to know it and what action it took?

Mr. PRESTON. There were loans that our people in Detroit referred to the IG. Ultimately, I know the IG worked with the U.S. Attorney based on work the U.S. Attorney was doing, I believe based on——

Chairman KERRY. Do you know what first flagged it within the SBA in terms of the referral?

Mr. PRESTON. Senator, I don't specifically recall. I personally know some of the people who told me about it, but I don't recall what they said were the indicators. But I think the overwhelming indicator that now, in the cold light of day, is many of these loans were to a particular industry, which doesn't always mean something negative. It can mean that a particular lender has expertise and is doing a good job reaching out to a particular industry. But that was done—that is before a lot of these activities were centralized, so I think it was primarily based on that, but we can get back to you on it.

Chairman KERRY. OK. I would appreciate that.

Mr. PRESTON. Now ultimately, when it was found, it was based on, I think, Secret Service out there doing a different investigation—the IG can comment on this.

Chairman KERRY. What specific steps have you taken to prevent it from happening? Please share with us some of what you learned from it.

Mr. PRESTON. Well first of all, I think it is important, for all of us to understand that generally, when fraud is perpetrated of this type, although it is bad for all of us and none of us like it, the one who ends up losing financially is the lending institution. You know, in cases of negligence like this, we don't cover it. So BLX is paid to cover initial losses that were detected, has set up additional funding to cover future losses, and is reviewing all loans going into the secondary market and coming out of it before we make any purchases to ensure that they are not part of this scheme. So I think it is important to understand that from a taxpayer perspective, we are protected to the extent that we don't cover those types of fraudulent activities.

Now, what we have begun to do is to work with other regulators to see the types of analytical tools they use, whether they look at industry concentrations and other types of factors to improve our ability to refer those loans to the IG and highlight them back to the lending institutions.

Chairman KERRY. Well, when you found out about the scheme, staff from the agency came to brief the Committee, which we appreciate, but ultimately—but you talked at that time about the tough disciplinary measures that were going to be taken against BLX, and then ultimately the agency entered into closed negotiations with the companies and really kept the details of any disciplinary actions confidential. What happened between that briefing and sort of the tough stance and then the private negotiations and the privacy with respect to——

Mr. PRESTON. I am not aware of the chronology, and unfortunately, I can't comment on that. Perhaps one of my colleagues can. What I would tell you is I didn't really view this as a negotiation, as much as our coming in as a regulator and an oversight body, providing our view on what we thought we needed to do.

The other thing is—my understanding is that you had a pretty full briefing on the decisions we made. Certainly I know, in the IG report, you all received a fully unredacted copy. So if there is any

lack of transparency between the agency and the Committee, I would like to understand kind of where you thought that was.

Chairman KERRY. Well, we are happy to share that with you, and I think there may be a little bit here. But coming back to this initial question, I mean, you said Secret Service or somebody related part of another investigation, et cetera. I think the question sort of hanging over the Committee a little bit—and potentially it ought to be hanging over the SBA—is sort of why didn't the SBA discover this? What is the mechanism in place for knowing that these kinds of loans don't take place?

Mr. PRESTON. Yes.

Chairman KERRY. I mean, how do we get a sufficient of scrutiny within the system——

Mr. PRESTON. Yes. The mechanisms that should be in place that I think are increasingly in place and will even more increasingly be in place are the following: I think, first of all, as we do onsite reviews, as we begin to look at practices and procedures, look at some individual loans, that match with portfolio performance that should be able to give us some indicators if there is a widespread ring of fraud. Second, as we purchase those loans in Herndon and elsewhere, when we do the reviews of the actual files, that should also provide us insight.

I would highlight here, though, that this was a pretty sophisticated ring of people. You had people in the institution, people in a bank falsifying equity injections, cashiers' checks—individual borrowers part of this scheme. Roughly 15 people were involved, and I think it is very difficult for a regulator to be able to get ahead of that type of sophistication. I think it is very important for us to look at the internal practices of those lenders to make sure that they get caught.

Like I said, once again, I do take some comfort in the fact——

Chairman KERRY. Are you not involved in the remedy component of this with respect to BLX, that you are not sure of the chronology and you are——

Chairman KERRY. I mean, as Administrator, are you directly going to be involved in determining what the——

Mr. PRESTON. In most cases, I wouldn't sit on the committee that determines remedies and issues for our lenders. In the BLX case, I have been——

Chairman KERRY. Well, isn't it unusual to have a $70-plus-million-dollar fraud?

Mr. PRESTON. Right. In the BLX case—early on, I was actively involved in the discussions on what I thought the next step should be. My view was a couple of things. Number one, I wanted to absolutely ensure that the taxpayer was protected and that to the extent that these issues—that we protected ourselves from that perspective. Let us leave it at that.

I think the other issue—this is where I think we continue to rely on trying to balance our judgment—is when you look at something like this. At what point is the issue behind you, and at what point is the issue continuing, and how do you weigh that against whether or not you want to in any way restrict capital to small businesses? Those are the kinds of factors we consider.

Chairman KERRY. Mr. Administrator, I do have a number of other questions, but the time is pushing us here and we have two other panels, so I am going to leave the record open and we are going to submit some questions to you in writing, if we may. We are not trying to burden you or anything, but we do want the record to be complete and appropriate.

Let me turn to Senator Snowe.

Senator SNOWE. Very quickly, Mr. Chairman——

Chairman KERRY. No, take your time.

Senator SNOWE I will be short because of time, but it really does get back to the fundamental responsibility of the Small Business Administration to conduct oversight activities and to do so aggressively.

Mr. PRESTON. Yes.

Senator SNOWE. Are you suggesting that there is no way to set in place procedures to detect fraud, for example?

Mr. PRESTON. No. I think what I am saying is we are a couple steps removed from the process by virtue of what we do as an external guarantor. So what we need to do is look for indicators where then we can take those loans and find patterns to pursue. Then in the purchase process look for individual loans to highlight and then refer those to the IG.

So no, there are certainly things we can do to be a more effective referrer of concerns to the IG, but ultimately, I think the most important thing we can do is make sure that the institutions involved in the processes and our programs have processes in place to catch that on their end since ultimately, that is where it happens. Ultimately, they are the ones that suffer the loss. I think we all obviously are impacted by it. It is a terrible thing.

So no, Senator, I think there are ways that we can improve it and ways to address it. I just think it is important that each player in this process understands how they can be effective, given what they have access to and what their roles are.

Senator SNOWE. But you have a number of remedies at your disposal to take action, do you not? I mean, you have a number of remedies, corrective measures——

Mr. PRESTON. Oh, absolutely.

Senator SNOWE [continuing]. Legally and otherwise, I mean, in terms of——

Mr. PRESTON. Absolutely.

Senator SNOWE [continuing]. Either the review process and taking legal actions against someone or an entity——

Mr. PRESTON. Actions, working with them on their plans to improve their internal processes, working—yes, any number of actions.

Senator SNOWE. Well, but it gets back to where you can be preemptive and preventive. Obviously, one of the issues is verifying the documentation of many of these loans at the outset——

Mr. PRESTON. Exactly.

Senator SNOWE [continuing]. And then looking at this repurchasing rate. That is a huge predictor of potential problems, and I don't think I understand if any corrective measures are taken to avert that.

Mr. PRESTON. Well, I think a couple of things. I think, first of all, getting the purchase process as tight as possible so that we have a standardized review process. We have a standardized process for getting things referred, and then secondarily it really is in the broader oversight process.

The only thing I do want to say, though, before I leave, and this may be opening up a bit of a Pandora's box, but one of the things we do not do is we do not—we obviously have a portfolio of risk. All lenders are not created equal in terms of what they do. We may have some lenders that look primarily at startup companies. Other large lenders have heavily diversified portfolios.

And I think it is also important as we look at performance in these portfolios to understand whether or not these lenders are taking our mission forward and what that implies for credit risk. That is a very complex set of issues that I don't think we fully understand at this point. I am not sure that everybody should be subjected to the exact same rating system, because ultimately, we are trying to reach people in this country who have a hard time getting access to credit.

And so what I would expect to do in the coming months, as we look at this regulation, is to build our understanding of that issue as well.

Senator SNOWE. But I think you have a number of road maps, including the Inspector General's report, this one and the 15 others along the way in the last year and a half. I mean, there are road maps to taking corrective measures immediately and putting in place certain procedures that are predictable and provide certainty.

Mr. PRESTON. Right——

Senator SNOWE. Just going back, in the Herndon situation, you have roughly 4,000 unprocessed loans? That would mean someone would be required to review over 20 repurchase requests a day. So you have to resolve that backlog, which is what you had to do——

Mr. PRESTON. Which is what we are working on——

Senator SNOWE [continuing]. In post-Hurricane Katrina and so on.

Mr. PRESTON. Right.

Senator SNOWE. But here we go again. And so this tells me——

Mr. PRESTON. This is a problem that has been building for 5 or 6 years——

Senator SNOWE. I know. That is the problem.

Mr. PRESTON. So I just want you to——

Senator SNOWE. That is why you sense the frustration here, because it has got to be either something is not working and we have got to find out what it is. I agree with you, and I have been sitting here for——

Mr. PRESTON. Right. No. I think the Herndon backlog issue has been building for many years and now it is coming down to——

Senator SNOWE. We objected to it.

Mr. PRESTON. Based on the corrective measures we are taking, so——

Senator SNOWE. I know, so——

Mr. PRESTON. I don't want anyone to leave here with the view that we are going in the wrong direction. I do think these are complicated, big issues, and I think addressing them requires some

real work. I think we are making a lot of progress, and we already have, and I think when you look at our proposed regulations, a lot of those do incorporate the GAO and the IG recommendations.

Senator SNOWE. According to a 2006 report, again by the Inspector General, the SBA improperly repurchased 44 of the 45 Small Business Express and Community Loans sampled because the SBA did not obtain the required lender to submit all necessary documentation required to make proper purchase decisions. That is a high rate of deficiency in that group, there is no question. The Inspector General estimates that roughly $130 million in disbursements on 2,729 loans purchased before February 1, 2005 were not properly reviewed by the SBA.

Senator SNOWE. Are we avoiding that now?

Mr. PRESTON. That is really part and parcel of the Herndon issue. The thing I would say is that doesn't mean that those were loans that ultimately we shouldn't have purchased. It implies that——

Senator SNOWE. They were all part of the Herndon Center——

Mr. PRESTON. Well, it says that you might not have had all the documentation you were supposed to get.

Senator SNOWE. Are we avoiding it for the future? I know what we are going through. Are we avoiding it for the future?

Mr. PRESTON. No. We are doing a lot of heavy lifting right now to fix this, and frankly, we would be, like I said, happy to take your staff through the detail of any of this stuff, because like I said, I think this is going to be a very positive story.

Senator SNOWE. I think for the Committee, I think we need it for the Committee.

Mr. PRESTON. Yes.

Senator SNOWE. I think we need to know where we stand.

Mr. PRESTON. Yes. We will——

Senator SNOWE. I think we have to have some time lines here, because——

Mr. PRESTON. We have got time lines——

Senator SNOWE [continuing]. With the volume of what SBA does, it has got to be loan quality, as well as loan volume. We understand some of the risks inherent——

Mr. PRESTON. But Senator, as anyone in my row behind me will tell you, we have time lines, deliverables, metrics, and milestones on virtually everything at the agency right now. So we will be happy to do that for you.

Senator SNOWE. One other question that I have. It is on the Women Procurement Program——

Mr. PRESTON. Yes.

Senator SNOWE [continuing]. For women-owned businesses. You said it would be implemented by the end of the fiscal year. It has been more than 2,500 days now. In 2000, this was established and it remains unimplemented——

Mr. PRESTON. Right.

Senator SNOWE [continuing]. By the Small Business Administration, and you said by the end of the fiscal year. That is coming along——

Mr. PRESTON. I said I would do everything I could. Yes. It has been a very frustrating process. I know it has been more frus-

trating for you because you preceded me, and we are in interagency process once again. I am very hopeful that by the end of the year, we will have something to go public with. But——

Chairman KERRY. Actually, Mr. Administrator, if you recall, we have a January 18 commitment on that, remember? We had a specific—you weren't here. Who made that? It was—I am trying to remember who made—your Associate Administrator for Entrepreneurial Development was here, Mr. Prakash, is that it?

Mr. PRESTON. Oh, OK.

Chairman KERRY. He guaranteed this Committee in open testimony that this will be implemented and done by January 18 in its entirety, and we agreed to have an oversight hearing here at the end of January, after the 18th, in order to review that to make sure it has been met. What I would like to do is add this other stuff to that and have an agreement, and I would like your agreement that you would personally be here with whomever you think is important from the agency so we can have an update on all of these issues, the disaster program——

Mr. PRESTON. Right.

Chairman KERRY [continuing]. And the 7(a) reforms that you are putting in place, and, of course, the Women's Procurement program which we have been waiting 6½ years for.

Mr. PRESTON. Yes. I would like to come over here when we have something to announce on Women's Procurement. I am pretty hopeful by that time we will have something to announce on Herndon and on——

Chairman KERRY. He made a commitment to this Committee. We will get the language to you. If accountability is going to mean anything, we will get the language to you.

Mr. PRESTON. OK. Yes. On disaster, we can come over tomorrow. We have got everything you could ever want on that right now.

Chairman KERRY. Seven years on the procurement program.

Senator SNOWE. Two thousand five hundred and seventeen days, to be exact.

Chairman KERRY. Thank you, Mr. Administrator.

Mr. PRESTON. All right. Thank you.

Chairman KERRY. We appreciate it.

Senator SNOWE. Thank you.

Chairman KERRY. Can I ask the Inspector General, please, Eric Thorson, if you would come for the panel.

Mr. Thorson, you have previously served as the Chief Investigator for the Senate Permanent Subcommittee on Investigations and the Senate Committee on Finance and we are grateful for your observations and reports and we welcome your testimony.

If you could try to summarize, we have questions and obviously we are very familiar with it, so if you could summarize and move on.

Mr. THORSON. Yes, sir.

Chairman KERRY. Thanks.

STATEMENT OF ERIC M. THORSON, INSPECTOR GENERAL, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC

Mr. THORSON. Chairman Kerry and Ranking Member Snowe, I appreciate being here this morning.

On the morning of January 9, 2007, as a result of a lengthy investigation, special agents from the Office of Inspector General, with the help of the Secret Service, began a sweep in Detroit, Michigan, resulting in the arrest of 18 individuals. Among those arrested were former BLX executive vice president Patrick Harrington and former Huntington National Bank vice president Deborah Lazenby. Mr. Harrington was charged with making at least 76 fraudulent SBA guaranteed loans totaling about $76 million. We believe this is the largest 7(a) loan fraud scheme in SBA history. Both Mr. Harrington and Ms. Lazenby have plead guilty. So far, our investigation has resulted in the indictment of 27 individuals, of which 3 are currently international fugitives. This criminal investigation is continuing with further indictments expected.

These rather dramatic events raise questions about SBA's oversight of its lenders and led our auditors to review SBA's oversight of BLX from 2001 to 2006. This audit focused on how SBA monitored BLX during this period and whether SBA took effective actions. It was not an audit of BLX.

In summary, we found that SBA was aware of recurring performance and compliance issues, but there were few consequences for its performance problems. We believe that the high rate of default and other problems with BLX loans presented undue financial risk to SBA and therefore merited in-depth reviews of the defaulted loans as well as possible suspension of SBA's preferred lender status, which allows BLX to approve loans with virtually no prior review by SBA.

Despite problems with BLX's loans, however, SBA continued to renew the delegated PLP lending authority and to honor guaranteed purchase requests without taking any additional precautions, paying out $272.1 million in guarantees between 2001 and 2006. Quite simply, SBA did not hold the lender accountable for its performance problems.

While SBA has been slow to develop its lender oversight program, we acknowledge that they have taken significant steps, which are identified in my written statement.

Despite these efforts, we believe the deficiencies we observed in SBA's handling of BLX are symptomatic of systemic issues that have restricted the effectiveness of SBA's oversight. These issues fall into five categories.

First, SBA has focused on the quantity of loans, not the quality. SBA sets goals for loan production, but not for loan quality or lender performance. This emphasis on production has created an environment where it may be difficult to take corrective action against the large lenders when doing so might jeopardize the attainment of SBA's goals. We believe SBA may have been reluctant to take enforcement action against BLX because it is among SBA's top ten lenders in the value of loans dispersed.

Second, SBA has delegated broad loan-making authority to lenders without making corresponding increases in its monitoring and oversight efforts. Currently, more than 87 percent of SBA loans are made using delegations of authority with minimal oversight by SBA. While SBA has assumed more risk and has taken some important measures to monitor lender performance, it has not fully implemented compensating controls to mitigate that risk.

Third, reductions in personnel over the past 5 years have diminished the agency's capacity to provide oversight at a time when it is growing its loan portfolio. SBA personnel have been reduced by 25 percent since 2001, while loan production has increased more than 100 percent during this time. SBA has not adequately staffed its lender oversight office and does not analyze loans to detect fraud schemes or identify high-risk situations.

Also, significant backlogs exist involving thousands of lender requests for SBA payments on defaulted loans, some going back 6 years. An inadequate review of these defaulted loans have failed to identify loan deficiencies. Although SBA is taking steps to revamp the purchase review process, it recently determined that more than 50 percent of all backlogged 7(a) purchase packages were missing significant documents. In addition, untimely reviews by SBA limit the OIG's ability to effectively investigate and prosecute criminal fraud.

Fourth, a conflict of interest exists between SBA's lender advocacy and oversight roles. The Office of Capital Access is responsible for promoting loan growth and lender participation, but at the same time, is also conducting lender oversight and enforcement. These functions are incompatible and should be separated to preclude organizational conflicts of interest.

Fifth, SBA has not focused on fraud detection. Although the size of SBA's loan portfolio and its reliance on lenders for loan making has made SBA's loan programs vulnerable to fraud, SBA has made only limited efforts to detect fraud. OIG investigations have found that loan agents, or packagers, perpetrate schemes on multiple loans causing losses of tens-of-millions of dollars. This was evident in the above-mentioned arrest. OIG has for years recommended that the agency track loan agent involvement so that quick action can be taken to prevent losses if fraud is detected. However, agency efforts to track loan agents have thus far been ineffectual.

Finally, let me briefly address questions regarding our audit report and the numerous redactions it contains. This report is a rather unusual circumstance because it necessarily discusses the actions of a private sector company and agency deliberations. I have great respect for Mr. Borchert, the SBA General Counsel, so when his office asserted that the redactions were needed to protect agency privileges and agency operational practices, we accepted those concerns. Simply put, we do not wish to cause any harm to the agency and, in fact, strongly desire to make it better. Although we do not necessarily agree with the legal explanation for some of the redactions, the safest path was to post the report with SBA's requested redactions.

I appreciate the opportunity to talk about our report today, and I also want to acknowledge the presence today of Mr. James Hudson and Debra Ritt who were responsible for the excellent report that you have in front of you. Thank you.

[The prepared statement of Mr. Thorson follows:]

Testimony of
Eric M. Thorson
Inspector General
U.S. Small Business Administration

Before the
Committee on Small Business and Entrepreneurship
United States Senate
November 13, 2007

Chairman Kerry, Ranking Member Snowe and Members of the Committee,

On the morning of January 9, 2007, as a result of a lengthy investigation, Special Agents of the SBA Office of Inspector General (OIG) and the U.S. Secret Service began a sweep in Detroit, Michigan, resulting in the arrest of 18 individuals. Among those taken into custody were former Business Loan Center, LLC (BLX) Executive Vice President, Patrick Harrington, and former Huntington National Bank Vice President, Deborah Lazenby. Mr. Harrington's indictment charged him with making at least 76 fraudulent SBA-guaranteed loans totaling about $76 million. We believe this is the largest government-backed loan fraud scheme in SBA history. Mr. Harrington has actually admitted to making about 96 fraudulent SBA-guaranteed loans, so attempts to identify and investigate additional fraudulent loans, not charged in his indictment, are ongoing. Since his arrest, Mr. Harrington has pled guilty to one count of conspiracy and one count of lying to a Federal Grand Jury. He is expected to be sentenced in January and faces up to 10 years in prison. Ms. Lazenby was recently sentenced to 2 years in prison for her role in providing phony cashier's checks to demonstrate borrowers' injections of equity into their businesses.

So far, the investigation regarding SBA-guaranteed loans made by the Detroit BLX office has resulted in the indictment of 27 individuals, with most of these indictments pre-dating the January 9, 2007, arrests cited above. Three of those indicted are currently international fugitives. To date, SBA recoveries from BLX, together with potential cost savings from the withdrawal of SBA guaranties on certain Detroit loans, have totaled approximately $16 million. This criminal investigation is continuing, with further indictments expected.

These rather dramatic events caused us to look at the broader picture of how such a widespread fraud scheme—involving so many loans made by one of SBA's largest lenders—could occur. Working with the information initially provided by the SBA Investigations Division in the criminal case, the Auditing Division proceeded with the effort of reviewing SBA's oversight of BLX from 2001 to 2006. This was not an audit of BLX's lending practices. Rather, this was an audit of how SBA monitored and oversaw BLX during this period and whether SBA took effective action to address any significant risks stemming from BLX's lending practices. We issued our first report on this effort in July and are currently evaluating SBA's oversight of other Small Business Lending Companies (SBLCs).

SBA Was Aware of Recurring Performance and Compliance Issues with BLX, but There Were Few Consequences for its Performance Problems

The purpose of our audit was to determine whether SBA had identified performance or compliance issues that should have alerted it to potential problems with the lender's loan origination practices. It should be noted that, for a number of years, BLX has been one of the most active lenders in SBA's 7(a) loan guaranty program. Unlike most lenders in the 7(a) program, BLX is an SBLC, which means that it is exclusively regulated by SBA. SBA has also delegated authority to BLX by admitting it to the Preferred Lending Program (PLP), which is generally reserved for the best and most knowledgeable SBA lenders. This allowed BLX to originate and approve loans with virtually no prior SBA review.

Our report disclosed that SBA, based on its on-site reviews of BLX, its evaluations of the lender's performance, and feedback received from its field offices, was aware of material and recurring issues with BLX's performance. Although the fraudulent activity surfaced by our investigation would not have been readily apparent to SBA, we believe that the high rate of defaulted loans and other indicators of problems with BLX's loans presented undue financial risk to SBA and, therefore, merited in-depth reviews of the defaulted loans, as well as possible suspension of BLX's PLP status. Despite the indications of problems with BLX's loans, however, SBA continued to regularly renew BLX's delegated PLP lending authority and honor the lender's guaranty purchase requests without taking any additional precautions, paying out $272.1 million in guaranties between 2001 and 2006. Quite simply, SBA did not hold the lender accountable for its performance problems.

SBA Needs to Strengthen its Oversight Practices

The broader topic of today's hearing—whether SBA has effective safeguards and a means of overseeing lenders that facilitates the prevention and detection of fraud—has been an area of concern and focus for my office for a number of years. Our audits and investigations have identified significant weaknesses in the Agency's oversight of its lenders and, since 2000, we have identified lender oversight, guaranty purchase reviews, and loan agent fraud as major management challenges facing the Agency. SBA has been slow to develop its lender oversight program, and only in recent years has the Agency made progress in addressing longstanding weaknesses.

We recognize, however, that the Agency has taken some significant steps that we wish to acknowledge. These include:

(1) Establishing a lender oversight office and an oversight committee made up of senior Agency officials;
(2) Establishing the Loan and Lender Monitoring System;
(3) Issuing a standard operating procedure (SOP) on conducting on-sight reviews;
(4) Issuing regulations on fees for performing lender reviews;

(5) Issuing proposed lender enforcement regulations; and
(6) Evaluating improvements needed in its reviews of requests by lenders for purchases of guaranties on defaulted loans (guaranty purchase reviews).

While we commend the Administrator and SBA staff for taking some important steps to improve the Agency's oversight practices, considerably more needs to be done to develop a meaningful oversight process that can effectively safeguard SBA's more than $60 billion portfolio of guaranteed loans. Despite these efforts, in our opinion, the deficiencies we observed in SBA's handling of BLX are symptomatic of broader, systemic issues that have restricted the effectiveness of SBA's oversight. These issues, which fall into five categories, must be addressed if SBA is to succeed in further strengthening controls over participating lenders.

- **SBA has focused on the quantity of loans produced and not the quality.** With the exception of 2005, SBA has increased its 7(a) loan production goals every year since 2001. In 2007, SBA set its most ambitious goal yet—to grow the Agency's loan portfolio by 15 percent. SBA has not, however, set goals to improve the quality of its loan portfolio or the performance of lenders participating in its loan programs. For example, SBA could develop and enforce portfolio quality evaluation standards to ensure that lenders minimize the Agency's losses.

  SBA's focus on loan production has also significantly affected how the Agency deals with unacceptable lender performance. By publicly announcing goals to grow the loan portfolio every year, SBA has created an environment where it may be difficult to take corrective action against large lenders when doing so might jeopardize SBA's ability to obtain those goals. We have also noted disparities in SBA's treatment of large and small lenders whose performance has been deemed unacceptable. For example, we have seen poor performing lenders with limited loan production have their delegated lending authorities denied, or be removed from SBA's lending programs. In other cases, large lenders with the same problems have been allowed to maintain their preferred lending status. This was evidenced most recently by SBA's handling of BLX. We believe SBA may have been reluctant to take enforcement action against BLX because it is among SBA's top 10 lenders in the value of loans disbursed.

- **SBA has delegated a considerable amount of loan making authority to lenders without making corresponding increases in its monitoring and oversight efforts.** Faced with dwindling staff resources, and in an effort to expedite the lending process, SBA has increased its reliance on lenders to originate, service, and liquidate guaranteed loans with little Agency oversight. Currently, more than 87 percent of SBA's loans are made using delegations of authority, where lenders are authorized to make loans with minimal oversight by SBA. SBA requires limited documentation from these lenders to demonstrate their compliance with the Agency's lending policies. Borrowers and lenders are also allowed to certify to various facts without subsequent verification by SBA personnel, even after the loans default. These certifications include such information as the borrower's citizenship, prior losses on

government loans, intended use of working capital, and the status of refinanced prior debt.

By increasing its use of delegated lender authority, SBA has assumed more risk. However, it has not fully implemented compensating controls to mitigate that risk. For example, our audit of the Office of Lender Oversight Corrective process disclosed that each year SBA has reviewed only a fraction of the lenders operating under delegated lending authority. Of the approximately 350 lenders eligible for on-site reviews, only 70 were reviewed in 2005 and only 55 were reviewed in 2006. Although SBA has a goal to increase the number of reviews it conducts in 2008 as it can now fund this activity through fees charged the lenders, it is unclear whether SBA will meet its goals given the criticism it has received from lenders over these fees.

- **Reductions in personnel over the past 5 years have diminished the Agency's capacity to provide oversight at a time when it is growing its loan portfolio.** SBA has had a 25 percent reduction in personnel since 2001, while loan production has increased by more than 100 percent over that same period. SBA's Office of Credit Risk Management (formerly the Office of Lender Oversight) has not had a significant staff increase, and is currently operating with less than its authorized number of personnel. As a result, it cannot perform the type of analyses that might detect fraud schemes and isolate high-risk situations or investigate lenders with high default rates.

  Staffing shortages at the SBA's National Guaranty Purchase Center have also prevented the Agency from conducting effective and timely purchase reviews of all defaulted loans. These reviews occur either pre-purchase, before the guaranteed portion of the loan is paid out, or post-purchase, involving loans that have been sold on the secondary market to investors. In our view, SBA's review of guaranty purchase requests by lenders on loans that have gone into default is a key lender oversight function. Currently, however, SBA has a backlog of 1,000 unprocessed pre-purchase requests and over 3,000 unprocessed post-purchase loan packages that vary in age from 12 months to over 6 years. Because SBA had not conducted post-purchase reviews on a significant backlog of loans, including many of those originated by BLX, the Agency does not have current or complete information on lender compliance issues, and only acquires this information long after the guaranties were purchased and the money paid out. As a result, SBA lacks critical data to determine whether corrective action is warranted to address lender deficiencies. In addition, untimely reviews limit the OIG's ability to effectively investigate and prosecute criminal fraud.

  Our office has identified recurring problems with the quality of purchase reviews used to support guaranty payments and control improper payments. The sheer volume of guaranty purchase requests that the Agency must process with current staffing levels, combined with the Agency's goal of paying lenders in a timely manner, have resulted in careless purchase reviews that failed to identify loan deficiencies. For example, last year we estimated that as much as $131 million in purchases of SBA*Express* and Community Express loans had not been properly

reviewed by SBA. We also examined the Agency's purchase process for 7(a) loans, which disclosed significant deficiencies in the Agency's reviews of lender purchase requests that led us to question the Agency's estimate of improper payments. We reported that almost half of the loans we reviewed were purchased by SBA without adequately analyzing whether lenders originated, serviced, and liquidated loans in accordance with SBA requirements and prudent lending practices. Although SBA has taken steps to revamp the purchase review process for 7(a) loans, in September 2007, it determined that more than 50 percent of all backlogged 7(a) purchase packages were missing significant documents required for effective review.

- **Potential conflicts exist between SBA's lender advocacy and oversight roles and the organizational structure supporting these functions.** The lender oversight responsibilities of SBA's Office of Credit Risk Management (OCRM) and the lender advocacy role of the Office of Financial Assistance (OFA) are not compatible. Both offices reside within the Office of Capital Access (OCA), which is responsible for the direction and administration of SBA's lending programs. Because the lender oversight role may involve taking necessary enforcement actions or revoking PLP status, the responsibilities of OCRM are not compatible with role of OFA and OCA in promoting SBA's lending programs and growing the Agency's loan portfolio. Furthermore, SBA's guaranty purchase centers report to OFA. It would make more sense to place the purchase centers under OCRM because guaranty purchase reviews are an important component of lender oversight.

- **SBA is not focused on fraud detection.** The size of SBA's loan portfolio, and its growing reliance on lenders for loan making, have made SBA's loan programs vulnerable to fraud, and presented SBA with significant challenges in ensuring the integrity of these programs. Historically, SBA's efforts to detect fraud have been limited. The Agency has relied primarily on third-party reviews of lender activities to ensure that lenders are making good quality loans, as well as guaranty purchase reviews.

  For years, OIG investigations have revealed a pattern of fraud by loan packagers and other for-fee agents in the 7(a) program. Often loan agents are able to exploit systemic weaknesses in SBA lending and the lack of SBA oversight. As a result, they are able to implement fraudulent schemes on multiple loans causing losses of millions or tens of millions of dollars. This was evident in the BLX arrests that were made in January. In fact, past and ongoing OIG investigations have identified loan agent fraud on hundreds of millions of dollars of loans. An OIG management challenge has for years recommended that the Agency implement effective measures to track loan agent involvement so that quick action can be taken to prevent losses if fraud is detected. However, to date, Agency efforts to track loan agents have been limited and ineffectual.

  While it is not the Agency's responsibility to investigate fraud, given the billions of dollars at stake, we believe SBA needs to take more aggressive steps to identify and address potentially fraudulent activity. We recognize that fraud detection is not an

exact science. No matter how sophisticated the fraud detection techniques are, not all fraud and abuse can be identified. However, implementing a variety of monitoring efforts holds more promise for identifying potentially fraudulent activity than the Agency's current strategy, and also provides a deterrent to such illegal activity.

Redacting the Audit Report

Finally, let me address the issue of our audit report and the numerous redactions it contains. I have been asked why we allowed any redactions, why we just didn't rewrite the report so it would not generate this controversy, and why we issued the report at all.

Regarding the issue of rewriting a report to eliminate controversy, we conduct an audit for one purpose, and that is to attempt to draw attention to issues, oftentimes weaknesses, which will allow the Agency to improve a process, procedure or program to make the Agency run better and more efficiently. We are also required to meticulously back up the statements we make with hard evidence so that we do not simply report unfounded whims of the writer. In doing so, we use whatever information or data we have to demonstrate the credibility of our report and to strengthen our recommendations. We have never rewritten an audit report to avoid controversy, and we will not do so in the future.

I have also been asked why, if the OIG is independent, we allowed anyone, even the Agency General Counsel, to redact portions of our report. The answer is that, although there is no requirement that we post audit reports on the Web, we generally post these reports because we believe that making the reports available serves the public interest. However, the public interest has to be balanced against the potential harm that could occur from releasing the report. We have, in the past, extensively redacted reports on SBA's Information Technology weaknesses in order not to provide a roadmap for hackers to disrupt SBA's systems.

In this case, the General Counsel stated that there could be harm to the Agency from releasing the report. Although our lawyers do not necessarily agree with the OGC legal analysis, this is an unusual circumstance where the report discusses the actions of a private sector company. We believe the reasons for doing so are self evident. I have great respect for Mr. Borchert, the SBA General Counsel. So, when he offered redactions that he felt protected various Agency privileges and stated that some Agency operational practices could be damaged if those redactions were not made, we accepted his concerns. Simply put, we do not wish to cause any harm to the Agency, and in fact, strongly desire to make it better. As I said, although we do not necessarily agree with the reasons for the redactions, the safest path was to accept, for now, those redactions and post the report.

I hope that we have provided both the Agency and the Committee a thorough picture of both the history of this important criminal case, as well as our summary of current problems that SBA is experiencing in the area of lender oversight. As I mentioned earlier, the Agency has made notable strides in strengthening its oversight capacity, but as I have also pointed out, there is much left to do.

Chairman KERRY. Thank you very much, Mr. Thorson. First of all, let me thank you for keeping your promise to this Committee, which we don't take lightly, which was the notion that you would fulfill these responsibilities with independence and to the best of your ability to protect the public interest, and I think you really have done that and are doing that, and so we welcome the report.

We certainly welcome any explanation the SBA may have to the contrary. We are here to find facts, not to pick winners, and so we would love to hear some of those things to the contrary. But I think the observations that you have made are not insignificant, and they are certainly important to understanding what is and isn't happening.

Let me just ask you up front if you could perhaps share with us, for a moment, on this issue of staffing and personnel and the questions Senator Cardin asked and I asked—can you just share with the Committee what your perception is about where the SBA is at this point in its ability to track fraud?

Mr. THORSON. In the area of staffing, obviously the fact that there is a backlog would address that question——

Chairman KERRY. I was struck by that. You just said a very significant backlog.

Mr. THORSON. Right. You have two different aspects here that you could address, and one, of course, is the effect of having this backlog exist and being able to deal with it and get rid of it. The other is to detect fraud, and those are really two very different issues.

One of our concerns is that, in the desire to get rid of the backlog, it is almost human nature to do a more cursory review——

Chairman KERRY. Push things through rapidly——

Mr. THORSON [continuing]. Of the files in order to move them out, and we understand that. We don't expect—this office certainly does not expect SBA to do an in-depth review of every single loan file. That is not practical. But where you can target, where you can find problems, there are a number of parameters that we could throw out here and discuss about how to identify the targets where you need to focus your efforts——

Chairman KERRY. Have you memoed the various responsible parties to that effect?

Mr. THORSON. There was a report done in February, among others.

Chairman KERRY. February of this year?

Mr. THORSON. Yes. But what we want to do is to get people to focus on where the effort needs to be made, and occasionally—not always, not in every case—do an in-depth review and look at what is there. We don't expect, for instance, the auditors to identify that in the case that I mentioned to you, there were phony cashier's checks creating evidence of equity injection, that these were phony checks. We don't expect that. But what we do expect is for there to be elements to alert people to possible fraud and, therefore, we can then take it from there and investigate it.

But it all comes down to the idea of staffing the purchase reviews so that you do get a good look at what has gone on with these loans. It may not involve fraud. It just may be that they didn't really fulfill all the requirements that were required of them when they

granted that loan. They are making credit decisions on behalf of the U.S. Government. The Government is backing those credit decisions and we need to make sure that we are living up to—or that the lenders are living up to their responsibilities.

Chairman KERRY. Do you have perhaps a two most important change list, or three, whatever it is, that you think the SBA ought to undertake in order to improve the oversight and prevention of future fraud?

Mr. THORSON. Rather than two, I would probably say there are four. The two that I just mentioned were: identify where your problems are and target those problems; second of all, devote the amount of resources to it that is necessary to do a timely review.

The third one would be to do occasional in-depth reviews in that target area so that you can—not every case, but where you can really find out what kind of product these lenders are giving you. And then the fourth one is accountability, that is to take some action based on what you are finding.

When you find that there are problems here with any lender, whether it is BLX or anybody else, be prepared to take some sort of action against that lender to, not to put them out of business, but to bring them around so that they will begin to improve their process.

Chairman KERRY. Now, your report said that since 2001, the SBA has identified recurring problems in the performance of BLX, is that correct?

Mr. THORSON. Yes, sir.

Chairman KERRY. Can you relate what those recurring problems identified were?

Mr. THORSON. I think they range anywhere from credit issues, how they administer credit, to analyzing the ability to repay. Is the package complete, were the elements that were required by SBA, were they complied with? Then, of course, you have any issue of fraud that may be present.

Chairman KERRY. Why was the investigation of BLX initiated?

Mr. THORSON. You mean the criminal investigation, or the audit?

Chairman KERRY. The criminal.

Mr. THORSON. The criminal investigation was actually started back around 2002 by allegations that were made from a number of sources, some of which I believe you have statements from, that are commonly referred to as short-sellers. The SBA did investigate a lot of those issues, but didn't find that there were enough specifics there to be able to bring a criminal case. There were other issues that developed along the way on the non-fraud side of it, which was an issue in 2002, which suggested that there were problems with loans; and then in 2005, the OIG issued a Management Advisory Report detailing, I think it was seven loans in violation of SBA procedures and material misstatements to SBA. In fact, to their credit, BLX offered to repay one of those loans, but for some reason, SBA sent them an e-mail stating that they were being too hard on themselves; and they didn't need to do that. The criminal investigation was pretty much——

Chairman KERRY. You have got to come again with that one.

Mr. THORSON. I am sorry?

Chairman KERRY. You have got to hit me again with that one.

Mr. THORSON. OK.

Chairman KERRY. The SBA did what? They wrote them back and said, don't worry?

Mr. THORSON. That is the information—neither myself nor Mr. Preston was with SBA at that time, but that is the information I have, yes.

Chairman KERRY. It is my understanding that you have a second report underway now. Is that because your judgment is that nonbank lenders and their oversight warrant additional concern from your office?

Mr. THORSON. Yes, also the fact that we are not—this audit report was not really on BLX. We used it as sort of a case study because of the criminal case, but what we wanted to do was to focus on the SBLCs, Small Business Lending Companies, and make a determination, is this widespread—are these problems as big as we may think they are, or is this an isolated incident? It seemed only natural that we would expand the report to look at other SBLCs, as well.

Chairman KERRY. And as you know better than anybody, the public version of your July 11, 2007 report was only released this past month. Why did it take so long after the official completion of the report for it to be released?

Mr. THORSON. Why did it take so long until what?

Chairman KERRY. For it to be released publicly.

Mr. THORSON. Primarily because of the debate on the redactions. We were dealing with both the attorneys for BLX, as well as the General Counsel of the agency——

Chairman KERRY. Who insisted on those redactions? Did you insist on them? Did the SBA——

Mr. THORSON. I am the one who made the decision to go ahead and put it out with the redactions that you see before you.

Chairman KERRY. Who insisted on the redactions?

Mr. THORSON. The General Counsel's Office was one. The BLX attorneys did.

Chairman KERRY. The General Counsel——

Mr. THORSON. We rejected the claims of the company, but I did accept the redactions from the General Counsel's Office.

Chairman KERRY. In your opinion, are all of the redactions legally supportable?

Mr. THORSON. No, but in fairness to their office—I am not an attorney—I used common sense when I looked at some of these and made my decisions on that.

Chairman KERRY. Was there any reason——

Mr. THORSON. We also have our own counsel, though——

Chairman KERRY. Can you explain why three of your recommendations would be redacted?

Mr. THORSON. I am still having a hard time with that one. They gave a legal reason for each of the redactions and I accepted those because of——

Chairman KERRY. Did your recommendations specifically mention any potential trade secret or anything specific to a company or anything specific that would fall under——

Mr. THORSON. No.

Chairman KERRY [continuing]. The three exclusions stated?

Mr. THORSON. No. Actually, they are—after you read it, I think you would pretty much come to the conclusions of what those recommendations would be just simply from reading the report. I think it is pretty common knowledge that we have taken—in fact, in my own statement, we have taken issue with the PLP status of BLX as it progressed. I mean, things like that would be a pretty normal situation for the office to recommend.

Chairman KERRY. Senator Snowe.

Senator SNOWE. Thank you again, Mr. Thorson, for your very sensitive and thorough work with respect to these critical issues and troubling ones, frankly. As you know, these longstanding issues are my deepest concern. I know that Chairman Kerry shares the same concerns as to whether or not the Small Business Administration is in a position to take the corrective measures that are essential to preventing similar problems in the future. I guess while there may be some distinctions obviously between fraudulent actions, and just having measures in place to make sure that they are following correct procedures; nevertheless, there is an ability to establish procedures that would ultimately detect fraud, a potential risk for fraud——

Mr. THORSON. Right.

Senator SNOWE [continuing]. And when you talk about 50 percent of some of the loans, is that what you are reviewing now? Are you saying that 50 percent of these loans don't have accurate documentation at the Herndon Center?

Mr. THORSON. Yes.

Senator SNOWE. Fifty percent?

Mr. THORSON. The problem with that is not only can we not really get a good feel for what some of these packages contain as we may look at them, but it also prevents the agency from really understanding whether or not the package was complete at the time it was made, whether or not they can, if they see problems to go back against the lender and get the money back in an improper payment—recovery of an improper payment.

Senator SNOWE. Well, what you heard this morning from Administrator Preston in response to questions, do you feel that the Small Business Administration is in a position of taking the measures necessary to begin to address many of these issues? You have obviously issued a number of reports over the last year-and-a-half. Have any of these recommendations been implemented or adopted by the SBA? Finally, what is your response to what you heard here today with respect to the responses by the Administrator to your report?

Mr. THORSON. In my written statement, we outlined the steps that the agency was taking, and we certainly applaud that. I guess it falls to the normal task of an IG to look at those as they progress through time and make sure that they work and that they accomplish what they were designed to do. It is going to take a little bit of time. Most of these are new. So we want to take a look at these over time to make sure that these steps are effective and doing what they were designed to do. But we certainly admire the fact that they have put these steps in place and are making these efforts.

Senator SNOWE. Do you think in both verifying the loans at the outset, as well as addressing the issues I mentioned, the repurchase rate as a predictor of the potential for loan default becomes a critical indicator?

Mr. THORSON. Absolutely, yes. You obviously have two types of reviews here, the pre-reviews which are done before—in this case—before BLX can sell the loan on the secondary market, and then you have the post-purchase reviews which are done after the money is paid out on a defaulted loan. So in each of those cases, what you really want to do is to learn what you can about—you can learn obviously about the package individually, but you can also learn a great deal about the lender and the way they are operating in the SBA guaranteed environment.

Senator SNOWE. Could you understand why they continued to renew the status of BLX? I mean——

Mr. THORSON. No. It is——

Senator SNOWE [continuing]. In reading the report here, it really truly is mystifying and disconcerting.

Mr. THORSON. It is really one of the things that we had a hard time with, and I understand the agency's concern about affecting their business, and the argument was made, I believe, by BLX that it would put them out of business. I personally don't believe that is true, but then again, I haven't seen all that was presented to them; so there is a legitimate concern for that as I do understand it.

But the other concern that they have to have is to make sure that when you have given a company—in this case—or a bank, or anybody, the right to make credit decisions on behalf of the Government because that is who is backing these loans, we expect the money to come back. We need to get that money back. And therefore when you do that, the primary concern has got to be that we have trusted that lender to use good judgment, to use good banking procedures, and to make good loans, and therefore we shouldn't have these kind of problems. How many ways can you hold them accountable? There are not many, but one of them is that big one. That is the PLP status.

Senator SNOWE. I couldn't agree more. That is something that we are going to have to clearly focus on, as you are recommending, established policies for penalties—that has to be abundantly clear and evident. The Small Business Administration must be prepared to invoke those penalties and consequences——

Mr. THORSON. Right.

Senator SNOWE [continuing]. On troubled lenders——

Mr. THORSON. And in fairness to the agency——

Senator SNOWE. We gave the preferred lender status to expedite the loan approval process, to make it easier, remove barriers, so on and so forth, but commensurate with that was a fiduciary responsibility to the American taxpayer, and that hasn't happened and——

Mr. THORSON. Right. In fairness to them, one of the things the Agency points out is that they will shorten the time span for the PLP renewal. But if it is always renewed, that doesn't really seem to have any effect. If you can count on the fact—and in one case we notice it was even renewed retroactively—it really has no effect. You can pretty well count on the fact that you have got it. But it

is one of the very few ways to really hold the lender accountable and to force them to move more toward compliance with your policies and procedures.

Senator SNOWE. You have mentioned, I understand, that SBA does not treat all lenders with troubled portfolios the same; the small lenders with poor performance often have the renewal of their preferred lending authority denied, but in other cases, large lenders with the same problems do not. Is that true? I mean, do you see that?

Mr. THORSON. Yes.

Senator SNOWE. You do? So there is a disparate approach to small lenders versus large, and it is all due to volume, again——

Mr. THORSON. It would probably be good to be able to try and provide you some exact numbers which I honestly don't have today. But that is the case. And in fact, I think one of the questions asked earlier of the Administrator was how many did you revoke, and if that is true, then what happened here? This was—I have got to believe—a pretty bad example of what can happen, and if this didn't result in revocation, then why did the others? Or another question is, how many of those that were revoked were due to other Federal regulatory agency actions, and not exclusively because SBA took action?

Senator SNOWE. Finally, in your estimation, given the analysis and investigations that you have conducted, do you believe that BLX is the norm, potentially the norm, or the exception?

Mr. THORSON. No, I don't think this is a normal situation. I think what it is right now is we don't know where this is going. I will tell you the Troy, Michigan office is closed, but the investigation is ongoing. So as far as the criminal case, that is about all we can really tell you. But this has been an interesting situation.

Senator SNOWE. Well, thank you. Thank you, Mr. Thorson.

Chairman KERRY. Thank you, Mr. Thorson. Thank you, Senator Snowe. It is an interesting situation. Obviously, all of us hope it is merely a singular individual situation and that it doesn't point to a larger issue. It obviously is incumbent on a whole bunch of folks to make certain of that——

Mr. THORSON. Right.

Chairman KERRY [continuing]. And that is the job of—your job, to some degree, Mr. Thorson, but it is particularly the job of the SBA itself and the lending institutions. They are going to have to take a look at their own processes to guarantee that an awfully important program doesn't get jeopardized as a consequence of what we all hope is a singular individual, a sort of aberration, and that is obviously our hope.

So I thank you for testifying today. As I said, the record will remain open. We may have a few more questions in writing, but we thank you very much for being here today.

Mr. THORSON. Thank you.

Chairman KERRY. Could I invite the third panel, please, Mr. Bob Tannenhauser, chairman of Business Loan Express; Anthony Wilkinson, president of the National Association of Guaranteed Government Lenders; and Jim Baird, executive director of the Bay Area Development Company and vice chairman of the Legislative Affairs Committee, National Association of Development Compa-

nies, all of whom are involved in and are deeply affected by the testimonies of the prior two panels and what we are talking about.

Thank you, folks. I appreciate you being here. Before we begin, let me just emphasize something. I want to reiterate. Mr. Tannenhauser, I want to make certain that you understand and the public understands that your invitation here is not intended to put some kind of undue or inappropriate focus on BLX, and personally, I know you take great pride in the leadership of your company and in your effort to help small business owners.

I fully want to respect the fact that this Committee exists for the purpose of helping small businesses. Our objective is to expand access to affordable financing for small businesses, and since this story broke, the Committee has taken a very measured approach to the news, asking the questions about the SBA oversight and reaction, but leaving the disciplinary decisions entirely to the SBA, and I think we have refrained from any sort of public bashing sessions. As you know, we have never recommended for or against radical calls for BLX to lose its preferred lender status, delegated loan privileges, or to cease BLX's ability to sell SBA loans on the secondary market.

BLX's representatives and employees have stated many times that BLX has been unfairly beaten up in the press as a result of the actions of one of its lending officers and that the SBA's IG report is unbalanced and inaccurate. So this is your opportunity to share with us your perspective and your side of the story and we look forward to having a good, healthy discussion here.

Mr. Baird and Mr. Wilkinson, we look forward to your input on this overall situation and the issues that have been discussed here this morning, so thank you very much, each of you, for being here.

Mr. Tannenhauser, why don't you lead off and we will go right down the line. If you could all summarize. I want to give you adequate time, but your full testimonies will be placed in the record as if read in full.

STATEMENT OF ROBERT F. TANNENHAUSER, CHAIRMAN, BUSINESS LOAN EXPRESS, LLC, NEW YORK, NEW YORK

Mr. TANNENHAUSER. Giving a brief summary. Chairman Kerry, Ranking Member Snowe, Members of the Committee, thank you for inviting me here today. I am Robert Tannenhauser, chairman of the board and formerly president and CEO of Business Loan Express, LLC, known as BLX, a national non-bank lender.

BLX is a leading participant in the SBA's loan programs, having made more than 9,000 SBA loans totaling more than $3.6 billion since 1994. BLX has played a critical role in the SBA's 7(a) program, which is specifically designed to help borrowers who cannot otherwise obtain credit. Since 2001, approximately 77 percent of BLX's SBA loans have been made to minorities, women, veterans, and borrowers in low- to moderate-income areas.

Even though SBA lending is inherently higher risk, BLX has a robust performance record. We have consistently maintained loss rates well below SBA industry averages by strong underwriting and collateralizing our loans with real estate. For the past 6 years, BLX has been audited annually by the Farm Credit Administra-

tion. SBA has taken into account the results of those audits in renewing BLX's PLP status.

BLX has no financial incentive to condone fraud and every incentive to avoid it. BLX generally retains at least a 25 percent stake in each loan and remains liable to the SBA for the remaining 75 percent if fraud or mistakes occur in our loan processes.

In January 2007, indictments were unsealed charging five individuals, including a former BLX office employee with fraud in originating SBA guaranteed loans. Last month, that employee—former employee, Pat Harrington—pleaded guilty to one count of conspiracy and one count of perjury. It is an understatement to say that this has been a difficult chapter in BLX's history, and I am personally saddened and disappointed by the misconduct of our former employee. I wish we had become aware of his activities earlier. Our records indicate that Farm Credit Administration reviewed several of these loans going back almost 4 years with no indication to us of fraud. Obviously, such wrongdoings are difficult to detect.

Well before the indictments, a nationally known law firm was engaged to conduct an internal investigation of our Detroit office. BLX also made a business decision to stop originating gas station loans in Detroit and removed Mr. Harrington as head of the office and from loan originations. By September 2006, we had closed the Detroit office and severed our relationship with Mr. Harrington.

BLX is a victim, not a perpetrator, of this fraudulent scheme. When the indictments were announced, before any findings of wrongdoing were made, BLX pledged to reimburse the SBA for any losses incurred as a result of the fraudulent activities by current or former BLX employees. BLX paid more than $8 million to the SBA and placed another $10 million in escrow. BLX has incurred significant losses of its own, writing off $9.8 million on loans that the Government asserts were fraudulent originated by our former employee in Detroit.

BLX is a very different company today than it was when these fraudulent activities began many years ago. We have invested millions of dollars and countless hours enhancing our internal controls.

I would now like to comment on the OIG report, which I believe is fundamentally flawed. The OIG did not itself audit BLX, but rather, relied on audits conducted by the Farm Credit Administration. The OIG report paints an inaccurate picture by excluding the Farm Credit auditors' ultimate findings and conclusions which strongly support the SBA's decision to renew BLX's PLP status. Instead, the OIG simply cited a few subsidiary comments in the Farm Credit audits to support an apparently preconceived conclusion.

Unfortunately, I cannot provide more detail because criminal laws prohibit lenders from disseminating the contents of Farm Credit audits. I urge you to request copies of the audit reports. I am confident that after reviewing them, as well as BLX's written response to the OIG, you will conclude that the OIG report is replete with inaccuracies and inconsistencies.

I appreciate the opportunity to testify today, and I want to state in the strongest terms that BLX is committed to preventing fraud

in the loan process. We welcome engagement with the Congress and our regulators in this endeavor. Thank you.

[The prepared statement of Mr. Tannenhauser follows:]

Testimony of

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

Introduction

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

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

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

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

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

efforts of the hundreds of dedicated BLX employees who do their jobs well and with pride.

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

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

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

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

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

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

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

The SBA has given BLX permission to operate under its Preferred Lenders Program ("PLP") nationwide. The SBA grants PLP status to lenders that have established a highly successful loan record in the market and a thorough understanding of the SBA process. Likewise, to maintain PLP status, a lender must substantially exceed minimum standards, including satisfactory ratings from annual SBA audits conducted by

the Farm Credit Administration. Under the PLP program, the SBA delegates loan approval, closing, and most servicing and liquidation authority to approved lenders like BLX, enabling those lenders to provide better, more efficient service to clients.

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

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

B. BLX's Record of Serving Underprivileged Communities

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

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

- Ethnicity & Gender Research. BLX underwrote a survey on Access to Capital conducted by the US Chamber of Commerce's Statistics & Research Center and its

diversity initiative. The study of more than 1,000 small business owners provides comprehensive funding information and identifies unique financing differences and challenges based on ethnicity and gender.

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

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

C. BLX's Record of Strong Performance

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

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

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

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

II. BLX Renews Its Commitment to Preventing and Remedying Fraud

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

loans, as well as the Huntington National Bank official – have been convicted or pleaded guilty to fraud in connection with loans originated by BLX's former Detroit office. Last month, the former BLX employee, Patrick Harrington, pleaded guilty to one count of conspiracy to originate fraudulent loans and one count of perjury.

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

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

A. BLX Agrees to Make the SBA Whole

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

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

I am here to tell you that while BLX is deeply concerned about the conduct that Mr. Harrington has now admitted, BLX is a victim – not a perpetrator – of Mr. Harrington's fraudulent scheme. It is important to remember that BLX incurs significant losses of its own on the unguaranteed portions of each and every SBA loan that defaults. And looking at the complete picture, in connection with the Detroit office, BLX already has had to write off $9.8 million in losses on loans that the government asserts were fraudulently originated by Mr. Harrington, including $8.7 million on SBA-guaranteed loans. In fact, BLX has been submitting victim impact statements in cases against the

borrowers detailing the company's losses as a result of the fraud, and several of those borrowers have been ordered to pay restitution to BLX. Finally, to the extent that Mr. Harrington's actions jeopardize BLX's PLP status, his scheme cuts to the very heart of one of BLX's most important assets.

C. BLX Enhances Anti-Fraud Procedures

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

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

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

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

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

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

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

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

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

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

III. The OIG Report Is Inaccurate and Incomplete

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

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

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

Conclusion

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

Chairman KERRY. Thank you, Mr. Tannenhauser. I appreciate it. Mr. Wilkinson.

STATEMENT OF ANTHONY R. WILKINSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS, INC., STILLWATER, OKLAHOMA

Mr. WILKINSON. Thank you, Mr. Chairman, Ranking Member Snowe. I appreciate the opportunity to testify today on SBA's lender oversight efforts.

We recognize the benefit of quality lender oversight and support its implementation. Since the introduction of Federal credit reform, our member institutions have witnessed the impact that portfolio performance has on subsidy rates and program fees. We are acutely aware that when individual lenders do not engage in appropriate loan underwriting, servicing, and internal control practices, the results to the program can be detrimental in terms of the future costs to borrowers and lenders. Therefore, it is in my members' individual and collective interests that SBA engages in a sustained, effective lender oversight program. That said, a quality lender oversight program cannot guarantee that it will detect or prevent all fraudulent activities.

In regards to BLX, I would like to just throw out a couple of numbers to put the information today in perspective. Since the start of credit reform, lenders and borrowers have paid in excess of $1 billion in fees more than were necessary to offset the cost of this program. During the time period that Mr. Tannenhauser referenced, over 500,000 loans have been made for something like $61 billion, which leads me to the conclusion that this has been a statistically insignificant event in terms of the entire portfolio.

We applaud Mr. Tannenhauser for his attention to this fraud issue and his willingness to minimize the agency's losses, and it is unfortunate that small business has lost a staunch minority advocate and the industry has lost a corporate partner that has historically supported SBA's goal of reaching underserved markets.

A quality lender oversight program should provide a cost effective, statistically valid means of detecting increased risk in the overall SBA portfolio, as well as in individual lender portfolios. Initially, this is typically accomplished with a properly functioning offsite monitoring program. Upon detection of adverse trends, the oversight program should direct an onsite review of the institution's asset quality and lending practices to validate concerns, provide corrective actions, or issue enforcement direction.

We do not believe the current offsite monitoring program being developed by the SBA will meet its intended objective. The SBA already has access to significant amounts of data relating to historical loan performance, delinquencies, and lender activity. However, it does not appear that this information is routinely utilized as part of an early warning risk assessment system.

The SBA is instead relying upon a Dun and Bradstreet computer program that forecasts a percentage of loans in a lender's portfolio at high, moderate, and low risk of default. Unfortunately, the forecast criteria, as well as the specific loans identified as high-risk are never shared with the lender. The lender is unable to determine whether it agrees with the analysis; and if it does agree, to take appropriate action. Our desire is not to know the precise formula for determining a lender's rating. However, we do expect sufficient detailed information that will help us implement corrective action and reduce the portfolio risk.

In addition, the SBA is requiring the participating lenders to pay for this Dun and Bradstreet program through separate fees. Lenders were not provided sufficient information to determine if they are receiving any value for this cost. Moreover, portfolio performance forecasts by the Dun and Bradstreet model are highly questionable and appear unreliable.

The results of the ongoing offsite analysis should be supplemented with onsite reviews for any participating lenders deemed to be high risk. It is imperative that the onsite activity provides timely feedback and meaningful analysis to the participating banks and the SBA. It is an established fact that the bank and credit union industries already have substantial lender oversight from its respective regulators.

NAGGL believes that before initiating its own onsite lender activities, the SBA should be required to demonstrate that it is adding value to current Federal and State oversight efforts and not just duplicating existing efforts and costs. It would appear reasonable for the SBA to work with the existing regulatory agencies to accomplish its onsite examination objectives and ensure consistent application of examination procedures by regulatory experts to provide safety and soundness testing of SBA portfolios.

Under the current fee structure for the lender oversight program, the SBA has based the monitoring costs on a lender's outstanding guaranteed balance versus a proper risk-based fee structure. SBA's evidence reflects the greatest risk in low-volume lenders and nonfederally regulated lenders. The SBA should reassess its fee structure under a risk-based allocation and not have the most active participants bear the cost of under-performing high-risk lenders.

Mr. Chairman, I would like to congratulate you and Senator Snowe on the introduction of S. 2288, a bill that would significantly improve SBA's lender oversight function without unduly increasing the regulatory burden on lenders. We believe that S. 2288 is a major step forward in improving lender oversight.

Also, the SBA has just published a 35-page proposed rule on lender oversight. The primary focus appears to be enforcement actions and not safety and soundness standards and we will submit a formal letter of comment on the proposed rule at a later date.

Despite the need for adequate lender oversight, the performance of the SBA portfolio has been good. If standardized banking calculations are applied to the SBA loss data, the annual net loss rate in the SBA 7(a) program would be in range of 0.4 to 0.5 percent. And looking at the FDIC Web site this week, their quarterly banking profile shows that in the second quarter of 2007, the conventional bank loss rate was 0.5 percent. Given the high-risk nature of the SBA loans, this loss rate reflects the lending community's desire and ability to effectively minimize the program's taxpayer cost while meeting its public policy objective of making credit available to the small business community.

Mr. Chairman, I would be pleased to answer any questions.

[The prepared statement of Mr. Wilkinson follows:]

"SBA Lender Oversight Hearing"

Testimony before the Senate Committee
On Small Business and Entrepreneurship

November 13, 2007

Submitted by
Anthony R. Wilkinson, President and CEO
National Association of Government Guaranteed Lenders
215 East 9th Avenue
Stillwater, OK 74074

NAGGL Gets It.

Mr. Chairman, Ranking Minority Member Snowe, and members of the Committee, my name is Tony Wilkinson. I am president and chief executive officer of the National Association of Government Guaranteed Lenders (NAGGL), a trade association of approximately 700 banks, credit unions, and non-depository lenders who participate in the Small Business Administration's 7(a) loan guarantee program. NAGGL members generate approximately 80% of the annual SBA 7(a) loan volume.

NAGGL is pleased today to testify on the Small Business Administration's lender oversight efforts. We recognize the benefit of quality lender oversight and support its implementation. Since the introduction of federal credit reform, our member institutions have witnessed the impact that portfolio performance has on subsidy rates and program fees. We are acutely aware that when individual lenders do not engage in appropriate loan underwriting, servicing and internal control practices, the results to the program can be detrimental in terms of the future cost to borrowers and lenders.

More specifically, history shows that the lending community is aware of the need to work with the SBA to police itself. For example, it was the 7(a) industry that raised concerns about the SBA's implementation and management of the LowDoc Program. Why? Since there were no written policies for quite some time after the LowDoc pilot program was implemented, the program invited participation by lenders that did not have sufficient interest in quality lending. In the 1990s, it was NAGGL that raised concerns to SBA and Congress about the practices of the industry's then largest lender. The evidence is clear: lenders and the industry do care about quality lending. Federal credit reform requires us to care because one bad lender can affect the ability of every other lender to lend; one bad lender can substantially increase the costs of other lenders and borrowers

participating in the program. One bad lender can make it impossible for future borrowers to receive capital at the lowest possible cost. Therefore, it is in my members' individual and collective interests that SBA engages in a sustained, effective lender oversight program. That said, a quality lender oversight program cannot guarantee that it will detect or prevent fraudulent activities.

A quality lender oversight program should provide a cost effective, statistically valid means of detecting increased risk in the overall SBA portfolio as well as in individual lenders' portfolios. Initially, this is typically accomplished with a properly functioning offsite monitoring program. Upon detection of adverse trends, the oversight program should direct an onsite review of the institution's asset quality and lending practices to validate concerns, provide corrective actions, or issue enforcement directives. And, in the case of the 7(a) program, which has a public policy purpose, devising an appropriate oversight strategy must also include consideration of how well the public policy goals of the program are being met.

We do not believe the current offsite monitoring program being developed by the SBA will provide a cost effective, statistically valid method for detecting increased risk in the portfolio. The SBA has access to significant amounts of data relating to historical loan performance, delinquencies, and lender activity. However, it does not appear that this information is routinely utilized as part of an early warning risk assessment system. The SBA is relying upon a Dun and Bradstreet computer program that forecasts a percentage of loans in a lender's portfolio at high, moderate, and low risk of default. Unfortunately, the forecast criteria, as well as the specific loans identified as high risk are never shared with the lender. The lender is unable to determine whether it agrees with

the analysis, and if it does agree, take appropriate action. In addition, the SBA is requiring the participating lenders to pay for this Dun and Bradstreet program through separate fees. Lenders were not provided the contract for review to determine the appropriateness of their individual fees, nor are they provided specific loan information to determine if they are receiving any value for their cost. Moreover, portfolio performance forecasts by the Dun and Bradstreet model are highly questionable. Below is a chart which we believe supports our position.

Column A shows the actual 7(a) repurchase rate for the previous 12 months. Column B shows the Dun and Bradstreet projected purchase rate for the next 12 months. Thus far, a consistent trend of projecting higher defaults than actually occur (similar to what was done for years in the 7(a) subsidy rate calculation) is evident. And there is a trend that shows a widening disparity: the actual repurchase rate is going down while the projected repurchase rate is going up. If one compares the 3/31/06 projected rate (2.4%) to the 3/31/07 actual rate (1.8%), and the 6/30/06 projected rate (2.3%) to the 6/30/07 actual rate (1.7%), the SBA and Dun and Bradstreet predicted approximately 25 percent higher defaults than actually occurred.

	A Actual Repurchase Rate Previous 12 Months	B D & B Projected Repurchase Rate Next 12 Months
06/30/2007	1.7% Actual	2.8% Projected
03/31/2007	1.8% Actual	2.8% Projected
12/31/2006	1.9% Actual	2.5% Projected
09/30/2006	1.9% Actual	2.4% Projected
06/30/2006	1.9% Actual	2.3% Projected
03/31/2006	1.9% Actual	2.4% Projected

NAGGL does not believe that the SBA can rely on these inaccurate projected repurchase rates. If that is the case, on top of apparent inability to accurately forecast them, why are participating lenders being forced to pay for the model in the first place? Why are some lenders being asked to pay in excess of $100,000 annually for lender oversight when they get no value from it?

The results of the ongoing offsite analysis should be supplemented with onsite reviews for any participating lenders deemed to be high risk. It is imperative that the onsite activity provides timely feedback and meaningful analysis to the participating banks and the SBA. It is also important that this oversight does not result in duplication of existing oversight activities from other regulatory agencies (and a duplication of the cost already associated with those activities). It is an established fact that the bank and credit union industries already have substantial lender oversight from the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, the Federal Reserve Board, and various state banking regulators. NAGGL believes that before initiating its own onsite lender oversight activities, the SBA should be required to demonstrate that it is adding value to current federal and state oversight efforts and not just duplicating existing efforts. It would appear reasonable for the SBA to work with the existing regulatory agencies to accomplish its onsite examination objectives. A partnership of this nature would ensure consistent application of examination procedures as well as regulatory experts to provide safety and soundness testing of SBA portfolios. We recognize that an inter-regulatory agency partnership will require the commitment and cooperation of several agencies; however, we believe that this type of arrangement is necessary to provide the most cost effective

and meaningful determination of risk. We would hope that the SBA is willing to pursue this avenue prior to arbitrarily requiring that participating lenders bear the cost of additional regulatory examination.

An onsite review of a participating lender's SBA portfolio should focus on underwriting criteria, internal controls, and servicing practices. For example, when a regulatory agency performs a safety and soundness review, the examiner is trained to determine the risk associated with a specific loan based on various categories including a borrower's historical cash flow, capital adequacy, repayment history, debt levels, collateral coverage, and overall industry and economic trends. The examiner utilizes this information to assess the institution's overall risk as well as risk in individual loans. The examiner discusses the results with the lender and gives the institution an opportunity to respond to the issues raised. Under the current onsite review procedures of the SBA, these steps are not occurring. Instead, the SBA auditor focuses more attention on the completeness of the file as opposed to the quality of the asset.

While it is important to ensure that an SBA loan file has sufficient documentation to comply with various SBA regulations, this activity does not provide a reasonable level of lender oversight or an early detection of increased program risk resulting from the activities of an individual participant. It would appear reasonable to assume that documentation compliance is assessed during the repurchase process for an individual loan. SBA's guarantee is a *contingent* guarantee, which means that if a lender fails to fully meet its responsibilities, the SBA can—and does—reduce the amount of the guarantee payment to lenders. In the most egregious cases of imprudent lending, the SBA denies its liability under the guarantee. Therefore, the very nature of the guarantee

relationship serves to assure that lenders comply with the various SBA regulations while engaging in quality lending. Also, the guarantee program is a sharing of risk and not a complete transfer of risk away from the 7(a) lending community. The lenders have an ongoing responsibility to their regulatory oversight group as well as to shareholders to ensure that safe and sound lending practices are maintained.

Mr. Chairman, before proceeding, let me digress a moment to clarify the distinction between credit underwriting and credit scoring. I think it will help illuminate the difference between a banking agency audit and an SBA onsite review. When a borrower asks for a loan, a lender gathers information on the borrower that ranges from information about whether the applicant is current on taxes and utility bills to what tax returns indicate about the applicant's ability to repay the loan. This point is critical: it is the credit underwriting—determining the borrower's ability to repay a loan—that protects a taxpayer. On the other hand, credit scoring looks at a borrower's performance on current obligations—certainly one ingredient in determining the ability to repay—but obviously not a singularly conclusive one. The banking agencies look over the lender's shoulders when they examine loan files to make sure the loan is creditworthy. This is not SBA's focus. Instead, their onsite review is principally a documentation review with less emphasis on the underwriting or loan servicing standards associated with a loan.

The SBA's current lender oversight efforts apply to the largest 350 lenders; however, SBA's own statistics say that it is inactive and active lenders with portfolios under $1 million that pose a significant risk to the 7(a) program. SBA's lender oversight system does nothing to address the problems associated with these lenders' portfolios. The SBA has recently announced a rural development initiative, similar to the LowDoc

Program, to induce even more smaller-volume lenders to participate in the program. NAGGL supports getting more small rural banks in the program; but at the same time, the SBA must assure that these lenders can perform the appropriate credit underwriting and servicing for loans made under this initiative.

Mr. Chairman, I would like to congratulate you and Senator Snowe on the introduction of S. 2288, a bill that would significantly improve SBA's lender oversight function without unduly increasing the regulatory burden on lenders. It directs the SBA to use information that is already available to identify on a real time basis those lenders whose portfolios are exhibiting a form of stress, to determine whether an onsite review is warranted due to such stress, and to work with the lender to address any portfolio problems. This is similar to other regulatory oversight programs conducted by the banking agencies. S. 2288 also requires the SBA to develop outcome criteria by which the effectiveness of the program can be measured. Again, this is an idea NAGGL has long supported. Therefore, we believe that S. 2288 is a major step forward in improving lender oversight.

Despite the need for adequate lender oversight, the performance of the SBA portfolio appears good. With respect to the misperception that 7(a) loans generally have an inordinately high default rate, it should be noted that according to the president's FY 2007 budget submission, the default rate on 7(a) loans made during FY 2007 was projected to be 6.96 percent over the entire 25-year life of the cohort, less an estimated 52% recovery rate, for a net loss rate of 3.34 percent. The annual net loss rate for loans at FDIC-insured banks is reported at 0.5 percent (June 20, 2007, *FDIC Quarterly Bank Profile*). While there appears to be a significant disparity between the loss rates, it

should be noted that this is not an "apples to apples" comparison. The 7(a) loss rate represents the life of the lending pool (loan inception through payment in full or final charge-off) while the commercial loss rate is for one year. If one applies the banking method to SBA loss data, the annual net loss rate in the SBA 7(a) program would be in the 0.40 to 0.50 percent range, a loss rate that is comparable to the conventional lending loss rate.

Credit risk relating to specific small businesses is only one factor when predicting future defaults. The long-term business risk, economic risk and interest risk all contribute to the 7(a) default estimate, while the default rate for commercial banks is reduced as a result of the short-term nature of the loans. This further illustrates the need for performance standards that appropriately measure risk and provide a meaningful comparison to commercial bank and regulatory standards.

Finally Mr. Chairman, the SBA has just published a 35-page proposed rule on lender oversight. NAGGL will submit a formal letter of comment on the proposed rule at a later date. The primary focus of the regulations is to establish "Grounds for Enforcement Actions", establish types of "Enforcement Actions" and describe "Enforcement Procedures". It does not address issues of loan underwriting and servicing. The proposed rule does create capital requirements for non-federally regulated lenders and allows the SBA to take enforcement action against lenders that the agency determines—at times subjectively in the proposed rule—to be violating agency rules and procedures. This is only one piece of an effective lender oversight puzzle.

Mr. Chairman, I would be pleased to answer any questions.

Chairman KERRY. Thank you, Mr. Wilkinson. That was important testimony and we appreciate it.

Mr. Baird.

STATEMENT OF JAMES BAIRD, EXECUTIVE DIRECTOR, BAY AREA DEVELOPMENT COMPANY, AND VICE CHAIRMAN, LEGISLATIVE AFFAIRS COMMITTEE, NATIONAL ASSOCIATION OF DEVELOPMENT COMPANIES, WALNUT CREEK, CALIFORNIA

Mr. BAIRD. Chairman Kerry, Ranking Member Snowe, thank you for the opportunity to appear before you to talk about this important subject. I am Jim Baird, the executive director of Bay Area Employment and Development Company of Walnut Creek, California, and the vice chair of Legislative Affairs for NADCO, the National Association of Development Companies for Legislative Affairs.

Our industry has a significant and ongoing interest in maintaining the highest standards of industry oversight and loan program performance. The purpose of my remarks today are not to tear down the efforts that SBA has made to date, but to try to add comments to strengthen the oversight program of the SBA.

Obviously, over the last 4 years, there have been dramatic program changes and dramatic growth in the 504 program. This has been growth in both number of loans, dollars of loans, and economic development impacts of the program. But this growth magnifies the importance and also the danger of growing a program without optimal oversight in place.

The 504 oversight program has evolved and is evolving, but it is still lacking in several important ways. For example, the Office of Credit Risk Management reviews the credit and eligibility of all the loans that they audit in their routine onsite audits. However, they review these factors independent of one another. I can't overstate the importance of taking a look at the whole, the adequacy of the overall project structure. To me, it is analogous to analyzing all the separate parts of a car without taking the time to ask if the car runs.

In PCLP, there are also significant lost oversight opportunities. PCLP has grown dramatically, but it has grown in only a few markets of the country and only by a small portion of CDCs participating in the program. There are rampant rumors of PCLP lenders doing 504 loans that are not properly underwritten. PCLP lenders are routinely providing 100-percent loan-to-value financing without any reasonable basis for doing so and rumored to be and obtaining SBA approval with incomplete information, incomplete analysis, and incomplete underwriting.

So how do we improve PCLP oversight? I would suggest we take a look at some of the processes in place at the Sacramento Loan Processing Center. They have been operating in an environment of substantially increasing volume while having substantially decreasing staff. They have developed a very efficient method of loan program overview called the Abridged Submission Method, or ASM.

In this process, CDCs submit limited packages rather than whole packages, but are required on 48 hours' notice and on a random basis to submit complete packages to Sacramento for review and audit. This is a proactive, real-time program that heads off prob-

lems before they occur, and lenders never know which loans are going to be chosen, so they are always acting diligent in order to preserve their status, whether it is ALP or ASM, or whatever their CDC status is.

However, the chronic staff shortages that have occurred in the Sacramento Loan Processing Center have caused, even for ALP lenders, the ASM program to be suspended. Somehow, we need to find the resources to fully staff the Sacramento Loan Processing Center. We need to fully staff the center so that it can reinstate the ASM program and so that it can, for the first time, apply the ASM audit process to PCLP lenders.

Comments have already been made on the D&B model, which in my opinion, looking at the big picture, represents an agency attempt to use modern technology and apply it to portfolio management, which is a good thing. It is a good direction, but there are issues with it, and we have already gone through. I would suffice it to say that we need disclosure and daylight, number one, to see if the model actually works; and number two, to allow lenders and CDCs to put the data to productive use.

We need the passage of S. 1256 and S. 2288. After 27 years, for the first time, S. 1256 defines the structure and expectations for the 504 program and its participants, and it is a critical foundation to establish proper 504 loan oversight. S. 2288, as introduced by the Ranking Minority Member and Chair, will also dramatically improve loan oversight. It also authorizes oversight fees, and we are concerned about the effect of those fees, particularly on small and rural CDCs. We would like to work with the Committee on this provision, but in our opinion, both bills need to be adopted in this session to strengthen oversight and NADCO endorses both bills.

The newly proposed loan oversight regulation is something that we are going to need some time to go through, given its recent introduction and its length, frankly. Our preliminary concerns are that it seems to identify the D&B system as the sole system of CDC initial oversight and it also requires compliance of CDC audits, with OMB Circular A–133, which would have substantial cost effects for all CDCs, and again, particularly small and rural CDCs. We believe it would drive many of them out of the program. The regulatory finding of no significant impact on CDCs or on small business is, frankly, in error.

In summary, there is currently no liquidation or default crisis whatsoever in the 504 program. We are here today to try to offer suggestions to improve oversight and enforcement, and we hope to continue to work closely with the Committee and the agency to obtain the best possible practices.

I would like to thank the Chairman and the Ranking Minority Member for holding this hearing and we would be happy to answer any questions you have.

[The prepared statement of Mr. Baird follows w/attachment:]

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program

Lender Oversight

Submitted to the

COMMITTEE ON SMALL BUSINESS AND ENTREPRENIURSHIP

UNITED STATES SENATE

by

Mr. James Baird
Executive Director

Bay Area Development Company
Walnut Creek, California

And

Vice Chairman for Legislative Affairs
NADCO

November 13, 2007

I would like to thank Chairman Kerry, Ranking Member Snowe and members of the committee for the opportunity to speak with you today on this important subject. I am Jim Baird, Executive Director of Bay Area Development Company. I also serve as NADCO Vice-Chair for Legislative Affairs. I would like to submit written comments for the record as well as provide a summary of my comments today on this important issue.

Our industry, as represented by NADCO, has a significant and ongoing interest in maintaining the highest standards of industry oversight and loan program performance. We have previously communicated some of these thoughts to representatives of the agency and to Congress. The association's May 23 letter to the agency on this issue is attached to my testimony for inclusion in the record.

Background

The agency's program of 504 lender and loan oversight is an evolving one. Over the last several years, the responsibility of implementing 504 lender oversight has moved from the District Offices to the Office of Lender oversight (now the Office of Credit Risk Management or OCRM). In addition, after an initial and limited round of CDC audits several years ago, the agency revamped its CDC audit methodology and is currently in the process of implementing a second round of audits on a much larger portion of CDCs.

The past and continuing evolution of 504 loan oversight takes on a critical importance as a result of other major recent changes in the 504 program. Even before the loan oversight function began to implement the changes above, the 504 program underwent the major changes of:

> The implementation of statewide competition for all CDCs (504 lenders) throughout the country;
>
> The relocation of SBA's 504 loan processing from the 70 District Offices to a Centralized Loan Processing Center in Sacramento, California;
>
> A dramatic expansion of PCLP program use by a small percentage of CDCs typically located in the highly competitive urban markets of only a few states; and
>
> The agency supporting the expansion of CDCs into any state contiguous to the CDC's home state, and the further expansion of

CDC territory into neighboring states under the auspices of 'Local Economic Areas'.

These changes have had a dramatic effect on 504 program delivery in most states and markets throughout the country, and many of these changes have been highly positive.

For example, in the four year period between FY2003 and FY2007, the 504 program grew dramatically in terms of number of loans (55%), dollars of assistance provided (100%), assistance to rural areas (65%), assistance to women and minority owned companies (78%), and in terms of jobs created and retained (51%). In short these changes spurred a huge and unprecedented level of industry growth in lending in all sectors of 504 operation and in their economic development impacts.

The Importance of Optimal Oversight

This huge increase that 504 lending has experienced over the last several years has had extremely substantial positive effects to date, not only on the vast numbers of additional small businesses assisted, but also on the economies of their communities. While these results are significant and ongoing, they also magnify the importance and the potential danger of growing a program at such a rate, with oversight that is anything less than optimal. My purpose today is not to criticize or tear down what has been done by the Agency. Rather it is to suggest additional changes that I and our industry believe would substantially strengthen the effectiveness of the agency's oversight program to insure the continuing growth 504 financing on small businesses and the substantial impacts on their communities.

Needed Improvements in Program Oversight

SBA 504 program oversight has evolved, but is still lacking in several important ways. Although the reviews do cover a myriad of credit and eligibility issues on a free standing basis, the most glaring omission is the failure to review or provide a finding on the adequacy of the overall structure of the funding.

For example, while the "504 File Review" checklist asks questions about ability to repay, management, capitalization, and collateral, no where on the form is there a question or place for a finding as to the overall reasonableness and/or adequacy of the overall structure of the project in view of all of the facets of the credit. To me this is analogous to analyzing

all of the separate systems in a car, without asking or ever determining if the car actually runs.

The role of the 504 program is to provide growing small companies with credit in amounts and on terms that the private sector alone would not. To do this properly, the underwriting and structuring of each financing must be done in a manner which balances the interests of the SBA with the needs of the small business concern and the community. This is absolutely critical to performing the proper role of the CDC and to maintaining the impact, quality and the integrity of the 504 program.

This issue has major implications on the effectiveness of the current OCRM audit process. It is very positive that CDC reviews are now being actively done on a prioritized basis by competent OCRM representatives. However, failure to examine the whole causes the process to miss critical opportunities to bolster program quality.

Gaps in PCLP Loan Oversight

In the PCLP program, a rapidly growing portion of SBA's overall 504 portfolio, the lost opportunities for loan quality control are also substantial. In several of the most competitive markets of the country, and perhaps particularly in California, it is common knowledge that some PCLP lenders are:

1. Doing 504 loans that are not properly underwritten according to established SBA loan regulations and guidelines;
2. Routinely providing up to 100% financing without any reasonable basis of doing so, which is adverse to the Congressional intent for the 504 program; and
3. Have even been reported to SBA for financing projects that are not eligible according to SBA regulation and policy, specifically in the area of environmentally impaired projects.

Unfortunately, the effect of this is not limited to one or two CDCS and SBA's field audits have, to the best of my knowledge, either failed to address these situations, or happen too long after a loan is made to be useful in this process. When a CDC's zeal to compete in the marketplace results in violating SBA rules and policy, other CDCs are then forced to either meet the lower standards or lose project after project. In the absence of needed additional oversight, this produces a competitive tide that is lowering all of the boats of credit quality and program integrity in some of the most active markets in our industry.

The Sacramento Loan Processing Center

In attempting to deal with ever increasing 504 loan volume with very limited staff, the SBA Sacramento Loan Processing Center (SLPC) has devised a number of efficiency mechanisms that save staff time, while continuing to insure loan quality. For non-PCLP lenders with good track records and portfolio performance, SLPC allows a limited submission of documents in a loan submission, called the Abridged Submission Method, or ASM. In exchange, it is Sacramento's goal to audit 10% of the files submitted through ASM. They do this by requiring the CDC to ship a complete package for review on 48 hours notice. Any ASM-approved CDCs caught with incomplete or ineligible applicants are suspended from ASM.

The ASM audit process utilized by the SLPC needs to be adopted for PCLP loans. Broader utilization of this efficient and low cost program would send a very strong message to PCLP lenders, who would not want to risk their ability to participate in PCLP for a single loan. This action would filter down to all CDCs, so that loan making quality would improve, and the playing field of the marketplace would be made more level.

How Much Can Be Done With How Little?

As mentioned above, the SLPC has utilized many techniques to try to get the absolute most production out of the extremely limited number of processing loan staff. However, in the opinion of the industry, the combination of the extremely limited staff positions, the major constraints in compensating staff to incent retention, and the restrictions and red tape now in place in filling critical positions that have become vacant, has pushed the Center beyond the breaking point.

A result of this staff shortage that has the most detrimental implications on lender oversight is that, in order to try to maintain loan turn-around goals, the Center has been forced to put off doing ASM audits for a number of months now.

A second result is that even though loan approvals (authorizations) can be issued in as little as five days, it now takes approximately 2 weeks to get the changes and clearances for environmental and appraisal reviews needed to enable the project to be funded. So while the nominal goal of issuing a loan decision is met, the small business concern must still often wait weeks in order to obtain the other clearances needed to fund their loan.

NADCO commends the work of the Sacramento Loan Processing Center and their staff, but believes the Center needs to substantially expand its authorized staff (and rapidly fill open positions) to meet the rapidly growing increase in 504 loan packages submitted to it, as well as re-implement ASM reviews for non-PCLP CDCs. Clearly, more SBA staff would be required to expand ASM to include PCLP lenders as well.

The Value of Predictive Loan Scores

The Agency has been working to introduce systematic and modern technology to portfolio management, an example of which is the program provided under contract with Dunn & Bradstreet. We believe that while the intent of this program was good, the value of the data is in question. Our experience with the D&B program is that it has significant problems, including:

1. From what we understand, the core of the D&B model is based on credit scores of the applicant company and loan guarantors. While this information could potentially be useful, it is redundant with current underwriting work, in that CDCs already pull credit reports and scores of all borrowers and guarantors, and do a much more thorough and fact-based underwriting of the applicant small business concern.

2. Other than an overall score and an aggregate counting of high, medium and low risk loans in a CDC portfolio, the data is useless to a CDC as D&B considers the information "confidential". D & B contractually restricts SBA OCRM from identifying to a CDC its borrowers that the model deems a high risk. This is a major weakness of this entire process, because it makes it impossible for a CDC to put the model results to practical use by working with potentially problem borrowers and using the information to modify their underwriting standards.

3. Even in aggregating a CDC's loan portfolio results, the scores or predictions seem questionable. For example, in the case of our CDC, and according to SBA data, our currency rate including loan deferrals is currently over 99%. Our liquidation rate 0.5%, or one liquidation for every 200 loans over the life of the loans. We service a portfolio of almost 800 loans, and last year had no liquidations at all. The D&B model indicates that 2.1% of our portfolio is comprised of higher risk loans, and 14.5% are "moderate risk" Based on my discussions with a number of my

counterparts in the industry, such "disconnects" with actual portfolio history are typically even larger for many CDCs, with regard to the model output.

4. Even if this predictive model is right, the model formulation includes no input whatsoever about how the CDC structured the overall project so as to hedge perceived higher risk. So CDC actions, such as requiring higher down payments or additional project collateral, are not even factored into the D & B model.

   One of the greatest values the SBA 504 program brings to the marketplace is to make capital available that the private sector alone won't do. CDCs often do this by balancing the extra risks in a particular financing by taking additional down payments, extra collateral, or other credit enhancements. This is the art of deal making in small business economic development, and these factors aren't even taken into consideration in the model at all.

In summary, the D&B system is a model, which in finance parlance is nothing more than a projection. In the world of small business finance, we discount financial projection deals. There needs to be significantly more openness and disclosure identifying a CDC's perceived weaker borrowers so that we can determine if the model is accurate. Only then can CDCs can put this information to productive use in working with higher risk borrowers and thus improving their portfolio performance and reducing potential defaults and loan losses for SBA.

The Current Pending Legislation

NADCO appreciates all of the hard work of the Committee that has gone into creating S.1256, the Small Business Capital Access bill. In short, we believe that this bill, and the recently introduced S.2288, is exactly the one-two punch that is needed in statute to address many oversight and operational issues of the 504 program that we have discussed today.

NADCO believes that S. 2288, introduced by Senators Snowe and Kerry, proposes a common sense approach to lender oversight by the SBA. The portfolio performance information that it requires SBA to collect and evaluate on a quarterly basis should be readily available to the agency. SBA's evaluation of a CDC's portfolio on a real time basis will provide a much better basis for evaluating and ranking CDC loan making performance than the current system employed by SBA. We are pleased to support this approach and look forward to working with the Committee

on any fine tuning of it that may be required. We are also pleased to support the executive compensation section of the bill, which we believe will help CDC boards of directors have a better understanding of their fiduciary responsibilities in overseeing the operation of a non-profit CDC.

We urge the Committee to move S.1256, and S. 2288 forward, as these are both critical pieces of legislation that will establish the foundation and strengthen the framework for enhanced SBA oversight and CDC operation.

Proposed New Lender Oversight SBA Regulation

SBA has just issued for comment a comprehensive new Federal Regulation governing lender oversight that will significantly impact all CDCs. Our industry will need some time to provide the Committee and agency with complete comments. Our initial review indicates several problems.

This Regulation appears to make the risk rating system created by the D & B database the sole system for CDC reviews. Our industry has concerns about this approach, as previously outlined and would not likely endorse it as the sole process of evaluation.

SBA proposes to require compliance by all CDCs with the Single Audit Act and OMB Circular A-133. Our preliminary inquiries indicate that the effect of this rule, if adopted, would be staggering for many CDCs in our industry. Many CPA firms do not even offer A-133 audits, Our own CPA indicated that our audit costs would double or triple. This could cause a severe increase in costs for numerous small CDCs that could drive them out of the 504 loan program. Moreover, such increased costs would almost certainly reduce economic development delivered by our CDC industry in many areas of our country.

Additionally, SBA has included in the preamble of the proposed Regulation its CDC compliance cost estimates and audit cost estimates for changes required by our industry. SBA has also certified that there will be no significant impact on small entities, either CDCs or small businesses. We believe these estimates and the certification to be substantially in error.

The Impact Economic of the 504 Program

SBA programs have recently been criticized for failing to measure the full economic impacts of their loan programs. Because of our own concern about this, last year NADCO commissioned a study of 504's economic

impact by Applied Development Economics (California State University, Chico). This study is currently being completed. In a final draft report to NADCO's board, the report found that within 2 years of receiving 504 loans, seventy-seven percent (77%) of the businesses increased their revenues and sixty-two percent (62%) reported job growth. During the two year study period (2003-2005), the 504 program supported a direct net growth of 54,000 jobs, and the economic multiplier effect added another 66,000 jobs. The total increased business activity and employment also generated an increase in federal taxes and other revenue of $1.75 billion per year, and state and local taxes and revenues of an additional $2.2 billion. For the federal revenue alone, this represents a 23% return for every dollar of 504 loans. When including state and local revenues, the return on investment increases to $94.00 per dollar of program cost.

NADCO will be furnishing copies to all Members of the Committee within the next few weeks, as the report is finalized and published. We are gratified that our contention that the creation of SBA's 504 program by Congress, and it's implementation by the SBA and CDCs has been found to have major economic effects in communities throughout the country. It is clear that 504 is, in fact, one of the most cost effective expenditures made by the entire Federal government, and certainly the most efficient economic development loan guaranty program in the government.

Summary

In closing, I am here today representing NADCO and the CDC industry. Currently, there is neither a loan liquidation nor loan default crisis in our industry. I am offering these comments with the hope that the adoption of our suggested changes will further improve the loan oversight of our industry, and thereby improve loan making and 504 program performance in the future.

We hope that we can continue to work closely with your Committee and with the SBA to insure that our industry operates according to the best practices and highest standards. In doing so, we will continue to assist more and more companies in creating new jobs within their communities.

I thank Chairman Kerry, Ranking Member Snowe and Members of the Committee for your work on the Small Business Capital Access bill and your steadfast and tireless work for the good of America's small businesses and the economic development of their communities.

May 23, 2007

The Honorable Steven Preston, Administrator
U. S. Small Business Administration
409 Third Street, SW
Washington, D. C. 20416

Dear Administrator Preston:

SBA and the CDC industry have experienced unprecedented change with the centralization of 504 loan processing in Sacramento, the advent of statewide and even multi-state competition, and significant growth in 504 loan volume.

While these changes have been beneficial to small businesses throughout the country by providing more companies with long term capital, these changes have also caused a dramatic increase in competitive pressures not only between and among non-profit CDCs, but also from our bank and non-bank lending partners.

We are concerned that these pressures are leading to practices that are not aligned with the statutory and regulatory intent of the program, and they have raised questions and concerns regarding the appropriate role of CDCs in the marketplace, and also federal oversight in ensuring regulatory compliance for the long term health of SBA 504 lending. We believe the vast majority of CDCs are operating well within current federal regulations. However, we are concerned that a relatively few organizations may need closer review by SBA. And, the recent Newsday article just serves to highlight one issue that needs to be addressed.

For several years NADCO has been discussing internally these issues and practices in order to determine what, if any, course of action should be taken. These discussions culminated at our recent Board of Directors meeting in Monterey with a Unanimous Resolution of the Board to communicate our concerns to the Agency regarding compliance with SBA regulations and procedures, particularly in the areas of determination of loan eligibility, insuring adequate credit quality, enforcing and even measuring standards of non-504 community reinvestment, and in adherence to ethical non-profit governance standards.

NADCO has been supportive of the significant progress SBA has made in establishing portfolio analysis systems, new SBA lender reviews by the Office of Lender Oversight and other CDC performance analysis improvements. Our concerns are not relative to these very positive changes. Again, NADCO continues to believe that there is near universal compliance with federal regulations under the program, but we are concerned that a few instances of possible non-compliance need to be addressed.

Adherence to SBA Rules in the Approval and Funding Process:
Current lender oversight is focused on the health and currency of CDC loan portfolios. However, NADCO is concerned that SBA regulations and policies regarding project eligibility, environmental review, appraisal practices and loan documentation, especially with, but not limited to PCLP lenders, are not always being adhered to by all CDCs. NADCO is aware of and is supportive of the recent redesign and redeployment of the OLO audits of CDCs. In addition, we recommend that the Agency implement an ASM-like review process for 504 loans submitted under the PCLP program.

Upholding Consistent Credit Quality:
NADCO realizes that credit quality is often in the eyes of the beholder and can change with market conditions. However, given its size and number of lenders, our industry is vulnerable to the "Tragedy of the Commons," in that questionable lending practices on the part of only a few CDCs could raise the cost of the program for all small business borrowers and CDCs.

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The Honorable Steven Preston, Administrator
U. S. Small Business Administration

Examples that cause our concerns include that: "stated income" first mortgage loans now being promoted by some lenders; that the largest secondary market lender in the 504 program recently expressed concern about declining 504 credit quality; and that we have received anecdotal reports from CDCs in some areas of the field regarding irregular and noncompliant lending practices. NADCO recommends that in addition to a renewed OLO loan review process that examines credit policies and quality, the ASM type of review for PCLP loans be implemented which would have credit quality as a review criteria.

SBA Regulations regarding "Reinvestment":
In 2001, SBA adopted regulations that require net income generated by CDCs be used for appropriate operating reserves and/or reinvested into other economic development activities to benefit the communities they serve. NADCO supports effective enforcement of this regulation. A major difference between CDCs and for-profit lenders is that for-profit lenders return their funds to investors, while it is the CDC's responsibility to return excess funds to the community to foster economic development. NADCO recommends that the Agency annually compile and report annually on the non-504 economic development data that is provided to the Agency in each CDCs Annual Report to fully capture the impact of our industry.

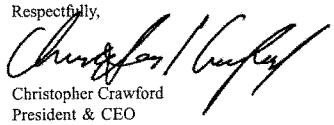
Corporate Governance of Non-Profits and IRS Regulations:
CDCs are non-profit corporations and must act as such. Most CDCs are economic development corporations, not foundations, and operate under Section 501 C(4) of the IRS code. NADCO believes SBA should not promote policies or make decisions that dilute the non-profit economic development mission of CDCs or blur the lines between for-profit and non-profit delivery systems. Additionally, SBA should not allow CDCs to operate outside of ethical lines established by either SBA or by the IRS. SBA and IRS already have significant rules and regulations in place prohibiting "self-dealing" by CDCs and do not need new rules on this subject. NADCO believes SBA should refer any CDC activities that appear to be in conflict with the appropriate non-profit mission of a CDC, including the appearance of excessive personal gain, to the appropriate regulatory authorities.

We do not take lightly discussing the above concerns and suggestions with the Agency. We believe what is called for is assurance of full compliance with Agency rules and regulations currently on the books.

NADCO welcomes the opportunity to work with SBA to provide relevant and consistent guidance regarding appropriate corporate governance for non-profits to comply not only with SBA regulations, but also with "best practices" in the non-profit sector.

The CDC industry and the 504 program deliver significant and critical capital to America's small businesses and we are committed to a high level of performance. We know SBA shares in that commitment. We are dedicated to ensuring that all program participants meet the highest ethical, operational and credit standards. We appreciate your attention to these issues and look forward to a continuing strong relationship with our SBA lending partner. We would like the opportunity to meet with you to discuss the substance of this letter.

Respectfully,



Christopher Crawford
President & CEO

CC: Mr. Michael Hager
Associate Deputy for Capital Access

Chairman KERRY. Thank you, Mr. Baird. We certainly appreciate the testimony and the observation, obviously, that you think that the program is fundamentally sound and not in any kind of liquidation crisis, and I think that is very important news for people to know and understand.

Mr. Wilkinson, I want to cut to the sort of heart of this thing, in a way, if we can a little bit. I think your observation about the default rate relative to the total portfolio measured against the commercial industry is an important one. So let me ask you sort of a summary question, in a sense, about that. Are you satisfied that the procedures in place within the SBA itself and/or the lender structure are sufficient to protect the taxpayer dollar with respect to these loans?

Mr. WILKINSON. Well, one of the benefits that we have in the——

Chairman KERRY. You gave some recommendations. Maybe you want to highlight the most important ones that would either guarantee that, if you don't, or——

Mr. WILKINSON. We have the benefit in the 7(a) program in that almost all of our members are regulated institutions who have to deal with OCC, FDIC, NCUA, so they already have systems in place for their entire institutions. So that is a benefit that we get in the 7(a) program.

Chairman KERRY. How do you feel—what about the non-bank lenders?

Mr. WILKINSON. Not having been through each of their institutions, that would be a tough call, but it does look like that could be where the SBA is trying to put in place some of the regulations that we as bankers have been subjected to for quite some time.

Chairman KERRY. Is it your judgment that the program would be advantaged by having some additional oversight in that regard? I mean, you have heard the testimony today. You have obviously followed this issue. What is your judgment as to procedures already in place?

Mr. WILKINSON. Again, having gone through a good part of my career in the commercial banking world, when we get an onsite review from a bank examiner, it is a very detailed loan-specific report that is also a management tool, so that we get an independent look at the loans and they come through and really make a judgment on the asset quality and it puts us in a position to then take actions to correct what they might see as a deficiency that we hadn't seen before. So it is a very useful tool and that is not something we get with the Dun and Bradstreet model that gives us a score that we don't know how it was derived, or what it means, and it does not provide a management tool, yet we get the privilege of paying for it.

Chairman KERRY. But specifically with respect to the SBA, your written testimony says that in the current onsite review process, the SBA is essentially looking for the completeness of the file——

Mr. WILKINSON. The bulk of the——

Chairman KERRY [continuing]. Not for the——

Mr. WILKINSON. Quality of the asset.

Chairman KERRY [continuing]. The quality of the asset.

Mr. WILKINSON. That would be correct. The bulk of the onsite review——

Chairman KERRY. Is that a problem?

Mr. WILKINSON. Well, it is——

Chairman KERRY. I mean, is that the extent of SBA's job? Does the other fall to somebody else? Are we missing something? Are we going down the wrong track here?

Mr. WILKINSON. Well, we would prefer to see more review of the asset. Is it a quality asset? What problems do you see, as opposed to, do we have this certain form in the file? I mean, that is something that if there is documentation missing, should the loan ever go into default, that SBA would say, hey, you didn't get a mortgage. You didn't get a UCC. You caused us harm. We will repair the guarantee.

Chairman KERRY. And you also believe—I think you asserted that there ought to be better coordination between the SBA oversight and the other oversight entities?

Mr. WILKINSON. Absolutely. The bank examiners are already in the bulk of 7(a) lenders. We would like to see the SBA work with the agencies and perhaps come up with a cooperative way that perhaps the banking agencies could expand their reviews to cover what SBA would need.

Chairman KERRY. Mr. Tannenhauser, I appreciate your testimony. I know that BLX and the SBA both consider themselves essentially to have been victims of a fraud here, and obviously, you were in the sense that one of your employees took a flyer. But the question is, where do you believe—what judgment do you make about the company's own sort of processes? You have spent a lot of money, and you have talked about the things you have done to try to correct that. Were there some signs that you believe that BLX should have picked up on [such] as $28 million in repurchases of loans originating out of one branch, all for the same kind of industry, i.e., gas stations? Was there something here that you think might have been done more effectively, or do you just think this was so hard to peg that somehow it escaped scrutiny?

Mr. TANNENHAUSER. Well, Senator, the issue of the performance in the Detroit office is something that we had looked at early on, and they did specialize in making loans to borrowers in the gas station/convenience store industry, and primarily these borrowers were of Middle Eastern descent. We looked at the performance of these loans and especially we were concerned after 9/11. Was there any impact as a result of that? And we did monitor the performance pretty clearly. And as a result of that, we did shut down the gas station operations well before any indication of fraud or wrongdoing came to light.

Also, prior to that, we conducted a—had an independent investigation of the Detroit office, which we utilized in making our decisions. We also removed Mr. Harrington as head of the office and from loan originations.

Chairman KERRY. What prompted that? What was the——

Mr. TANNENHAUSER. That was strictly loan performance. We historically do close down offices and terminate business development officers on a performance basis, again, with no indication of fraud, but we are in business to make good loans and if people are giving us loans that don't perform well, that doesn't serve us very well, nor the program.

Chairman KERRY. But you nevertheless kept him on?

Mr. TANNENHAUSER. We kept him on—well, he had a contract and there was no reason under his contract to terminate him, but we did keep him on in a role which took him out of the loan origination process.

Chairman KERRY. Does BLX monitor the performance of loans by branch?

Mr. TANNENHAUSER. Yes, we do. We monitor it by branch. We monitor it by underwriter. We monitor it by closer. We monitor it by referral sources. And, in fact, we keep a blacklist of referral sources that we no longer do business with, some of which were involved in this fraud.

Chairman KERRY. So in other words, you break them out, your loans from other loans, such as USDA and other non-Government guaranteed loans?

Mr. TANNENHAUSER. Yes. Well, we slice and dice in every possible way we can. We have been dedicated to process improving since 2000——

Chairman KERRY. Were the SBA loans the bulk of the Troy office loans?

Mr. TANNENHAUSER. Yes, they were, but there were conventional loans, also, which I believe were alleged to be involved in the fraud and which we take the full loss.

Chairman KERRY. When did BLX first notice that they were one-industry focused?

Mr. TANNENHAUSER. We knew that right away. The Troy office——

Chairman KERRY. Did you also know they were linked to one specific employee?

Mr. TANNENHAUSER. Well, he was head of the office. The Troy office came to us as a merger. BLX is really an amalgamation of four different companies and the Troy office came to us in a merger of one of these companies that we integrated and their primary focus was gas station/c-store loans. Mr. Harrington was really the rain maker for that office.

Chairman KERRY. With respect to the settlement agreement between you and the SBA, it requires you, number one, to cover any losses to the SBA related to the Troy, Michigan fraud, and two, to repurchase the guaranteed portion of BLX loans that default after being sold in the secondary market if they are related to the fraud scheme. So you have to repurchase——

Mr. TANNENHAUSER. No, actually, I believe it requires us to repurchase any loans that default after March 6 in the secondary market.

Chairman KERRY. So in effect, was this obligation an obligation that you assumed under the law, or was it an obligation that was required of you as part of the settlement with the SBA itself?

Mr. TANNENHAUSER. No, this was not required in the law. This was negotiated in connection with the settlement agreement.

Chairman KERRY. Now, initially, when the fraud was first discovered, BLX hired a law firm to look into the lending of that branch. What were the findings of that and what prompted you to do that?

Mr. TANNENHAUSER. Well, the independent investigation by this law firm occurred prior to any indication of fraud. The reason we

did that is there were several—we had been foreclosing on several loans and several of the borrowers had, over the course of, I think, 2 or 3 years, several of the borrowers had put in counter-claims alleging wrongdoing on the part of Mr. Harrington. So we engaged a nationally known law firm to conduct an independent investigation of the office.

Chairman KERRY. Did they find at that point any fraudulence in those loans?

Mr. TANNENHAUSER. No, they didn't. They found no evidence of wrongdoing. In fact, in the lawsuits, they were disposed of with no finding of wrongdoing, either. But that did not stop us from shutting down the Detroit gas station operations because of performance.

Chairman KERRY. What did you see that caused you to move in and to shut it down? What was it that you saw?

Mr. TANNENHAUSER. Well, we do gas station/convenience store loans all over the country and the performance of the loans from the Detroit office was well below the performance levels we had been seeing elsewhere, so——

Chairman KERRY. So this was a performance-related return on investment decision?

Mr. TANNENHAUSER. That is correct. I mean, I believe as late as December 2005, we were under the impression that Mr. Harrington was a witness on behalf of the prosecution investigating certain of the loans, not a target of the investigation.

Chairman KERRY. Now, here you are. What is the total business that you have been doing with the SBA?

Mr. TANNENHAUSER. We have done over $3.6 billion worth of loans.

Chairman KERRY. And what percentage of your business is that?

Mr. TANNENHAUSER. I am sorry?

Chairman KERRY. Of the overall business you do.

Mr. TANNENHAUSER. Oh, that is the bulk of the business, although lately we have been moving more toward a conventional loan product, and that is becoming the majority of our——

Chairman KERRY. Now, here you are, sort of an important player in a small family of—this will be my last question; I just want to get to you, Senator Snowe—you have been the key player in this effort and this is an aberration, according to you and other folks. So the question I think looms large, why have you effectively said you are going to get out of the 7(a) business?

Mr. TANNENHAUSER. The problem, Senator, is really the confluence of several events over this past year which have really made it extremely expensive for us to remain in the business. One of the events is obviously the impact of the Detroit indictments and the plea, the cost of us complying with the March 6 agreement with the SBA, the delay in our ability to securitize our SBA unguaranteed portions, which we didn't get permission until the end of August, and of course as you are obviously aware, the capital markets disintegrated by then, so we couldn't get those off. Our obligation to repurchase loans, which we will continue even if we are in the business or out of the business, creates a situation where we keep these loans on our balance sheet now at the highest possible cost of funds to us. We are not a bank, so we have to borrow

to make loans. The delay in selling the guaranteed portion of the loans until after reviews by Deloitte and others keeps these loans on our balance sheet longer. Again, we are paying the highest possible rate that we can. And, of course, the increased cost of credit to us as a lender that needs to access the credit markets have all really caused us to think about scaling down, at least temporarily, our operations in the SBA business.

We regret having to do this because we are dedicated to serving this community and we have been servicing minority borrowers throughout our existence, and I think we are one of the larger members——

Chairman KERRY. Well, we are certainly very sensitive to that and we certainly want to acknowledge that. I think there is a component of this that if this is a narrow and singular individual kind of event, one hates to see an entire operation diminished as a consequence of that and we ought to try to be smart about how we go forward with that.

Let me cede to Senator Snowe.

Senator SNOWE. Thank you, Mr. Chairman, and I will just ask a few questions. Mr. Tannenhauser, just to follow up, I notice in your testimony that you felt that the Inspector General's report was inaccurate and incomplete. Am I right in saying that?

Mr. TANNENHAUSER. Yes, that is what I testified to.

Senator SNOWE. OK. You raised your eyebrows and I thought maybe——

Mr. TANNENHAUSER. No, no. That is correct.

Senator SNOWE. And because they excluded the Farm Credit Administration's analysis, I gather, of your operation, as well?

Mr. TANNENHAUSER. Yes, and——

Senator SNOWE. And also obviously for the confidential information that has been redacted from the report, and we understand all that. But in the IG's report, it did indicate that there were recommendations to not renew the preferred lender status for BLX.

Mr. TANNENHAUSER. Again——

Senator SNOWE. So it wasn't an indiscriminate analysis, I don't think, from that standpoint.

Mr. TANNENHAUSER. If I may, Senator, again, this is one of the issues that I take with the report as far as the inaccuracy and the incomplete presentation, and I will go back to maybe a little bit of that to correct what I believe is a misconception in what Tony said.

Farm Credit does a very, very complete review when they come into a non-bank lender. They spend approximately 6 weeks, seven or eight people going through our files who safety and soundness audit review our files for loans for credit quality, make recommendations. The reports that they issue over this 5 to 6-year period consistently supported renewal of our PLP status. Yes, we domake mistakes. There are human errors. But in these reports, I believe if you review them, you will see that they acknowledge that we address the issues that are presented, that we consistently take steps to improve the quality of our loans and our processes.

Now, with respect to what the IG set forth about guidelines in the Sacramento Center, those are at odds with what were the benchmarks in place under the lender oversight SOP and those were not generally the benchmarks that we used. For some reason,

they used these benchmarks, which are not the ones used for PLP renewal, and applied it against BLX when with other lenders they used different benchmarks.

So I believe that perhaps they may have been confused about what the actual benchmarks were, and if they had used the real lender oversight benchmarks, they would find that we did comply with them and were entitled to renewal of our PLP status.

If I can further state, that is not all that we went through when our PLP status was renewed. We spent countless hours with the SBA going over our portfolio performance, reconciling our numbers with them, showing them the improvements that we have made over the years. This was not just an idle rubber stamp. They spent time and effort, and believe me, after the year we had, I am no great fan of the SBA, but they did their job in overseeing us. So I can't criticize them for that.

Senator SNOWE. Well, would the Farm Credit Administration have done anything any different, I mean, in terms of evaluating something that raised a real concern? I mean, you can understand from a public interest standpoint——

Mr. TANNENHAUSER. Well, again, Senator, I urge you to read the Farm Credit report——

Senator SNOWE. I will.

Mr. TANNENHAUSER [continuing]. And read the conclusions and they will—I believe you will find that they support our contention that our lending practices were safe and sound and that we were one of the lenders in the industry that deserved to have PLP status——

Senator SNOWE. The IG report raises significant issues that had surfaced with BLX. I mean, wouldn't you say from the standpoint of the Government that those would be legitimate interests to be concerned about?

Mr. TANNENHAUSER. Well, there will always be issues raised because when you do the volume of loans that we do, there will always be human error—excuse me, there will always be mistakes. We do take the steps necessary to address those mistakes when we become aware of them and we do constantly try and improve our processes. That was discussed at length with the SBA during our renewal process and they took that into account and——

Senator SNOWE. No, I understand that they might have taken it into account. What I am saying is that you understand from a public perspective, I mean, representing the public's interest and the American taxpayers, that there would be some serious issues. Would you not view those issues that manifested itself back then on the part of BLX might have been a precursor, a predictor for some of the problems that emerged ultimately? Did you see that as a bad sign, or did people in your organization see it as a bad sign in any way, or just that?

Mr. TANNENHAUSER. We are always concerned with a high purchase rate, but we make loans to a segment of the population that is higher risk. However, our loss rate is significantly lower than the industry averages, so that is the real risk to the Government and we have maintained that over the 10 to 14 years that we have been doing this, and that is really—no one has taken that into account and everybody seems to ignore that fact. What is the risk to the

Government? How much money are you going to lose on the loan? Well, guess what. On BLX's loans, the loss rates are below the industry averages.

So you can pick a particular statistic and say, oh, this company is doing terribly, but you have to take the overall picture and I believe that is what Farm Credit did and I believe that is what SBA did, and I don't believe that is what the Inspector General did. And I don't say they did it with malice or for any reason other than perhaps they didn't have access to those facts and records.

Senator SNOWE. Again, you can understand what is at risk here, ultimately. We have a public obligation to the American taxpayer to explore those issues, to have the Inspector General provide an independent evaluation. Consequently, we have to make sure that we are doing our jobs in pursuing these negative activities. Obviously, when you have fraudulent activities emerge, it is certainly going to garner attention in addition to everything else to making sure that we have got appropriate procedures in place. That is our public obligation.

I thought it was interesting that you said the IG report was incomplete. We will look at the Farm Credit Administration report. But I think you should know that others at the SBA saw serious issues emerging with BLX. That is what I need to bring to your attention based on the IG report now——

Mr. TANNENHAUSER. Absolutely. Again——

Senator SNOWE. That is what I am saying——

Mr. TANNENHAUSER. There is no question, but you have to look——

Senator SNOWE. Reservations within the SBA were not indiscriminate. They were based on the factors that they were considering at the time.

Mr. TANNENHAUSER. Well, some areas we do less loans. You may have a higher repurchase rate in that area. I mean, there are different aspects. But if you take our portfolio performance as a whole, I think you will find that it is quite satisfactory.

Senator SNOWE. I appreciate that, and I know that you are taking remedial measures and hiring an independent party to evaluate all of your procedures.

You also mentioned in your testimony that BLX agrees to make SBA whole. Where does that stand now?

Mr. TANNENHAUSER. Well, where it stands now is we have paid them over $8 million. I believe there was one loan which Mr. Harrington pleaded to which was not in the original eight. We will be making them whole on that. And to the extent that there are any other loans in which fraud is found, there is a $10-million escrow plus we are obligated beyond that. So the SBA will not lose money as a result of fraud by any of our employees. We will lose that money.

Senator SNOWE. Thank you, and I think that is important, as well, in all of that. So you stand prepared to reimburse the Government for any losses that occur——

Mr. TANNENHAUSER. Absolutely, and that obligation is there whether we continue to make loans in the program or not.

Senator SNOWE. OK. Well, I think that is an important issue. Thank you.

Mr. Wilkinson, you mentioned in your testimony about SBA's projected repurchase rates, between the actual and projected. I gather from what you are saying is that the SBA consistently provides inaccurate projected repurchase rates compared to what is actual and in reality?

Mr. WILKINSON. SBA issues what is called a portal report, and I was able to get the portal reports on the entire 7(a) portfolio going back in time for 18 months and was able to go back and look—and I forget the exact date, but say at 3/31/06 where they predicted that defaults, or there would be a repurchase rate of X over the next 12 months, well, when 3/31/07 rolled around, we went and said, OK, what was our actual repurchase rate, and it was 25 percent less than what had been predicted, and that has now happened quarter and quarter. So it appears that whatever is in this Dun and Bradstreet predictive model, it is overestimating defaults.

Senator SNOWE. So what would be the basis? They are using a Dun and Bradstreet model.

Mr. WILKINSON. That is where that number comes from.

Senator SNOWE. So it becomes less, in your estimation, less reliable?

Mr. WILKINSON. I don't know what we could rely on out of that number. I mean, we just—I don't know what is in the model, don't know how that number is derived, and thus far, comparing actual performance to their previous predictions, they are at least 25 percent off.

Senator SNOWE. Well, it is interesting because of what I mentioned earlier in the question to Administrator Preston that there are projected increases from 9 to 167 percent by the SBA's lender monitoring system.

Mr. WILKINSON. I don't have the actual numbers in front of me, but the Dun and Bradstreet model had predicted about a 2.3 percent repurchase rate, and I believe our actual number came in around 1.6, quite a bit less than what had been predicted.

Senator SNOWE. So obviously, if that is the case as you are saying, that——

Mr. WILKINSON. And that would be a gross repurchase rate. You would net out from that any recoveries we would get from liquidation of collateral.

Senator SNOWE. From what you heard here this morning in terms of the questions and answers in Administrator Preston's and Inspector General Thorson's responses, where do you think the SBA stands in terms of being prepared and able to provide effective oversight and monitoring?

Mr. WILKINSON. They are a lot better today than they were just a few short years ago. So there has been improvement. One of our concerns is that the agency's budget is continually cut, and they now continue to rely on an outsource function and then try to pass those fees along to the lending community. So our fees have gone up dramatically, and rather than SBA staff handling the review functions, they now outsource that, which some would argue leads to inconsistent application.

Senator SNOWE. So we have argued for years about the staffing.

Mr. WILKINSON. Absolutely.

Senator SNOWE. Ultimately, this lack of staffing will produce consequences.

Mr. WILKINSON. They can only cut so far.

Senator SNOWE. I know. Exactly. One of the issues that emerges consistently is underwriting. I want Mr. Baird to comment on underwriting. Is the SBA's underwriting sufficient? Is there enough guidance or standards or criteria? If not, what can be done to improve it?

Mr. BAIRD. I think that what we can do first and foremost to affect and improve 504 underwriting is to fully staff the Sacramento Loan Processing Center. I hate to sound like a broken record here, but that is really critical. We have taken the 200 processing loan officers and support staff in 69 district offices and compressed them into about 15 people in Sacramento, and they are 15 of the hardest-working people that you will find in Government, but they have had problems keeping that office staffed, I think in part because of the workload, perhaps in part because the positions may be rated at lower levels than they need to be rated to retain staff. Then there have been issues replacing staff who have left. The result is trying to do so much more with so much less that it just can't be done.

Senator SNOWE. OK. Well, thank you all very much. I appreciate it. Thank you, Mr. Chairman.

Chairman KERRY. Thank you so much, Senator Snowe.

So in other words, something is wrong here. There is either a gap in the Administrator's understanding of what he needs, or there is a gap in the availability of people out there, one or the other. Mr. Baird.

Mr. BAIRD. Yes.

[Laughter.]

Chairman KERRY. I respect your reluctance to comment.

Just a last question, Mr. Baird. You say lenders are not adhering to SBA guidelines?

Mr. BAIRD. Yes. I think that with all of the changes that the 504 program has gone through, opening up all the markets to Statewide competition, CDCs going into contiguous States, the centralization of the processing, and just basically competitive pressures, I think that all those have contributed to—caused CDCs and to some extent their lending partners to start competing against one another with credit criteria and underwriting criteria, and that is not really the proper role of the CDC.

The proper role of the CDC for a, let us say a more challenging small business credit, part of our role is to put credit where the private sector alone won't provide it. But for, let us say a tougher project, rather than providing 95 or 100, or even 90 percent financing without additional collateral, one of the critical roles of the CDC is to balance the interest of the small business concern and the community and the SBA in a fiscally responsible manner and it takes the right policy and it takes, in my opinion, optimal oversight in order to make sure that abuses in underwriting aren't happening for the competitive advantages of certain CDCs.

Chairman KERRY. Very important observation, and the Committee will take note of it. What I would like to do is ask the SBA and IG to respond to these observations in writing for the Com-

mittee as part of this record. We will leave the record open in order to submit additional questions in writing so that this record is complete.

We have just run out of time. Both Senator Snowe and I have to be at our respective caucuses, but I do want to emphasize the need in these next days to complete this record and get some responses to some of the comments that have been made and various specifics so we can kind of chase down the hard facts here.

So we thank you, all of you. Mr. Baird, Mr. Wilkinson, Mr. Tannenhauser, I know this is not the most pleasant experience in the world, going over some of this stuff, but on the other hand, it is very important for the Committee and very important to the taxpayers and to all of us to understand how the SBA can do a better job and we need to do that.

Thank you. We stand adjourned.

[Whereupon, at 1:12 p.m., the Committee was adjourned.]

APPENDIX MATERIAL SUBMITTED

Questions for the Record
Lender Oversight Hearing

Senator Kerry Questions

Question #1
IG Report Redactions- The public version of the SBA Inspector General's July 11, 2007 report on SBA's Oversight of Business Loan Center, LLC (BLX) is very heavily redacted, almost to the point of being useless to the public in trying to ascertain if SBA is doing good lender oversight. Why did you insist on so many redactions?

SBA Response
We believe that the public has been well-served by the process. Congress has been able to fulfill its oversight responsibilities, and important governmental rights and objectives have been preserved. More than three months prior to the November 13, 2007 hearing on SBA's lender oversight activities, the Committee was provided with the full unredacted report by the Office of the Inspector General (OIG) in order to assist the Committee in its oversight role. The Report in its unredacted form is not a document that as contemplated by the Freedom of Information Act (FOIA) and related caselaw can be, or even should be, released to the general public apart from its release to the Committee. The reasons for this were outlined in Administrator Preston's letter to the Committee on November 6, 2007. That letter is available on the Committee's website for public viewing. As noted in that letter the redactions were necessary in order to accomplish three important objectives:

"First, SBA invoked the deliberative process privilege to redact information that: (1) threatened open, frank discussions on matters of policy; (2) risked the premature disclosure of proposed SBA policies or determinations; and (3) engendered potential public confusion. Second, in its capacity as Small Business Lending Company (SBLC) regulator, SBA relied on the bank examination privilege and FOIA Exemption 8 to ensure the financial security of SBLCs and to protect SBA's regulatory effectiveness. Third, SBA utilized FOIA exemption 4 to protect trade secrets and privileged and confidential commercial and financial information."

As previously pointed out, these redactions are consistent with the standard practices of other Federal agencies responsible for the regulation and oversight of financial institutions, such as the FDIC. It is not the standard practice of Federal Agencies to make pre-decisional recommendations public prior to a final decision. The potential for negative unintended consequences is extreme. It not only could do grave financial damage to the public, the company and its investors, but would subject the Commission to severe criticism and likely hamper its investigative ability in future cases regardless of the decision was ultimately made to not stop the trading.

Finally, we believe the content of the Report (Report Number 7-28) required the Agency's need to make many of the redactions. The Report is derived in large part from a review of some past Farm Credit Administration examinations of BLX. By naming the

company and using the confidential examination and proprietary information in the exam report, the Agency had to make those redactions. If the company had not been named and the confidential examination and proprietary information had not been used in the IG's Report, the redactions, if any, would not have been nearly as extensive.

While we support and appreciate the IG's investigation into the BLX situation, including detailed propriety information in the report made it impossible for the Agency to allow the public release of the full report. We believe a report focused on SBA's policies and procedures to oversee thousands of lenders would have been more effective at reaching the stated purpose of the report, which was to review the performance of SBA's lender oversight role.

Question #2
As I indicated in my letter to you just after this audit report was made public, I am concerned about the number and breadth of the redactions that the SBA required. For instance, the SBA's response to the Inspector General's report was redacted *in its entirety*. How do you justify suppressing this information, while at the same time claiming that the SBA is trying to achieve greater transparency?

SBA Response
Nothing was suppressed from the Committee Members and their staffs. The Committee was given the full unredacted report by the OIG.

The legitimate reasons for the redactions are noted above in answer to the first question. Furthermore, while the Agency strives to be as transparent in its operations as possible, transparency is not absolute when other principles necessary for the proper functioning of the Agency's operations come into play. SBA's role as a regulator of certain financial institutions would be severely crippled if confidential examination information, as well as proprietary information obtained from a lender on the basis of confidentiality, were made available to the general public. We have consulted several agencies that have regulatory responsibilities similar to ours with respect to financial institutions and we have been informed that they follow the same practice with respect to confidentiality of examination information that we have in making the redactions.

Question #3
The Freedom of Information Act (FOIA) requires that virtually every record in the possession of a Federal agency be made available to the public if specifically requested in writing unless an exemption applies. The SBA has made these redactions in a sort of pre-emptive FOIA process. The SBA IG has indicated to the Committee staff that it feels some of SBA's claims are valid, but that far fewer redactions are justified than you insisted upon. Aren't you concerned that your voluminous redactions not only look suspicious, but also are a violation of the spirit (and possibly the substance) of the Freedom of Information Act? What is your response to the IG's opinion that you went too far with the redactions?

SBA Response
We do not agree that the redactions look suspicious or are a violation of the spirit of the Freedom of Information Act. As previously noted, there are legitimate reasons for the redactions, as set forth both here and in the Administrator's November 6, 2007 letter explaining the need for them to the Committee, and that letter has been put on the Committee's website for viewing by the general public. It should also be noted for the record that FOIA's nine exemptions leave a large portion of Agency information exempt from disclosure. In fact, the Inspector General often withholds information in accordance with the exceptions provided by FOIA.

We respectfully disagree with the opinion of the IG that the redactions went too far. The redactions are in accord with ample court precedent and the practice of other regulatory agencies. See e.g. American Federation of Government Employees, AFL-CIO v. Department of the Army, 441 F. Supp. 1308 (D.D.C. 1977). Moreover, as we noted in the answer to question number one, while the Agency would have preferred not to make any redactions, the nature of the confidential information on BLX contained in the report required the Agency to make redactions.

Question #4
In your response to my letter to the SBA about the report redactions, you indicate that the reason SBA redacted the majority of the IG's recommendation is due to the deliberative process privilege, which encompasses internal, pre-decisional communications within an agency and is not meant to bar factual material from being released. These recommendation from the IG are final, this was not a draft of the report, how can you justify keeping factual material (like an IG's final recommendations) out of public view?

SBA Response
As the question itself notes, the IG's recommendations are just that, recommendations not facts, and as such are part of the Agency's deliberative process that we would not disclose under the Freedom of Information Act. As the Court noted in Providence Journal Company v. United States Department of the Army, 981 F.2d 552, 561 (1st Cir. 1992): "Accordingly, since public release of the recommendatory sections in the IG Report would either 'inaccurately reflect or prematurely disclose the views of the agency,' the Army may not be required to reveal any information [from them]." Moreover, as we stated in the answer to the first question, no one would expect a regulatory agency such as the SEC to make public a recommendation to stop trading in the company's stock or to take other action against a public company before a final decision had been made. That is exactly why Congress adopted the deliberative process exemption in FOIA.

Question #5
With respect to the 6 to 7% of PLP lenders that had their PLP status revoked by SBA, please specify how many lenders had their PLP status revoked each year from 2001 through the present. Please specify the reasons for each revocation, specifying the

nature/type of violation of SBA rules or other reasons for each revocation. For each lender, please specify whether the lender voluntarily withdrew from the PLP status or was involuntarily removed by the SBA.

SBA Response
First, it should be clarified that the percentage figure cited in our testimony included non-renewals of both PLP and SBA*Express* status, both of which are delegated lending authorities subject to approval/renewal by SBA. Lenders often apply for both PLP and SBA*Express* delegated lending authority, and SBA will simultaneously review the Lender to determine whether they should be approved for the PLP and SBA*Express* programs.

In FY2007, SBA denied a total of 86 PLP and/or Express applications, or 6.2 percent out of a total of 1,398 applications. Of those 86, 44 were denied primarily due to unsatisfactory performance or performance-related issues, 26 were denied primarily due to enforcement actions imposed by the lender's regulator, and 16 were denied primarily due to a lack of loan volume. None of the lenders included on this list voluntarily withdrew their request for PLP and/or Express authority.

Prior to FY2007, SBA did not systematically track and retain the information requested.

Question #6
Mr. Tannenhouser mentioned the ultimate "loss rate" was the metric that the SBA should use to measure performance. Please specify how many lenders had their PLP status revoked each year from 2001 through the present.

Response
Please refer to the answer provided in the previous question.

Question
Is "loss rate" an appropriate measure? Is loss rate the only measure of performance?

Response
When SBA developed its Risk Rating System, we chose to measure loan purchases rather than ultimate losses because the "loss rate" (which SBA generally calls the "charge-off rate") is not the optimum metric to measure performance. Charge-off rate is a lagging indicator; the actual loss on a loan purchased by SBA cannot be calculated for many months, or even years, after purchase. This extended recovery period is a result of the time necessary for the Lender to fully liquidate real estate collateral, or for the government to determine that it can no longer recover losses from the borrower. As a lagging indicator, it is limited in its ability to fairly reflect positive changes that a Lender has made in its origination or servicing processes. It also would likely fail to timely detect recent declines in Lender performance.

We also note that SBA regularly validates its credit models to ensure their predictiveness, and to determine the performance factors that are the best predictors of purchases by SBA. One of the factors that we have reviewed is the charge-off rate; however, thus far the charge-off rate has not proven to be as predictive for credit cost modeling as the factors currently used in our current Risk Rating System. The factors that SBA currently uses provide a better indication of Lender performance because they measure past, current, and predicted future performance. Finally, the credit scoring models and SBA's Risk Rating System were developed by private sector leaders in predictive modeling and credit scoring, Dun & Bradstreet and Fair Issac. SBA's Loan and Lender Monitoring System has been recognized by GAO as indicative of private sector industry best practices.

Question
Please address the question of whether it is possible for lenders to retain purchased loans as unresolved for years and thus manipulate this statistic?

Response
While we do not want to speculate on the reasons for our Lender's actions, it is possible that Lenders may have some difficulties in providing documentation SBA needs to process the purchase of a loan. However, if the Lender is unable to provide SBA with that documentation, it runs the risk of having SBA deny the loan guaranty or reducing the amount of the guarantee. Since a reduction of the guaranty would directly impact the Lender's bottom line, attempting to delay the purchase process may be a risky strategy for Lenders. Delays in purchases may also be reflected in the Lender's other performance measures, such as delinquency rate and problem loan rate. In addition, systemic delays in providing purchase documentation would be revealed in an on-site review of the Lender. Finally, it is important to understand that the process of liquidating assets, particularly real estate, can be time-consuming. Thus, it may be easy to misinterpret delays in the purchase process that are actually the result of delays in the asset liquidation process.

Question #7
BLX has committed to making the SBA "whole" in connection with the $76 million in fraudulent loans by Patrick Harrington in BLX's Michigan office. BLX has paid $8 million to the SBA thus far. Please specify the anticipated timing of payments by BLX to SBA for the remaining $68 million of fraudulent loans.

SBA Response
When the initial indictment of Mr. Harrington was handed down in January, 2007, the OIG was asked for a listing of the loans that were involved in the fraud. OIG indicated that that this information could not yet be given to SBA because the investigation was ongoing. Nevertheless, officials were able to identify 30 loans involved in the indictment and this served as a basis for the payment in the agreement that BLX signed of approximately $9 million. In addition, BLX has provided an escrow of another $10 million to cover additional losses due to fraud should that be uncovered. The Agency can recover any additional losses due to fraud through its standard procedures for recovering

such losses should that be necessary. It is important to note that payments are being made on some of the loans involved in the case, other loans were paid in full, and for some of the loans involved in the case, the recoveries from liquidations have paid the loan in full.

We believe it is possible that the losses from the fraudulent activity may not reach the $76 million amount noted in your question and that this is in reality an estimate that does not reflect the exposure to SBA. Mr. Harrington pleaded guilty to the fraudulent origination of loans that total only approximately $6.5 million. Based upon the information that we have been able to ascertain, and Mr. Harrington's guilty plea, SBA believes it is possible that it may have already been made whole through the payment of more than $9 million by BLX. Whatever the amount, we can assure the Committee that the Agency will aggressively seek to recover any such losses once they can be verified and expect that a loss will not be incurred and the taxpayer will not have to pay for any losses related to this situation.

Question #8

Of the $272 million of guarantee payments made to BLX from 2001 to 2006, please specify how many of those defaulted loans have been reviewed by SBA following a default to detect possible fraud.

Response

SBA reviews all loans that have been purchased by the agency. However, it should be noted that the role of the purchase review process is not for the specific purpose of detecting fraud, but to assess the eligibility of purchased loans for the purpose of paying claims. Detecting and investigating fraud is the role and responsibility of the Inspector General. If, during the course of the guaranty purchase review, suspicious activity is identified, it is referred to the Office of the Inspector General. We note, as the Inspector General has stated to senior management on a number of occasions, detecting fraud is by its very nature extremely difficult. As Mr. Thorson testified at the November 13, 2007 hearing in response to a question from the Chairman, OIG had received allegations of fraudulent activity on the part of BLX on several occasions in 2002 and 2003, but was unable to verify them at that time. Mr. Thorson's testimony also indicated that the fraudulent activity uncovered by the Inspector General's investigation would not have been readily apparent to SBA. In addition, SBA did refer some BLX loans to the OIG in 2006. Ultimately, the fraud was detected by the Secret Service in an unrelated investigation. As noted in answer to previous questions, the OIG investigation is continuing but has remained confidential, and so it is not possible for the Agency to provide the Committee with a definite number. Of course, if we are able to develop a more definite number based on information from the OIG we will advise the Committee.

Question

To the extent those loans have been re-reviewed, what has been found?

Response
To date, the contractor has not found evidence of any suspicious activity that would warrant referring the loan file to the Office of Inspector General for possible investigation.

Question
Does the SBA specifically plan to investigate the loans that BLX has not yet "charged off"?

Response
SBA reviews loans purchased by the Agency regardless of whether the lender has already charged off that loan. SBA plans to review many of the BLX loans that were previously purchased; however, a number of loan files have been retained by the U.S. Attorney/Inspector General's Office and, therefore, are not yet available for review by either SBA or its third-party review contractor. SBA or the contractor will review those BLX loans purchased over the past several years. If any loan review indicates that there may have been criminal activity, the loan will be referred to the Inspector General's office for possible investigation.

Question
When will these reviews be complete?

Response
As stated above, a number of the files are still under U.S. Attorney/OIG review. We seek not to compromise their examination. As such we must be limited as to what we can do at present. We expect to complete our review as soon as practicable, after the return of the files and the completion of the U.S. Attorney/OIG reviews.

Question #9
During your testimony, you predicted that the Herndon centralization project will be a "good news story" for the SBA in coming months. Can you provide us with a date certain, at which time we can fairly evaluate the effectiveness of the changes you have implemented at the Herndon facility?

SBA Response
We are several months into our reengineering and backlog reduction efforts in Herndon and there is indeed good news to report. In September we announced a campaign to restore the loan guaranty as the heart of SBA's Brand Promise. To that end, the Agency has pledged a 45-day turnaround at our National Guaranty Purchase Center in Herndon on all new guaranty purchase requests received in a complete and reviewable fashion beginning November 1 of last year. Through the end of the year, we have processed 149 guaranty purchases under the pledge worth over $19.3 million and have averaged less than 20 days for our reviews. We have reduced our backlog by 731 cases since September and expect to be fully current on our entire inventory by May 31, 2008. However, the post-purchase review, where we have paid an investor in the secondary market for SBA's guaranty, takes longer to resolve as we have to work with the

originating lender to fully document the loan. Unlike the pre-purchase reviews, these lenders have no financial incentive to expedite that process.

Additional Kerry Question:

Question
Why is the default rate higher for the Community Express program, and how does it compare to Express and the general 7(a) loans?

SBA Response
While there are a number of likely reasons why the default rate is different, as of November 30, 2007, the 12 month purchase rate for Community Express loans was 4.43%, compared to 2.94% for SBAExpress and 1.93% for the entire 7(a) program. The higher purchase rate may reflect the greater use of Community Express loans to serve higher risk borrowers in underserved markets, and may also reflect the relatively small balance of the Community Express portfolio.

Senator Snowe Questions

Question # 1
How will Administrator Preston work with Mr. Thorson, the Small Business Administration's Inspector General (IG), on the SBA's lender oversight issues? How soon will the SBA report back to this committee with the Agency's improvements, findings, and any suggested legislative changes needed to assist the SBA's efforts to improve its lender oversight activities?

SBA Response
Since my arrival at SBA, I have made it a priority for this Agency to work in cooperation with the Office of Inspector General. We have worked together to address Management Challenges that the IG believes are necessary to strengthen Agency controls, including action items related to lender oversight. As Mr. Thorson recognized in his testimony before the Committee, we have made significant strides to increase our lender oversight effectiveness. And we continue to work with OIG staff to resolve audit issues. SBA intends to further strengthen its lender oversight through a process of continuous evaluation and improvement, with the goal of maintaining a system of lender oversight that includes industry best practices. However, we must note that many of the Inspector General's concerns stem from audits that were based on review periods prior to the implementation of most of the oversight controls that have been introduced. Therefore, the audit recommendations may not reflect the improvements we have already made.

Question #2
I recently introduced a bill with Senator Kerry to improve the SBA's lender oversight. One of the bill's provisions would increase the transparency of the measurements the SBA uses to evaluate Lenders. How would this provision increase the equitable treatment of Lenders with troubled portfolios? Would this provision address the IG's concerns about favoritism, and would it increase the legitimacy and unbiased nature of the SBA's oversight activities?

SBA Response
We believe the SBA provides an appropriate level of transparency to our SBA Lenders, while also balancing our oversight and regulatory responsibilities. To that end, we have published in the Federal Register (for notice and comment) our SBA Lender Risk Rating System, including the underlying risk components. In addition, we currently provide SBA Lenders on-line access to their Risk Rating and their individual component scores, along with peer group and portfolio averages. We have also published on the web our SOP for on-site reviews/examinations and share with each Lender the results of its review/examination.

The Risk Rating System, including the components and measurements, was developed by one of the private sector leaders in predictive modeling and risk scoring, Dun & Bradstreet, and has been recognized by GAO as reflective of industry best practices. It

groups Lenders by SBA portfolio size. This is an important feature that facilitates fair comparisons as performance statistics can be strongly influenced by the relative size of a Lender's portfolio. The system also allows SBA to consider an SBA Lender's performance relative to the performance of the portfolio as a whole. This adds another level of fairness, particularly if a peer group either outperformed or underperformed the norm for all Lenders.

An SBA Lender's Risk Rating is but one of several factors that SBA would consider before taking an enforcement action. As stated in SBA's proposed Lender Oversight rule published in the Federal Register, SBA expects to also consider other factors, for example, on-site review results, corrective actions implemented, and an SBA Lender's contribution toward SBA's mission, before taking formal enforcement action. These factors would be equally applied to Lenders, regardless of size.

Small volume lenders, in general, have less experience with SBA loans and tend to put less resources towards compliance with SBA requirements. They are also much larger in number; 90% of lenders hold portfolios of less than $10 million. Consequently, one can understand why these lenders may more often fail to meet SBA's criteria for participation in the delegated authority programs.

SBA has made significant progress in lender oversight. This includes implementing a solid Risk Rating System and thoughtfully proposing coordinated oversight regulations that reflect principals of the bank regulators. SBA respectfully requests that the Committee give SBA the needed time to let the oversight system work.

Question #3

Does the SBA object to measures to increase the transparency of the SBA's lender oversight activities? Please explain why measurement would or would not enable Lenders to determine if they are being treated fairly – based on the SBA's stated standards.

SBA Response

It is important to note that SBA is not a direct lender or servicer of the loans, but rather provides a guarantee. Thus, each lender has more information directly available to them about their individual and loan portfolio than SBA does. In addition, to facilitate that transparency and communication, SBA has provided Lenders with access to their loan portfolio data – which includes the data that SBA uses as the basis for oversight and risk rating its Lenders. Each Lender's data is contained in a secure, web-based portal available to each Lender, and the portal informs all Lenders of the factors upon which they are risk-rated. In addition, the portal provides each Lender with eight quarters of their own portfolio performance data for internal performance measurement and trend analysis; SBA also provides comparable peer group and overall portfolio data to enable the Lender to measure its portfolio performance against a broader range of Lenders. In other words, SBA provides its Lenders with the information it uses as its basis to monitor

those Lenders and to compare each Lender's performance against its peers and the overall loan portfolio.

Question #4

On October 4, 2007, the SBA announced a contract to modernize the Agency's 50-year-old mainframe computer, update its loan management systems, and consolidate all of its loan information into one location. It would appear that this contract provides the SBA with a unique opportunity to utilize technology to address many of the lender oversight issues it currently faces. How will the SBA use this new contract, to address the lender oversight issues in the 7(a) and 504 lending programs? How does the SBA intend to work with participating Lenders, and listen to their suggestions about how to streamline the SBA's underwriting and loan servicing process, when making this contract?

SBA Response

SBA is proceeding with the replacement of its mainframe-based loan accounting system. The new system is referred to as Loan Management and Accounting System or LMAS. Integration of the Agency's Loan and Lender Monitoring System (L/LMS) as a component of LMAS is envisioned. L/LMS is the primary tool by which OCRM conducts both oversight and portfolio analysis. The SBA data contained in L/LMS comes from SBA's current loan accounting system. In LMAS, the same dynamic will be in place. To the degree LMAS contains more data points on loans and lenders, the data can be leveraged for oversight purposes. Ultimately, LMAS is a tool by which we can integrate various lending activities and better integrate the data for purposes of loan, portfolio, and lender management.

With regard to how SBA will work with lenders on streamlining the loan underwriting and servicing processes, we already have a good model for soliciting input from the industry. We recently worked with the industry as a step in updating our Standard Operating Procedures (SOPs) for underwriting/processing SBA loans; specifically, we briefed industry trade groups and participant lenders on the project and requested input from participants. An electronic mailbox was created to encourage comments and input from any interested parties. These comments were considered as part of the revision process. We anticipate a similar approach to obtain input from lenders as we move forward with updates for all of our SOPs and as we consider additional streamlining in connection with LMAS.

Question #5

Of the oversight issues discussed in the hearing, which issues can and should be resolved through a better use of technology and which issues cannot be resolved through technology? What is the SBA's plan going forward to address the issues the Agency has identified as capable of being resolved through technology?

SBA Response

The lender oversight issues that can best be addressed through technology are those that will benefit from better collection and integration of data. From collecting a more robust set of data at loan origination, to a more efficient system for lenders to update loan information to reflect changes, to better integrated data collection, consolidation and integration of lender transactions to identify lender specific trends and address them from a lender oversight perspective, we anticipate that LMAS will play a role in meeting theses needs. In the interm, we continue to look for ways to identify existing data sets, ensure that the data is accurate and timely, and then incorporate it into oversight activities.

Question #6

The SBA's lender monitoring system generates a "projected repurchase rate," that informs each Lender about the potential for defaults within its portfolio. The SBA argues that the projected repurchase rate enable Lenders to take corrective action in their portfolios and improve the performance of their loans. Why doesn't the SBA provide to Lenders information – aside from the "projected repurchase rate" – about the specific loans that may default in their portfolios, to help the Lenders take "corrective action" or improve loan performance?

SBA Response

SBA believes its portfolio monitoring efforts may be used to assist Lenders in the management of their portfolio. However, the data available to Lenders through the Lender portal is not meant to replace the Lenders' oversight of its own portfolio. More than 90% of all SBA 7(a) loans are originated through delegated lending authority. Under that delegated authority, Lenders are responsible for nearly all of the origination and servicing of their loans; SBA's role in these processes is limited. As a result, the Lenders will always have more information about the individual loans in their portfolio than the SBA. The Loan and Lender Monitoring System is designed to allow the SBA to measure each Lender's overall portfolio for risk, as well as the risk of the overall 7(a) and 504 loan portfolios. It is not intended to replace each Lender's portfolio monitoring tools, because it cannot replicate each Lender's familiarity with its individual loans.

Question #7

How can the SBA sufficiently safeguard the 7(a) and 504 loan portfolios if it does not provide information to lenders on loans it believes could possibly default?

SBA Response

As previously stated, SBA provides its Lenders with all of the portfolio data within its authority to make available. However, the data we make available to Lenders cannot match each Lender's knowledge of its own portfolio, because each Lender's responsibility for servicing its loans provides them with a familiarity with their borrowers that is simply not possible to be simulated by SBA or its credit models.

Question #8

According to an analysis of the SBA's predicted loan repurchase rates the SBA forecasts that lenders default rates could increase by 9 to 167 percent over the next year. (This analysis takes the current default rate and compares it to the projected default rate to arrive at the projected increase or decrease in defaults the SBA predicts will occur over the next 12 months.) If the SBA truly believes that loan defaults could increase by 167 percent in the next year for some lender – what is the Agency doing to mitigate these losses?

SBA Response

While SBA is not able to confirm the analysis upon which the statistics cited in the question was based, we do believe there is a fundamental misunderstanding of how the projected purchase rates should be evaluated and utilized

The Projected Purchase Rate (PPR) is a projection of the next 12 month actual purchase rate for loans disbursed ("on the books") and scored as of a specific point in time. A concern had been raised that the PPR of loans in the 7(a) portfolio was different from the actual purchase rate 12 months later, so it was assumed that the PPR was not very predictive of actual future purchases. However, this presumption is based upon a misunderstanding of the basis of measurement of the PPR and the actual 12 month purchase rate.

For SBA's purposes, the 7(a) PPR rate is calculated on a quarterly basis. Thus, for example, the September 30, 2006 PPR rate projected purchases for the October 1, 2006 – September 30, 2007 period based upon the outstanding SBA share of loans disbursed as of September 30, 2006. On the other hand, while the actual 12 month purchase rate as of September 30, 2007 measures the same 12 month period, it is based upon the outstanding SBA share of loans disbursed as of September 30, 2007, including those new loans disbursed between October 1, 2006 and September 30, 2007 that were not included in the initial analysis. The actual 12-Month Purchase Rate calculated as of September 30, 2007, adjusted to exclude those loans disbursed during October 1, 2006 – September 30, 2007 period, was 2.368 percent. By contrast, the September 30, 2006 PPR was 2.363 percent. As you can see, after adjusting for the difference in the basis of measure, the PPR is very predictive of purchases when compared to the actual 12-Month purchase rate. My staff would be happy to discuss the specifics of this information in more detail with you at your convenience.

SBA has not seen an increase in purchases to date; however, we are sensitive to the potential for higher purchases and continue to carefully monitor our portfolio for any trends that might indicate an uptick in future purchases.

Question #9

If SBA does not believe that loan defaults will increase by 167 percent, and so is not taking dramatic action to reduce these projected defaults with specific lenders, why should the participating lenders have any confidence in the Agency's numbers?

SBA Response
Please see our response to question 8 as we believe it is important to understand how to analyze and interpret the data comparisons relative to the projected purchase rate. We would be happy to meet with your staff to walk through the Projected Purchase Rates and actual purchase rates; we are optimistic that your staff will share our confidence in the predictive capabilities of the computation.

Question #10
The SBA IG stated in his testimony that there is an inherent conflict in the lender oversight responsibilities of SBA's Office of Credit Risk Management (OCRM) and the lender advocacy role of the Office of Financial Assistance (OFA). Both offices reside within the SBA Office of Capital Access, which is responsible for the goals and oversight of SBA's lending programs. According to the SBA IG, regulatory oversight of the lending programs and SBA's enforcement capabilities run counter to growing the Agency's loan portfolio. On January 8, 2007, the SBA sent a letter outlining its revised organizational structure that would "clarify and add transparency to the [SBA's] management structure." This revised structure did not address the reporting conflict between the OCRM and OFA. What is the rationale for retaining a reporting structure on lender oversight that leads to such conflicts and the serious situations that were identified in the hearing?

SBA Response
It is important to balance SBA's mission to assist small businesses obtain access to credit and oversee our lending partners. To most effectively achieve this balance, it is important that OCRM and OFA remain within the Office of Capital Access. To run a strong loan program there has to be constant communication between these key offices that can only truly be achieved if they operate in tandem. Close proximity ensures that the lender oversight staff will be current and well versed in SBA program requirements. It also allows for constant feedback from lender oversight to the program office to facilitate safe and sound policy development.

SBA has taken several strong steps to establish and bolster the independence of the lender oversight function and to minimize, if not eliminate, potential conflicts. The separation of oversight and program responsibility for SBA's loan programs began in the late 1990s, when SBA separated the lender oversight function from the Office of Financial Assistance (OFA). In 1999, the Office of Lender Oversight (now called the Office of Credit Risk Management or OCRM) was established as a separate office. Shortly thereafter, the office was staffed and SBA's lender review and examination functions were transferred from OFA to OCRM. In addition, the office reported directly to the Office of Capital Access (OCA) on a peer level with OFA.

In 2003, greater independence was recommended for the lender oversight function. SBA increased the independence of lender oversight in 2004 by establishing two risk management committees, through which offices both inside and outside of OCA became involved in monitoring the Agency's loan portfolios and engaging in oversight and

enforcement activities related to individual Lenders. To further ensure the independence of lender oversight, the committee responsible for reviewing OCRM's activities and taking certain enforcement activities is comprised of a majority of voting members from outside of OCA. The head of OCRM also directly briefs the Chairperson of the Committee, who is the Chief Operating Officer of the Agency, on oversight matters without the participation of OCA executives as an additional measure to ensure that OCRM has the necessary independence to take appropriate action with regard to SBA Lenders.

Finally, we note that the Office of Inspector General concurred with the policy document through which the 2004 improvements were made. Therefore, presumably, at that time the OIG concluded that the structure and controls established through the policy changes satisfactorily addressed the independence of the lender oversight program within the Agency.

Question #11
Is legislation necessary to address this departmental conflict of interest or is this something the SBA will resolve without congressional involvement?

SBA Response
SBA believes that it has taken the necessary steps to strengthen the independence of its lender oversight responsibilities. However, we will continue to review the relationship between lender oversight and program management, and take appropriate steps, if necessary, to maintain that independence.

Question #12
In June 7, 2007, the SBA implemented a lender examination and review fee in order to cover the costs that the SBA currently absorbs for on-site lender examinations and reviews, and for off-site review and monitoring activities pertaining to the 7(a) loan guarantee program. Please explain why this fee will or will not adversely impact lender participation in the 7(a) loan program.

SBA Response
SBA values its partnership with Lenders to bring financing opportunities to those small business owners most in need – those unable to obtain similar financing in the conventional credit markets. However, we also understand the need to monitor those Lenders to ensure that they are complying with our program requirements, and that they are not lending in a financially imprudent manner. As shown below, we have attempted to strike a balance by charging Lender review costs only to those Lenders that use, and likely profit from, the 7(a) program the most and that subject the Agency to most of its program risk. We also believe that we have developed an appropriate balance between lender oversight and continuing to encourage Lenders to participate in the 7(a) program.

For its on-site reviews, the Agency determined that the most cost-effective approach was to focus its on-site reviews on only the largest Lenders (approximately 350), or less than 10 percent of all Lenders in the 7(a) program. In general, only those 7(a) Lenders holding at lease $10 million in SBA guaranteed dollars are subject to on-site review. The Inspector General insisted that SBA should conduct on-site reviews of all 7(a) Lenders holding at lease $4 million in outstanding guarantees, which would have required that another approximately 450 Lenders be subject to on-site review. However, SBA has resisted the IG's call to perform on-site reviews of smaller Lenders because our system of targeted reviews will allow the Agency to review on-site Lenders holding more than 80 percent of all SBA guaranteed dollars outstanding, or the overwhelming majority of all SBA dollars at risk.

That does not mean, however, that SBA is neglecting smaller Lenders not subject to on-site review. These small Lenders are included in SBA's off-site monitoring process. Again, to minimize the possibility that Lenders would reduce their participation in the 7(a) program, SBA has limited the number of Lenders subject to the fee to ensure that Lenders would not pay a fee for maintaining a small portfolio. Each Lender's off-site review fee is commensurate with the size of their SBA portfolio, to reflect the relative level of risk that their portfolio represents to SBA.

Finally, SBA expects that through on-site and off-site reviews/monitoring and related Lender feedback, more Lenders can improve their performance and comply with Agency guidelines, cutting Agency processing times and possibly reducing both Lender and SBA relative losses and ultimately improving the 7(a) program.

Though these factors, SBA has achieved the proper balance between our mission to assist small businesses in their efforts to access credit and oversight of our lending partners.

Question #13
How can the SBA more effectively involve lenders in the fee determination process so they are able to realize the fairness of the costs and their benefit to the 7(a) program?

SBA Response
SBA believes that it has involved Lenders in the fee determination process. We published a proposed rule for comment, and advertised the proposed rule at national and, where possible, regional lending conferences while the fee rule was open for comment. SBA received only 56 comments on the proposed fee, of which 52 came from the more than 4,500 individual 7(a) Lenders. SBA reviewed all of those comments carefully. In fact, SBA adjusted the rule in response to concerns that were raised about the potential to drive small Lenders out of the program; as noted above, we eliminated the fee for all Lenders that would have had to pay less than $200 annually. By establishing a minimum fee threshold, SBA substantially reduced the number of Lenders subject to any oversight fee, and reduced the possibility that it might cause some small Lenders to leave the program.

Additional Snowe Questions

Question
In April 2007, the Federal Deposit Insurance Corp. (FDIC) issued a cease and desist order to Oakland-based Innovative Bank, which makes SBA Express and Community Express loans, among other services. The FDIC order directed Innovative Bank to cease following "unsafe and unsound" banking practices. Though there are numerous media reports about the FDIC's efforts to reign in Innovative Bank's questionable lending practices, none of the reports mentioned any oversight activity by SBA. Did SBA's oversight mechanism detect a problem with Innovative Bank's loan practices? If so, what was SBA's response?

SBA Response
As you know, SBA's Office of Credit Risk Management monitors the SBA loan program performance of SBA Lenders and responds as needed. In general, financial institution examination information is confidential in accordance with law. Accordingly, SBA's actions with respect to Innovative Bank cannot be disclosed publicly. However, to assist the Committee in their oversight function, SBA is forwarding the financial institution examination information that you requested under separate letter to facilitate its confidential treatment together with a confidential explanation of the Agency's information and actions.

Question
What has the SBA done to coordinate with FDIC, or the other bank regulators, to otherwise improve its oversight strategy in situations like these?

SBA Response
SBA has discussed the need to share information about regulated SBA lenders with FDIC and other regulators, and we continue to work with them in an effort to improve . communications between SBA and the regulators in matters concerning our lenders.

Questions for the Record
Lender Oversight Hearing
Senator Johnny Isakson

Question
Administrator Preston, would you please clarify what action(s) the Associate Administrator of the Office of Entrepreneurial Development stated to the U.S. Small Business Committee would be completed by 1/18/08?

Response
Not available at time of printing.

Questions from Chairman Kerry to Inspector General EricThorson

1. *Your report makes 5 recommendations to the SBA. Has SBA been following up to your satisfaction on the recommendations issued in your report?*

Response: Although the BLX report was issued in July of 2007, SBA has not yet implemented any of the report's five recommendations. In its formal comments to the draft report, SBA was generally unreceptive to the audit findings and recommendations, partially agreeing with one recommendation, neither agreeing nor disagreeing with another, providing a conflicting and unclear response to one recommendation, and disagreeing with two recommendations. After the final report was issued SBA proposed alternative actions for all five recommendations. The OIG accepted four of the proposed actions, and agreed to accept the fifth action involving recommendation 4 if the Agency notified lenders of the circumstances under which it would suspend or revoke Preferred Lending Authority. Because the Agency has not yet agreed to notify lenders, recommendation 4 remains unresolved. The Agency has also not completed final action to close out the four agreed-to recommendations, and the target completion dates have passed for two of them.

2. *Representatives of BLX contend that the IG report was not fair because the Farm Credit Administration ultimately concluded that the lender was fiscally safe and sound. Please comment on why that conclusion by the Farm Credit Administration was not sufficient to satisfy IG concerns that BLX should retain delegated lending authority?*

Response: FCA's conclusion that BLX was fiscally safe and sound was largely based on the financial condition of the lender as demonstrated by the adequacy of the lender's capital, earnings, access to reliable funding, and other factors. Nevertheless, the FCA also identified material deficiencies in loan performance and compliance issues, which are a more relevant indicator of the quality of loans originated by BLX, how well the lender managed its loan portfolio, and the degree to which it complied with SBA lending requirements. In determining whether to renew a lender's delegated lending authority, SBA relies on a variety of loan portfolio performance measures, such as the volume of delinquent loans in the lender's portfolio, losses from defaulted loans that were charged-off, volume of loans purchased relative to total loan disbursements, and the loan liquidation rate. Because our report focused on portfolio performance issues that should have impacted SBA's decision to renew the lender's delegated authority, we focused on those areas of the FCA examination that addressed the quality of the lender's loan portfolio and asset management. We believe the information reported by FCA relative to BLX's credit administration practices and volume of adversely classified loans were the relevant items in FCA's report that should have impacted SBA's decision.

3. *You testified that "short sellers" brought you information as far back as 2002 regarding fraudulent loans in BLX's Michigan office.*

- *What steps did you do to follow up?*
- *When you say that the information was not specific enough, what was it lacking?*
- *Have you pursued the other areas of possible fraud brought to your attention by the short sellers, such as hotel loans in the Southeast and the shrimp boats? What have you found?*

Response: In 2002, the OIG received allegations from several parties, known as the "short sellers," alleging that BLX was not conducting proper due diligence in making and approving SBA guaranteed loans and possibly committing fraud against the Agency. Various OIG employees closely reviewed these allegations over the course of several years. Our efforts included taking the following steps: (1) we held extensive discussions with the short sellers regarding their numerous allegations against BLX; (2) we reviewed extensive records, including a report prepared by Kroll, a private investigative firm, concerning numerous BLX loans where improprieties were claimed; (3) we interviewed former BLX employees; and (4) we reviewed a sample of BLX loans to see if we could validate the concerns expressed by the short sellers.

Despite this extensive review, however, we were not able to identify sufficient evidence to support prosecutable criminal violations based upon the short sellers' allegations. One significant problem was that most of the information received from the short sellers lacked specific detail. Although we followed up with the short sellers, they were often unable to provide more concrete information. For example, in many cases, information provided by the short sellers lacked sufficient detail to identify any corresponding SBA loan numbers. In some cases, loans were identified, but were being paid on schedule, contrary to the allegations. In some cases, allegations could not be substantiated due to the complainants' lack of familiarity with SBA programs.

One example of the latter problem concerned various allegations relating to the many loans that BLX made to operators of shrimp boats. The short sellers alleged that BLX committed fraud in making these shrimp boat loans because it failed to disclose to SBA underwriting deficiencies that made the borrowers non-creditworthy. However, these allegations failed to take into account that, under SBA policy, shrimp boat loans were not eligible to be made under the preferred lender program, and SBA personnel were required to review and approve the underwriting and credit decisions of each loan. Additionally, the short sellers claimed there was wrongdoing because many loans were made to the same address. Aside from the fact that SBA had approved all of these loans and was therefore on notice of this fact, our investigation determined that there was a plausible explanation for this in that many of the shrimp boat owners did not have a fixed business address and relied on a common party to act as a mail-drop. We also found that there were alternative legitimate explanations for other allegations made by the short sellers. Due to SBA's involvement in approving these loans and the fact that many of the allegations did not pan out, the investigation of BLX's role in making the shrimp boat loans was closed. We note that a qui tam action that the short sellers brought involving its allegations regarding the BLX shrimp boat loans was recently dismissed by the United States District Court in Atlanta.

In addition, an investigation of the short sellers' allegations regarding loans to finance various hotels located in the Southeast also determined that these allegations did not support prosecutable criminal violations.

4. *Mr. Tannenhauser mentioned the ultimate "loss rate" was the metric that the SBA should use to measure performance.*

- *Is "loss rate" an appropriate measure?*
- *Is it the only measure?*
- *Please address the question of whether it is possible for lenders to retain purchased loans as "unresolved" for years and thus manipulate this statistic.*
- *Has your office ever investigated into the practice of delaying "charge off" after the SBA has purchased the guaranteed on a defaulted loan as a way to manipulate the loss rate?*

Response: The loss rate, by itself, is not an appropriate measure of lender performance. This rate indicates only how well the lender collateralized and liquidated loans, and does not measure the quality of the loans originated by the lender. In addition to the loss rate, SBA uses a number of other performance metrics and data to assess lender performance on a continuing basis, including the lender's:

- problem loan rate (percentage of loans delinquent for 90 days or more and in liquidation);
- 12-month purchase rate (percentage of outstanding loan guarantees purchased within the past 12 months);
- small business predictive score (likelihood that loans will default within 18 to 24 months);
- projected purchase rate (percentage of loan portfolio dollars expected to be purchased by SBA);
- currency rate (percentage of loans that are 0 to 30 days current in scheduled payments); and
- liquidation rate (percentage of loans in liquidation status).

Further, in evaluating lender performance SBA considers the results of FCA examinations, comments obtained from commercial servicing center staffs who evaluate lenders for expedited authority, and the number of repairs/denials of guarantees resulting from deficiencies identified during purchase reviews. Our audit identified concerns with nearly every facet of BLX's performance evaluated by SBA. Therefore, we cannot support Mr. Tannenhauser's assertions regarding the sole use of the "loss rate" to measure lender performance.

Moreover, Mr. Tannenhauser's comment suggests that it is acceptable for lenders to originate bad loans, as long as they collect on the loans when they default to minimize SBA's losses. This implies that it is acceptable to make loans to non-creditworthy borrowers as long as the loans are sufficiently collateralized. However, SBA regulations provide that all SBA-guaranteed loans must be made to credit-worthy businesses and are

so sound as to reasonably assure repayment. 13 C.F.R. 120.150. Further, ensuring that small businesses obtain necessary capital that allows for stable long term success is critical to achieving SBA's 7(a) program goals. The 7(a) loans are intended to help small businesses establish themselves and to operate successfully. If the businesses default on their loans and have to sell off the collateral they need to stay in operation, then SBA has not served those businesses well or succeeded in accomplishing its mission. The loss rate mentioned by BLX would not demonstrate that the lender had, in fact, provided for the long-term stability of a small business concern. Each liquidation and resulting purchase demonstrates the opposite -- i.e., the business failed and may have ultimately put the principal(s) and employees in a worse position than prior to obtaining the SBA-guaranteed loan. Consequently, BLX does not make a valid argument for the use of the loss rate as the sole measurement of its effectiveness in achieving SBA program goals.

SBA regulations and procedures require that lenders act promptly in liquidating loans when it appears that there is no reasonable prospect that the borrow will repay the loan. However, under normal liquidation procedures, some loans take longer to liquidate than others due to the nature of the collateral, especially loans with significant real estate collateral. While SBA has procedures for monitoring the timeliness of a lender's liquidation efforts, we do not know the extent to which these procedures are being followed. In prior years SBA would review lender liquidation plans and monitor lender progress in liquidating their loans, but in May 2007 SBA stopped requiring PLP lenders to submit such plans. Thus, it is possible for lenders to retain purchased loans as "unresolved" for years and to manipulate their loss rates by delaying charge-off of purchased loans. We have initiated an audit that will assess whether SBA is adequately monitoring lender liquidation efforts and determine whether loans are being charged-off in a timely manner.

5. *In your testimony you identified an email exchange, which occurred between officials at BLX and SBA during the early stages of the BLX investigation, in which BLX offered to repay one of the fraudulent loans, but the SBA responded by declining the offer and stating that BLX was "being to hard on themselves." Please provide a copy of that email exchange.*

Response: To clarify, I was referring to "non-fraud" problems that were discovered during our review of the allegations made by the "short sellers." This review led to the issuance of a management advisory report in 2005, which noted that BLX had agreed to repay a loan that had been made in violation of SBA procedures, but that SBA had concluded that the lender was imposing too "harsh" a penalty on itself in an email sent to the lender. A copy of the email is attached to this response.

Attachment

Leonard Rudolph

From: Relyea, Dana M [Dana.Relyea@sba.gov]
Sent: Tuesday, November 16, 2004 8:28 AM
To: Leonard Rudolph
Subject: FW: Eligibility - 7(a) Change of Ownership Where SBA Loan Gets PIFed
Attachments: fax1.tif

-----Original Message-----
From: Coleman, W. Sloan
Sent: Monday, November 15, 2004 3:22 PM
To: Relyea, Dana M.
Cc: Miller, John A.
Subject: Eligibility - 7(a) Change of Ownership Where SBA Loan Gets PIFed

Dana,

When SOP 50-10(4) was issued in December of 1997 it said a loan to purchase a business that has an existing SBA loan is not considered refinancing even though an existing SBA loan would get repaid as a result of disbursing the new loan. It also said the purchaser should be encouraged to assume the existing loan but it stopped short of saying they must assume.

When revision "E" came out on December 1, 2000 the above policy was changed. The new policy said

> Paying Off Seller Debt is Not Refinancing to Effect a Change of Ownership
>
> SBA does not classify the act of a seller using the funds they receive from a purchaser to pay off some or all of the existing debt of the sellers business as refinancing, providing the purchaser is financing a complete change of ownership. A loan for this purpose is considered to be for the purchase of a business, not the refinancing of any existing debts
>
> However, if it is known that the debts of the business being sold include existing SBA debt, the loan can not be processed under any of the Agency's expedited loan processing programs. In such cases, the application must be processed under standard procedures. In addition, the option to assume the existing SBA debt should be offered the buyer. This is recommended so that the Agency's limited appropriations are not unnecessarily used.

In your case around the time SBA was changing its policy on what was PLP eligible a PLP lender who had one or more existing SBA loans to the borrower who was selling his property was preparing two new SBA PLP loans for the buyer of this property. Because the lender had the SBA loans to the seller and was proposing SBA loans for the buyer it is assumed that they knew making a new SBA loan to effect a change of ownership would pay off one (or two) existing SBA loans.

The lender says they internally processed and approved the buyer's loans prior to 12/1/00 but by the time these loans actually got approved by SBA (December 4, 2000) the new rules had been put in place.

Our historical position in such cases is that the rules of eligibility are set at the time of processing by SBA (The SBA Approval Date).

Since both existing SBA loans (number 410-557-40-04 and 410-553-40-06) were approved on December 4, 2000 they were subject to the December 1, 2000 policy. As such the prohibition against paying off an SBA loan

Attachment

through the act of a business acquisition with another loan was in effect for these two loans.

In the lender's 11-15-2004 correspondence the lender said:

1. BLC would like to honor its obligation to SBA and relieve SBA of its guarantee
2. BLC will reimburse SBA for its purchase of the guarantee in the secondary market

These comments and gestures are appreciated

In the lender's 11-15-2004 correspondence they also say:

1. Although BLC approved these loans at a time when the loan transaction was eligible under the SOP, the delay in closing and the receipt of the PLP number after December 1, 2000 would indicate that the loans were technically ineligible for PLP processing

One interpretation of this statement could be that the lender disbursed the loans before they even came to SBA for a guaranty. Not a good practice

Now to the cases.

The lender appears to have imposed a rather harsh penalty on themselves. If they had complied with the December 1, 2000 policy the new borrower (buyer) would have assumed the existing debt (which may have been re-amortized) and SBA would most likely still have been purchasing the guaranteed portion on the remaining balance of the original debt. The lender would also have most likely made a new loan for any new money purposes and SBA would have been purchasing that

In addition, did the act of giving the borrower (buyer) two new loans rather than have him assume the existing loans actually make any difference? Wouldn't SBA have just been purchasing the remaining balance on the existing original loans plus maybe the balance on any new loan - if there was a need for renovations or other funds, including the difference between purchase price and debts, etc?

The fact that the loans were not PLP eligible does not always mean we don't purchase

Did the act of giving them new loans rather than have them assume cause the failure? Assuming the borrower would have had the same amount of debt the answer is most likely not.

I believe there should be a repair for the amount of the unnecessary funds the buyer (borrower) had to borrower (like for a new grp fee and redundant recording fees) but not a full denial

Give me a call and we can discuss this further.

Good Issue

Sloan

11/15/2004

6. *In 2006, your office released a review of the SBA's Express and Community Express programs.*

- *Based on your findings, would you recommend making the Community Express program permanent, authorizing the program for three years with a review period, or not continuing the program?*
- *If reauthorized, what recommendation do you have?*
- *What is the default rate for the Community Express program, and how does it compare to Express and the general 7(a) Loans?*

Response: The OIG issued two reports in 2006 concerning the SBA Express and Community Express loan programs: (1) Report 6-34, *Management Advisory Report on the Policies and Procedures for the SBAExpress and Community Express Loan Programs* (September 29, 2006); and Report 7-08, *Audit Of The SBAExpress and Community Express Loan Purchase and Liquidation Process* (December 29, 2006). Report 6-34 identified concerns with SBA's policies and procedures governing these programs, including the lack of regulations and permanent and effective program procedures. Report 7-08 identified deficiencies in the procedures that SBA used when reviewing lender requests for purchase of guaranteed loans that had defaulted and in referring defaulted loans to the Treasury Department for debt collection.

Although SBA introduced the Community Express program as a pilot in 1999, the Agency's administration of this program in the intervening eight years has been problematic. For example, although one central feature of the program was to encourage provision of technical assistance [TA] to borrowers in economically disadvantaged areas, as discussed in Report 7-08, the Agency then instructed lenders not to provide any evidence of whether any TA was provided when requesting purchase of a guaranty on a defaulted loan. As a result, SBA lacked information to determine whether TA was being provided or whether this was improving the success rate of disadvantaged borrowers. Additionally, as discussed in Report 6-34, SBA administered the program without any officially approved policies and procedures.

Nevertheless, it is our understanding that the Office of Capital Access has conducted an extensive review of the Community Express Program, and that the Agency is close to issuing revised procedures for this program. Given this effort, although we are, as a general matter, concerned with the prospect of a "pilot" program continuing on for more than a decade, we believe that SBA should establish clear benchmarks and criteria to measure success, continue with the pilot for another year or so, and then determine whether the program has been successful and whether it should be established on a permanent basis. We believe it would be premature to make the program permanent at this point in time.

As to the question regarding the default rate for the Community Express program, we lack current information on program default rates and how this compares to other 7(a) programs. Therefore, SBA has agreed to provide a response.

Questions from Ranking Member Snowe to Inspector General Eric Thorson

1. *The Inspector General's (IG) testimony argues that the SBA needs to improve its lender oversight activities in 5 ways: 1) by focusing more on the quality instead of the quantity of loans the SBA guarantees, 2) by making the Agency's level of loan monitoring activities comparable to its level of delegated "preferred" lending authority, 3) by addressing the difficulties that arise from the SBA's reduced staff and rapidly growing loan portfolios, 4) by resolving internal agency conflicts of interest between its lender advocacy and lender oversight roles, and 5) by focusing on fraud detection? Which of these five areas should the SBA's top priority. Where should the SBA focus first in order to dramatically improve the effectiveness of its lender oversight activities?*

Response: Although we believe that each of these areas is very important, the biggest concern is whether SBA is devoting sufficient staff and resources towards the oversight of lenders and Certified Development Companies (CDCs) participating in the 7(a) and 504 loan programs. Oversight of lenders and CDCs used to be one of the primary responsibilities of hundreds of employees in the approximately 80 district and branch offices throughout the country who, often, were very knowledgeable about the lenders and CDCs in their area. In the last decade however, SBA's staffing has been significantly reduced, and, at the same time, SBA has delegated considerably broader responsibilities to its lending partners. Although this delegation of authority increases the need for lender oversight, currently, oversight is being performed by far fewer staff and is generally being done through centralized offices which do not have the same familiarity with the lenders and CDCs. Of particular concern (as reflected in the OIG Management Challenges 4 and 5) is that the Office of Credit Risk Management is charged with the responsibility for overseeing several thousand 7(a) lenders and several hundred CDCs with a staff of about 20 people and that the National Guaranty Purchase Guaranty Center in Herndon, Virginia, which annually reviews numerous requests for purchases of defaulted loans, is also understaffed. We believe that one of the Agency's top priorities should be to ensure that offices responsible for conducting oversight are adequately staffed. If SBA is not able to allocate sufficient staffing then we believe it would be important for the Agency to put greater focus on the quality instead of the quantity of loans it guarantees.

2. *I recently introduced a bill with Senator Kerry that directly addresses a number of the lender oversight issues discussed in the hearing. Has the SBA IG been able to review the legislation? What legislative solutions does the SBA IG suggest to the Committee as we work to improve the SBA's lender oversight?*

Response: We have reviewed S. 2288, and generally support the bill. In particular, we support:

(1) the provisions in section 5 relating to quarterly monitoring of lender performance criteria and conducting on-site reviews of poorly performing lenders as long as this is

intended to supplement, rather than replace, SBA's current portfolio monitoring and on-site review process;

(2) the provisions in section 8 requiring SBA to develop criteria to measure the benefits to the borrowers from its financial assistance programs, and periodically publish reports assessing this information and evaluating aggregate economic changes resulting from the SBA business loan programs, as we believe that this would provide important program performance information; and

(3) the provisions in section 10 addressing the issue of large salaries paid to executives of CDCs by establishing procedures for CDC approval of such salaries and reporting of such salaries to SBA.

One concern that we have is with the wording in section 4, relating to the changes to paragraph 5(b)(14) of the Small Business Act; this amendment could be interpreted to limit SBA's use of fees paid by lenders for lender oversight reviews to pay only for improvements in lender oversight technology and software programs. Under this interpretation, the provision could actually hinder SBA's lender oversight capabilities if the fees could not be used to pay for on-site examinations and reviews. We would be happy to discuss this concern at greater length with your staff.

Other than these proposed changes, we believe that SBA has, for the most part, adequate statutory authority to establish an effective lender oversight program. This has been helped by the recent congressional passage of authority to charge fees for oversight of 7(a) lenders and enhanced authority over Small Business Lending Companies (SBLCs). However, several critical areas where we believe that legislative action would help improve SBA lender oversight and fraud deterrence capabilities are the following:

(1) Extension of the statute of limitations for fraud cases involving SBLCs from the current 5 years to the 10-year period that applies for fraud against most other lending entities. The OIG has not been able to obtain prosecution of cases involving fraud by certain borrowers due to the 5-year limitations period.

(2) Authorization for SBA to collect the social security numbers of loan agents and brokers that package or refer SBA-guaranteed loans to lenders, and direction to SBA to implement a licensing system for these third parties. As discussed in the OIG's Management Challenge 8 to the Agency, OIG investigations in the past decade have identified fraudulent loans in the hundreds of millions of dollars involving loan agents and brokers, and the agency needs to implement an adequate loan agent tracking system.

(3) Authorization for SBA to collect fees from CDCs to pay for lender oversight activities, as requested by the Agency in its legislative package.

3. *The SBA has authority to suspend or revoke preferred lender status for any reason including: unacceptable loan performance, failure to make a sufficient number of loans under SBA's expedited procedures, and violations of statutes, regulations, or*

SBA policies. However, as the SBA IG note in its audit, the SBA has not developed policies and procedures that describe when it will suspend or revoke preferred lending authority or how it will do so. How would the SBA's development and enforcement of these policies help prevent a future problem like the one that was encountered with the Business Loan Corporation (BLX)?

Response: As discussed in the OIG Management Challenge number 5, one critical challenge that SBA faces is the development of guidance providing for effective oversight of lending programs and to establish an effective corrective action program. While it is not always possible to prevent fraud, the OIG believes that if SBA had established a hierarchy of enforcement actions with specific criteria for implementing each action, BLX's expedited lending authority would have been revoked or at least would not have been renewed in previous years. Such action would have reduced the number of defaulted BLX loans that SBA purchased from the secondary market as SBA would have reviewed the underwriting prior to the disbursement of loan proceeds. This review would likely have reduced losses and could have resulted in earlier detection of the fraudulent activity and possibly limited the magnitude of the fraud.

4. *What steps has SBA taken to create the type of uniform enforcement policies or improve the existing policies to hold lenders, with troubled portfolios, accountable? What recommendations has the SBA IG made to the SBA on how it can create consistent and uniform enforcement actions?*

Response: SBA has taken several steps to improve existing policies to hold lenders with troubled portfolios accountable. For example, the Agency established the Office of Credit Risk Management to monitor lender performance; created Portfolio Analysis and Lender Oversight committees to assess the loan portfolio and individual lender performance; commenced on-site reviews of lenders; and established a corrective action process for poor performing lenders. In addition, the Agency issued operating procedures for on-site lender reviews; published a regulation implementing its statutory authority to collect fees from lenders to finance the oversight process; and published a proposed rule that incorporates SBA's risk-based lender oversight program into SBA regulations and that provides for more comprehensive enforcement provisions for corrective actions against lenders with unsatisfactory performance.

The OIG has made many recommendations to the Agency on how it can improve the consistency and uniformity of SBA lender oversight and enforcement actions. OIG Management Challenge Number 5 identifies a series of recommended actions for the Agency including development of adequate oversight and enforcement procedures. Further, in the course of OIG reviews of proposed SBA oversight regulations and procedures, we have made numerous recommendations to promote consistency. In addition, we have issued a number of audit reports. In particular, we recently issued two audit reports with recommendations to SBA that, if implemented, would help SBA establish consistent and uniform enforcement actions.

Our report on *SBA's Use of the Loan and Lender Monitoring System,* Number 7-21, recommended that the Agency develop and implement comprehensive loan-monitoring policies and procedures that define acceptable lender performance and risk tolerance levels; identify enforcement actions the Agency will take when risk tolerance limits are violated; and describe how L/LMS data will be incorporated into mission activities agency-wide and Agency credit models. The Agency has agreed with most of the recommendations but has not implemented them yet.

Our report on *SBA's Oversight of Business Loan Center, LLC*, Number 7-28, recommended that SBA develop standard operating procedures to complement its revised regulations describing the circumstances under which the Agency will suspend or revoke PLP authority and how it will do so.

5. *Which of the oversight difficulties currently facing the SBA can be addressed, or improved, through the better use of technology? Is the SBA doing enough to use technology to streamline automate, and standardize its procedures?*

Response: SBA could do more to strengthen its ability to detect loan fraud by modernizing and upgrading its Loan Accounting System (LAS), which is out of date. Currently, the system does not provide SBA with sufficient capabilities to identify risky or suspicious lending patterns. This information would augment loan activity reports that SBA currently uses to oversee lenders, which would facilitate early fraud detection and identify risky lending patterns. While it is not possible to always prevent fraud or risky lending, early detection can help SBA to mitigate its losses.

For example, the LAS cannot identify the loan officer involved in making each loan. This shortcoming makes it difficult to link loan defaults to specific individuals responsible for originating the loans. Also, the LAS does not allow users to search loan data by borrower address, making the detection of loan flipping (purchasing a business and rapidly reselling it for an inflated price) difficult.

In September 2005, we reported that SBA had not yet implemented a definitive strategy for replacing or upgrading its Loan Accounting System. Subsequently, in November 2005, SBA initiated a project to modernize the system; however, the project remains in the initiation phase -- the first stage of the systems development effort -- as SBA revised its acquisition strategy in May 2007. Currently the project is not expected to be completed until 2012.

In addition, as set forth in the OIG Management Challenge Number 8, SBA also needs to develop an adequate system for tracking the involvement of loan agents, such as loan brokers and packagers.

We would also recommend the development of an SBA database where lenders could input borrower data at the time of application to prevent the approval of duplicate loans being issued to the same borrower. Our criminal investigations have identified problems in the SBA Express program where some corrupt borrowers use a shotgun approach of

simultaneously applying to multiple lenders with the same basic information. Because lenders have no way of knowing that a borrower has applied to other lenders at the same time, the lenders and SBA are exposed to risk.

6. *Can better use of technology help the SBA better manage its loan and oversight caseload? Could the better use of technology help to prevent another case like BLX? Why or why not?*

Response: As discussed in our response to question 5 above, better use of technology would improve SBA lender oversight by giving the Agency better capability to detect fraud or high-risk lending patterns and take earlier action to mitigate losses. However, the OIG believes that it was not a lack of technology, but SBA's less-than-aggressive enforcement policies toward problem lenders that permitted BLX to retain its PLP authority despite its poor lending practices.

7. *Does SBA's current organizational structure and lender monitoring activities make it capable of properly overseeing the SBA lending programs and participating lenders? Why or why not?*

Response: As stated in the BLX report, SBA's placement of the Office of Credit Risk Management (OCRM) within the Office of Capital Access (OCA) results in an apparent, if not actual, conflict of interest. OCRM's responsibility to take necessary enforcement actions against lenders and revoke lenders' expedited lending status when necessary is not compatible with OCA's role of promoting SBA's lending programs and growing the Agency's loan portfolio.

8. *Has the OIG detected evidence of deficiencies in the onsite, field audits as it has investigated the SBA's lending problems? What are the consequences of these shortcomings and what would the OIG recommend that SBA do to improve its onsite field audits and lender reviews?*

Response: The scope and content of the FCA examinations were established by SBA through an interagency agreement between the two agencies. Based on this agreement, FCA renders overall conclusions about the safety and soundness of lenders based largely on their asset and liability management practices and interest rate risk exposures. Consequently, as noted in the BLX exams, lenders can be assessed as safe and sound despite poor credit administration and regulatory compliance if they are also determined to be financially solvent.

As part of an ongoing audit we are evaluating whether the FCA examination, as currently structured by SBA, provides the type of analysis and information needed to make proper determinations about lender risks. We will also address whether the examinations are providing lenders with accurate and detailed information about their performance and compliance with SBA lending policies. Although our review has indicated some deficiencies with this process, we believe it would be premature at this point to discuss preliminary findings.

9. *Because BLX and other Small Business Loan Corporations (SBLC) are not subject to normal banking and institution regulations is it more challenging for the SBA to monitor their activities or prevent fraud? What should the SBA do to improve its oversight of SBLCs?*

Response: For non-SBLC lenders in the 7(a) program, SBA can generally rely as part of its lender oversight on the regulatory examinations by other banking agencies in gaining a confidence level that the lender has established effective internal controls to limit risk. As SBA is the sole regulator for SBLCs, overseeing these lenders is necessarily more challenging. SBA's oversight of SBLCs is further complicated by the fact that all of these lenders have been delegated lending authority, and are allowed to originate, service and liquidate loans with minimal oversight by SBA. In addition, as most of these lenders also sell their loans on the secondary market, SBA does not review individual loans for compliance until after it has purchased the guarantees.

We believe that as the regulatory agency for these lenders, SBA should take appropriate enforcement actions to hold these lenders accountable when they do not perform, including removing their delegated lending authority. As noted above, the OIG will issue an audit report of SBA's oversight of SBLCs and non-federally regulated lenders in early 2008, which will contain recommendations for improving this oversight process. However, we believe it would be premature to discuss preliminary findings at this point.

10. *In a 2006 IG report, which was written in response to problems associated with the SBA Express and Community Express loan programs, the SBA IG provided a series of recommendations designed to mitigate lender deficiencies. Is the SBA implementing the recommendations the IG made back in 2006? How long should it take for the SBA to make these changes?*

Response: As noted above, the OIG issued two reports in 2006 concerning the SBA Express and Community Express loan programs: (1) Report 6-34, Management Advisory Report on the *Policies and Procedures for the SBAExpress and Community Express Loan Programs* (September 29, 2006); and Report 7-08, *Audit Of The SBAExpress and Community Express Loan Purchase and Liquidation Process* (December 29, 2006).

Report 6-34 contained 16 recommendations. As of today's date, the OIG and the Agency have reached an agreement on the appropriate course of action for 10 of these recommendations and are in the process of working out a resolution on the remaining recommendations.

Report 7-08 contained 12 recommendations. As of today's date, the Agency completed final actions on two of the recommendations. While the OIG and the Agency reached agreement on the appropriate actions needed to close the remaining 10 recommendations, the Agency has not met the dates agreed to for completing the final actions on all of the recommendations, and 8 agreed-to actions are 200 days overdue.

11. In April 2007, the Federal Deposit Insurance Corp (FDIC) issued a cease and desist order to Oakland – based Innovative Bank, which makes SBA Express and Community Express loans, among other services. The FDIC order directed Innovative Bank to cease following "unsafe and unsound" banking practices. Though there are numerous media reports about the FDIC's efforts to reign in Innovative Bank's questionable lending practices, none of the reports mentioned any oversight activity by SBA. Did SBA's oversight mechanisms detect a problem with Innovative Bank's loan practices? If so, what was SBA's response?

Response: As we lack information to be able to respond to this question, the SBA has agreed to provide a response.

12. What has the SBA done to coordinate with FDIC, or any other bank regulators, to otherwise improve its oversight strategy in situations like this?

Response: As we lack information to be able to respond to this question, the SBA has agreed to provide a response.

Questions from Senator John R. Thune to Inspector General Eric Thorson

1. *When was the unredacted version of your report provided to the Senate Small Business Committee?*

Response: The Chair and Ranking Member were provided with unredacted copies at meetings that we believe took place on July 12, 2007. We provided the full Committee with an unredacted copy on August 23, 2007.

2. *Who else did you provide the unredacted version of the report to?*

Response: Unredacted copies were provided to certain SBA officials, the Chair and Ranking Member of the House Small Business Committee, and various law enforcement officials.

3. *What basis was used to accept or reject the redactions recommended by the SBA's General Counsel and BLX?*

Response: This report involves unusual circumstance because it necessarily discusses the actions of a private sector company, agency deliberations, and lender examinations conducted by the Farm Credit Administration. The SBA General Counsel asserted that there could be considerable harm to the Agency from the public release of an unredacted copy of the audited report. Although we do not necessarily agree with the legal analysis offered to justify the redactions under the Freedom of Information Act, the safest path was to post the report with SBA's requested redactions. We do not wish to cause any harm to the Agency, and in fact, strongly desire to make it better. In addition, attorneys for BLX contended that portions of the audit report should not be released because they contained proprietary or confidential business information. Although we also disagreed with the legal analysis offered to justify most of these redactions, these contentions became moot given the breadth of the OGC requested redactions.

Responses to December 10, 2007 Questions for the Record for Mr. Robert Tannenhauser, Chairman, Business Loan Express, LLC from the November 13, 2007 Hearing on SBA Lender Oversight from the U.S. Senate Committee on Small Business & Entrepreneurship

Q: In your testimony to the Committee, you stated that BLX keeps 25% of the risk associated with each PLP loan such that the interests of the SBA and BLX are aligned. What percentage of the assets of BLX's total PLP loans are retained in full by BLX and not securitized, and what percentage of the assets of those loans are not retained and securitized?

A: With respect to the loans contained in BLX's SBA 7(a) portfolio as of November 30, 2007, 17 percent of the unguaranteed portions of those loans are retained in full by BLX and not securitized. 83 percent are pooled and securitized.[1] It is important to understand that BLX retains risk of loss for each loan originated under the 7(a) program, including loans that are securitized. In other words, BLX does not avoid losses from loans that default through the securitization of its loans. In fact, for each and every loan that BLX has securitized to date, it has borne all of the losses associated with any defaults.

Here is how securitization works: To achieve the liquidity necessary to operate as a non-bank lender, BLX periodically pooled the unguaranteed portions of hundreds of SBA loans together and issued bonds that entitle the holders to a portion of the income from those loans. This process was established and is sanctioned by the SBA, which has recognized that increased liquidity from securitization permits non-bank lenders like BLX to serve the SBA mission of promoting small business development. To ensure that lenders remain accountable for their securitized loans and to protect outside investors, both SBA regulations (13 C.F.R. § 120.425) and BLX's rating agencies require that BLX implement a securitization structure where BLX effectively bears the risk of loss associated with each loan.

The securitization issues several classes of bonds, reflecting their priority in claiming the income generated from the pool – BLX always occupies the lowest-priority position within this structure. As monthly payments towards interest and principal on the securitized loans are received, they are first distributed to the most senior bondholders, then the next-most senior, and so on down the line. BLX realizes a return only if all of the other investors have been fully paid. In other words, before any outside investor can suffer a single cent of loss, BLX must suffer a complete loss on its piece of the securitized pool. Accordingly, for every loan in the pool that defaults, BLX suffers the entire loss up to an amount that in practice has not been reached. The SBA's regulations make it highly unlikely that BLX will ever exceed that amount because it is set at the greater of two percent of the pool or twice BLX's historic loss rate.

BLX's rating agencies also require BLX to maintain a reserve account or post a letter of credit to protect outside investors from losses in excess of BLX's piece of the pool. When a loan in the pool defaults, BLX must add extra cash to that account over time to cover the full outstanding balance of the defaulted loan. To avoid having funds sit idle in that account, when loans in the

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[1] Please note, as BLX has announced, that it will not participate in the SBA's 7(a) program going forward in order to concentrate on conventional small business loans and commercial real estate lending. Thus, these numbers will not be indicative of future practices.

pool default, BLX often buys them back from the pool, so that the defaulted loans sit on BLX's books as if they had never been securitized.

Thus, BLX does in fact retain a stake in the face value of every loan it has originated in the past under the 7(a) program. Securitization does not change this fact. If a loan defaults, BLX suffers a loss along with the SBA. In addition, it also bears noting that there would not be a market for BLX's pooled loans if BLX's loans historically defaulted at a high rate. No investor in any securitization of BLX loans has ever suffered a loss. Quite simply, the premise that BLX does not have an incentive to be concerned about issuing credit quality loans – which is a criticism that many short sellers of BLX's majority owner have been making for years – is contrary to the facts.

Q: You testified to the Committee that BLX's "loss rate" is very low.

- *On average, how long (in months) do BLX loans that are in default take to liquidate?*

A: BLX, like any prudent lender, does not immediately begin foreclosure proceedings upon a borrower's first missed payment. It works with the borrower to try to save the loan. In many cases, it succeeds, either returning a distressed loan to health or obtaining some additional payments for the SBA. Though it is difficult at times, BLX strives to achieve a balance between serving the borrower's interest in resuscitating the loan and the government's interest in minimizing loss. When it becomes clear, however, that a loan cannot be turned around, BLX acts quickly to maximize recovery. On average, for loans BLX originated between 2001 and 2005, 19 months elapsed between default (marked by the SBA's repurchase of its guaranteed portion of the loan) and liquidation (marked by the date on which a loan was paid off entirely or charged off at a loss). Loans originated in 2001 have required an average of 20 months to liquidate; while those originated in 2002 have taken an average of 18 months; 2003 loans have required an average of 18.6 months to liquidate; and loans originated in 2004 and 2005 have required an average of 16.6 months to liquidate.

Despite this average, the time required to liquidate any given loan varies widely based on many factors often outside of BLX's control. The overwhelming majority of BLX's SBA 7(a) loans (other than Community Express loans) are collateralized with real estate to maximize recovery for the SBA and BLX in the event of default. It typically takes longer to liquidate real estate collateral than other types of collateral. In some states, lengthy statutory notice and redemption periods can delay by years a lender's ability to liquidate in even the quickest foreclosure. For example, in Kansas, after notifying the borrower of its default, filing a foreclosure petition, and then receiving an entry of a judgment of foreclosure, the lender must wait ten days for a stay of execution to expire. The lender must then advertise the foreclosure sale for at least three weeks and wait at least another week to conduct the sale. Significantly, after the sale, the lender must hold the property for a twelve month redemption period during which the borrower may repurchase the property as a matter of statutory right. It is only after this additional year has passed that the lender has full ownership of the property, allowing the company to liquidate the property and receive any proceeds. After the closing period customarily accompanying a sale, BLX must then pay all the expenses associated with liquidation before finally charging off any remaining principal. The presence of a federal tax lien on a property, a borrower's decision to declare bankruptcy, or the need to address

environmental problems on a collateral property are other factors outside of BLX's control that can substantially delay the liquidation process.

Although, as mentioned above, BLX will no longer participate in the SBA's 7(a) lending program, the company will continue to service the SBA-guaranteed loans it originated in the past in a prudent manner. Like all SBA lenders, BLX has a strong economic incentive to liquidate collateral as quickly as possible. BLX's liability for the unguaranteed portion of any SBA loan provides a powerful motivation for the company to liquidate collateral quickly and efficiently to achieve maximum recovery and limit losses for itself and the government.

Q: There are concerns that some SBA lenders skew their loss rates by originating new SBA loans for businesses or properties associated with defaulted SBA loans.

- *Does BLX have any such loans?*
- *If so, how many such cases has BLX had during the period 2001-2007?*
- *Please provide this information by year for any second loan provided to a defaulted business or property, and the amounts involved in the first default and in any second loan.*

A: The attached table lists the 46 SBA loans BLX has identified as having been originated between 2001 and 2007 for businesses or properties originally associated with a defaulted SBA loan. BLX did not originate these loans to skew its loss rate. When a loan defaults, BLX has a strong economic incentive to ensure maximum recovery, both because the company is committed to minimizing SBA losses, and because BLX remains liable for the unguaranteed portion of the loan. In some cases, BLX has achieved significant recovery on a defaulted loan by locating a new buyer for the associated collateral and then assisting that borrower with SBA-guaranteed financing. The new buyer, bringing new management experience and frequently new investment to the enterprise, can often revive the distressed business, generating payments for the government that would not have been made had the defaulted property been liquidated differently. That new buyer is also then able to maintain the jobs associated with that small business. This mechanism for recovery also benefits the original borrowers by protecting them from lengthy foreclosure and total loss.

Experience has shown that this method of reviving a lagging small business has been extraordinarily successful. Of the 46 identified SBA loans, one-fifth (9) have already been paid off and another two-thirds (31) are current. Just five of these new loans have entered liquidation, and only one has been charged off at a loss.

Notably, this method of maximizing recoveries does not limit a lender's loss rate by merely delaying losses until some later period. BLX has charged off significant losses associated with loans that defaulted initially – thus increasing BLX's loss rate – but for which the second loans have been successful. Indeed, as demonstrated above, the second loans have been successful in supporting and sustaining American small businesses and jobs in the overwhelming majority of cases.

BLX has also at times pursued assumptions as a means to salvage struggling small businesses and enhance recoveries for the SBA and BLX. In an assumption, BLX does not originate a new loan, but instead permits a new borrower to assume responsibility for paying down an already-existing loan's outstanding balance. BLX enjoys a healthy success rate for assumptions as well and this practice has been sanctioned by the SBA. Since its inception, BLX has closed 88 assumptions, and more than 73 percent of these are either current or have been paid in full.

SECOND LOAN			INITIAL LOAN		
SBA Loan No.	*Note Date*	*Loan Amount*	*SBA Loan No.*	*Note Date*	*Loan Amount*
1983444101	10/21/2003	525,000.00	1983444003	5/29/1998	800,000.00
5466464107	11/26/2003	740,000.00	5466464009	6/28/2002	945,000.00
5454614107	6/21/2004	575,000.00	5454614009	6/20/2002	750,000.00
4146914107	8/6/2004	500,000.00	4146914009	12/28/2000	800,000.00
5187714107	10/4/2004	700,000.00	5187714009	3/8/2002	940,000.00
3979774102	10/7/2004	450,000.00	3979774004	9/29/2000	640,000.00
5355934103	10/19/2004	670,000.00	5355934005	5/22/2002	925,000.00
5822674108	10/19/2004	475,000.00	5822674010	11/8/2002	780,000.00
5701824109	1/20/2005	750,000.00	5701824000	10/18/2002	1,120,000.00
4939264102	3/1/2005	475,000.00	4939264004	10/5/2001	745,000.00
4443824100	3/2/2005	463,500.00	4443824002	8/23/2001	686,000.00
5636384100	3/11/2005	1,000,000.00	5636384002	9/6/2002	1,300,000.00
5239434109	3/19/2005	758,558.04	5239434000	3/14/2002	1,333,000.00
5122464103	3/29/2005	165,000.00	5122464005	1/15/2002	212,000.00
4316454104	3/31/2005	240,000.00	4316454006	3/28/2001	530,000.00
5356604100	4/1/2005	740,000.00	5356604002	5/6/2002	970,000.00
2851504109	5/3/2005	330,000.00	2851504000	4/20/1999	1,000,000.00
4296354100	5/4/2005	375,000.00	4296354002	9/5/2001	670,000.00
5407844103	5/5/2005	625,000.00	5407844005	5/30/2002	900,000.00
4691414105	5/5/2005	375,000.00	4691414007	10/1/2001	800,000.00
3083924107	5/12/2005	960,000.00	3083924009	7/29/1999	1,300,000.00
5563064107	6/22/2005	620,000.00	5563064009	7/31/2002	960,000.00
5816294105	5/25/2005	450,000.00	5816294007	11/13/2002	820,000.00
4412734105	5/25/2005	625,000.00	4412734007	4/10/2001	800,000.00
5710724105	5/26/2005	260,000.00	5710724007	11/14/2002	1,240,000.00
5558174100	6/2/2005	300,000.00	5558174002	8/1/2002	780,000.00
4099944101	6/3/2005	125,000.00	4099944003	12/20/2000	250,000.00
5186044105	6/6/2005	625,000.00	5186044007	2/13/2002	890,000.00
4344764100	6/8/2005	450,000.00	4344764002	3/12/2001	987,000.00
5433754104	6/30/2005	352,750.00	5433754006	6/7/2002	720,000.00

5467014103	8/18/2005	360,000.00	5467014005	6/27/2002	800,000.00
Pending	12/19/2005	340,000.00	2095004007	6/26/1998	500,000.00
2183594107	12/30/2005	500,000.00	2183594009	5/6/1999	1,150,000.00
5749074108	2/13/2006	585,000.00	5749074010	8/13/2003	815,000.00
Pending	2/14/2006	325,000.00	4763374008	8/9/2001	795,000.00
6011044108	3/29/2006	692,500.00	6011044010	4/21/2003	1,160,000.00
5720184102	3/29/2006	585,087.88	5720184004	11/18/2002	990,000.00
4526884102	3/31/2006	125,000.00	4526884004	5/30/2001	545,000.00
Pending	3/31/2006	550,000.00	5204854008	3/7/2002	920,000.00
2067174102	5/10/2006	164,045.57	2067174004	9/30/1998	1,000,000.00
Pending	6/8/2006	500,000.00	5287454000	4/2/2002	1,215,000.00
Pending	9/19/2006	475,000.00	4501604005	5/31/2001	780,000.00
Pending	9/20/2006	550,000.00	5466464107	11/26/2003	740,000.00
Pending	9/25/2006	550,000.00	5435744007	6/11/2002	970,000.00
Pending	12/14/2006	500,000.00	3541054006	5/19/2000	1,038,130.55
5389434104	12/15/2006	620,000.00	5389434006	5/24/2002	900,000.00

COMMENTS FOR THE RECORD

TESTIMONY OF JIM BRICKMAN
U.S. SENATE COMMITTEE ON
SMALL BUSINESS AND ENTREPRENEURSHIP
NOVEMBER 13, 2007

SBA LENDER OVERSIGHT:
PREVENTING LOAN FRAUD AND
IMPROVING REGULATION OF LENDERS.

I. Introduction & Overview

Chairman Kerry, Ranking Member Snowe, and Members of the Committee, I appreciate this opportunity to submit this testimony on preventing loan fraud at the Small Business Administration ("SBA") and improving the SBA's regulation of lenders.

I am Jim Brickman, a semi-retired real estate developer and investor in Texas. I concur with and incorporate by reference herein the entirety of David Einhorn's testimony submitted to this Committee in connection with this hearing. I offer to the Committee additional details from my investigation into the improper and fraudulent lending practices that systematically have corrupted the SBA's § 7(a) federal loan guarantee programs, including specifically the Preferred Lenders Program and the General Purpose Lenders Program.

Like Mr. Einhorn, since 2002, I have been concerned about the lending practices of Business Loan Express, LLC and Business Loan Center, LLC (collectively, "BLX"), subsidiaries of Allied Capital Corp. ("Allied"), a publicly traded company. I do not currently hold a short position in the stock of Allied, although I have in the past. Additionally, as stated in Mr. Einhorn's testimony to this Committee, Greenlight Capital, Inc. and I are Plaintiffs-Relators in a qui tam action brought against BLX on behalf of the United States Government regarding hundreds of shrimp boat loans made by BLX in the General Purpose Lenders Program. The case involves scores of specific, documented examples of BLX's violations of the False Claims Act by knowingly and recklessly submitting false claims to the SBA for payment of guarantees on dishonest and fraudulently underwritten shrimp boat loans.

II. My Communications with the SBA

Among the most important questions for the Committee in light of the exposure of BLX's fraud in connection with the SBA programs are:

- What did the SBA know about the frauds?
- When did the SBA learn of the frauds?
- What did the SBA do when it was advised of the frauds?

In addition to the timeline set forth in Mr. Einhorn's testimony regarding red flags raised at the SBA about BLX, I submit to the Committee summaries of my correspondence with the SBA regarding BLX's fraudulent and reckless lending practices.

- In June 2004, I notified Jim Albers at the SBA's Office of Inspector General ("OIG") in Atlanta, Georgia about a fraudulent loan made by BLX's Richmond, Virginia office run by Matthew McGee, a felon convicted for securities fraud. Mr. Albers told me that he did not have adequate resources to investigate the loan I identified.

- Also in June 2004, I provided details to Mr. Albers about another fraudulent loan made by BLX. Mr. Albers forwarded my communication to Keith Hohimer with the OIG in Chicago, Illinois, where the fraudulent loan occurred. I received no response from Mr. Hohimer and assume that no further action was taken by the SBA.

- On June 3, 2005, I submitted to Janet Tasker, Associate Administrator for Lender Oversight for the SBA, a letter and extensive, detailed and specific supporting documentation regarding numerous fraudulent and reckless loans made by BLX in Arizona, Arkansas, Georgia, Illinois, Michigan, Missouri, New York, South Carolina, and Virginia. One of the focuses of my letter was on new fraudulent loans made by BLX in Michigan that were not contained in Mr. Einhorn's detailed analysis shared with the SBA in August 2003. I also described BLX's fraudulent and reckless loans to shrimp fishermen along the Gulf Coast in Florida, Louisiana, Mississippi, and Texas. I urged the SBA not to renew BLX's PLP status. To my knowledge, the SBA took no action in response to my submissions.

- On December 8, 2005, I authored another letter to Janet Tasker, articulating additional reasons why the SBA should not renew BLX's PLP status. I provided specific and detailed calculations of BLX's poor loan performance, showing that BLX was in material violation of the SBA's loan performance benchmarks. I further detailed BLX's fraudulent and reckless lending scheme, identifying, among others, Patrick Harrington as an active participant in that scheme. Once again, so far as the public record shows, the SBA took no disciplinary action against BLX. To the contrary, the SBA renewed BLX's PLP status and allowed it to continue originating fraudulent loans.

Despite these and other detailed communications by Mr. Einhorn, others, and me to the SBA regarding BLX's fraudulent and reckless lending practices, as well as reports from the OIG warning of rampant fraud by BLX, the SBA allowed BLX to continue participating in the § 7(a) loan programs, enabling further fraud and causing additional losses to the taxpayer.

The SBA's failure to respond to clear evidence of BLX's fraud over many years exposed the § 7(a) loan programs to gross abuses by BLX at substantial cost to taxpayers. It is disturbing to see that even now the SBA is continuing to avoid providing full disclosure to Congress and to the public of what went wrong, instead of taking the necessary corrective actions. Rather than own up to its failure to investigate BLX's Michigan loan frauds earlier, the SBA recently issued a press release taking credit for

"protecting the taxpayer." In reality, it appears the SBA took action only after one of BLX's borrowers informed the Department of Justice about BLX's fraudulent loans in Michigan after the borrower was indicted in connection with a non-BLX loan.

Given this history, I urge the Committee and Congress to take appropriate measures to put an end to the fraud in the § 7(a) loan programs by (i) making publicly available the entire July 11, 2007 Report by the OIG without redaction; (ii) remedying the financial incentives in the § 7(a) loan programs that enable fraudulent and risk-free profiteering by lenders such as BLX; (iii) revamping the SBA's program goals to focus on the quality, rather than the quantity, of loans guaranteed; and (iv) ensuring that BLX makes full and proper restitution for the entirety of its fraud. Furthermore, I concur with the Policy Prescriptions set forth in Mr. Einhorn's testimony and am hopeful that the Committee will give them full and careful consideration.

I am grateful to the Committee for the opportunity to submit my statement into the record of this hearing and would be happy to provide supporting documentation for any of the issues raised herein. I look forward to the Committee's recommendations.

TESTIMONY OF DAVID EINHORN,
PRESIDENT, GREENLIGHT CAPITAL
U.S. SENATE COMMITTEE ON
SMALL BUSINESS AND ENTREPRENEURSHIP
NOVEMBER 13, 2007

SBA LENDER OVERSIGHT:
PREVENTING LOAN FRAUD AND
IMPROVING REGULATION OF LENDERS.

I. Introduction & Overview

Chairman Kerry, Ranking Member Snowe, and Members of the Committee, thank you for offering me the opportunity to submit written testimony for the record for this hearing on preventing loan fraud and improving regulation of lenders. It is a topic that I have raised with the Government for several years, as I have investigated fraudulent lending practices that have infected the Small Business Administration's ("SBA's") federal loan guarantee programs. These corrupt loans have lined the pockets of the lenders but have defrauded the United States Government and the American taxpayer on hundreds of millions of dollars of loans.

I am David Einhorn. I am the President and co-founder of Greenlight Capital, Inc. ("Greenlight"), a private investment management firm. Since 2002, I have identified numerous instances of fraudulent lending practices under the auspices of the SBA, focusing on those involving Business Loan Express, LLC and Business Loan Center, LLC (collectively, "BLX"), subsidiaries of Allied Capital Corp. ("Allied"), a publicly traded company. For your background and to ensure full disclosure to the Committee, I want you to be aware that Greenlight holds a short position in the stock of Allied based on my investigations into BLX's abusive lending practices in the § 7(a) federal loan programs, as well as other improprieties involving Allied that are not relevant here. Greenlight has held a short position in Allied since 2002. Additionally, James R. Brickman and Greenlight are Plaintiffs-Relators in a qui tam action brought against BLX on behalf of the United States Government regarding hundreds of shrimp boat loans made by BLX in the General Purpose Lenders Program. The case involves scores of specific, documented examples of BLX's violations of the False Claims Act by knowingly and recklessly submitting false claims to the SBA for payment of guarantees on dishonest and fraudulently underwritten shrimp boat loans.

The structure of the § 7(a) federal loan guarantee programs has made the SBA, and, ultimately, U.S. taxpayers, vulnerable to fraudulent profiteering by lenders such as BLX that are willing to engage in irresponsible and deceitful lending practices. Since at least 1999, BLX has earned hundreds of millions of dollars in fees by fraudulently originating, servicing, and securitizing unsuitable § 7(a) loans that were inevitably going to default. As a result, the SBA has paid hundreds of millions of dollars in loan guarantees on defaulted loans that BLX never should have underwritten. The United States has an ongoing exposure to further loss from fraudulent BLX loans, because BLX continues to submit requests to the SBA for guarantee payments from its current portfolio. Additionally, BLX's fraudulent and abusive lending practices have harmed the

very contingent of American small businesses that Congress intended to assist when it passed the Small Business Act in 1953.

Recently, BLX's fraud partially came to light when Patrick Harrington, the head of BLX's Michigan office, was indicted by the Department of Justice with respect to 76 fraudulent SBA loans. On October 1, 2007, Mr. Harrington pleaded guilty to conspiracy to commit fraud and making a false statement to a grand jury. BLX has attempted to dismiss these fraudulent loans by maintaining that they were limited to this single rogue employee in this single office and that BLX was not aware of the fraud until sometime in recent months. BLX now even goes so far as to claim that it was a victim of the fraud. Nothing could be further from the truth. My research shows that BLX and Allied were aware of allegations against Mr. Harrington half a decade ago and did nothing about it. My research further shows that BLX's fraudulent loans were not confined to Michigan, but rather occurred throughout the country. Indeed, BLX's systematic lending practices have injured American small-business owners and entrepreneurs in Arizona, Arkansas, Georgia, Illinois, Michigan, Missouri, New York, South Carolina, and Virginia, as well as struggling shrimp fishermen along the Gulf Coast in Texas, Louisiana, Mississippi, and Florida. While BLX takes in big fees, these individual borrowers are induced into loans that often end up burying them in unmanageable debt and forcing them into bankruptcy.

By manipulating the structure of the § 7(a) lending programs and capitalizing upon the SBA's lax enforcement efforts, I have found that BLX has been able to engage in rampant, systematic fraud causing the SBA to purchase guarantees on hundreds of millions of dollars of reckless and fraudulent loans made by BLX. The Office of Inspector General's ("OIG's") July 2007 audit that generated today's hearing says, "[L]enders can essentially ignore SBA's delegated lending authority requirements without suffering any material consequences." As a result, lenders, "may not take SBA's oversight seriously." Further, BLX understood how essential it was to helping the SBA achieve its volume goals. BLX exploited the SBA as an ineffective regulator to commit the largest fraud against U.S. taxpayers in SBA history.

These kinds of abuses have gone on for years and I fear that they will continue well into the future in the absence of vigilant oversight and follow-up action by this Committee and Congress. As I will discuss, I believe it is vital for Congress to insist that the SBA make public all of the relevant facts and not be permitted to continue to cover them up. I also have concluded that the SBA needs more funding specifically allocated for its oversight and investigative function to guard against future abuses. My other policy recommendations are provided at the conclusion of my testimony.

II. BLX's Corruption of the § 7(a) Loan Guarantee Programs

Under the § 7(a) loan programs, the SBA guarantees a percentage (typically 75%) of a loan made by a private lender to a qualified borrower. The § 7(a) loan programs contemplate that the private lender will retain the balance of the credit risk (typically

25%). The private lender's retention of a significant credit risk is intended to ensure that the interests of the SBA and the private lender are aligned and that both the SBA and the private lender will have an ongoing financial stake in the repayment of the loan. Congress intended for this 75%–25% allocation to create an incentive for private lenders to make prudent loans to borrowers who exhibit a reasonable assurance of repayment on the loan. If the borrower defaults on the loan, both the SBA and the lender suffer palpable financial consequences.

In practice, I found that BLX developed a system to avoid maintaining the 25% stake in the loans it originated. Instead, it bypassed prudent loan underwriting practices and cleverly finessed its risk by selling the guaranteed portion of these loans to the secondary market and securitizing the unguaranteed portion of the loans, thereby retaining virtually zero credit risk. As is typical in any churning operation, BLX has earned substantial fees upon origination and servicing of the loans regardless of whether the loans default. This scheme is best described in a statement by Joan Sweeney, the Chief Operating Officer of Allied, during an investor conference call on July 23, 2002:

> If you originate a million dollars SBA 7(a) loan, you immediately sell $750,000 of that loan into the secondary market. Those are paying cash premiums today of 10 percent. You get $75,000 of cash right on that sale. You then only have [$250,000] left in the loan. . . . And you sell that via securitization . . ., but you sell off of that $250,000, $245,000 and you get cash back through a securitization. So, out of that million-dollar loan, you only end up with [$5,000] of equity capital required to capitalize it.
>
> So, [$5,000] in and your first year cash proceeds are the $75,000 gain on sale. You get $7,500 on your servicing fees that you get on that loan that you sold. And, you get $9,800 in interest on the [$245,000] piece sold for a first year. . . revenue of $92,000. So, on a $5,000 investment, you get $92,000 of cash in the first year.

For BLX it's "heads I win, tails you lose" because, regardless of the borrower's creditworthiness or the likelihood that the borrower will be able to repay the loan, BLX earns substantial fees while retaining virtually none of the credit risk. In this model, the interests of the SBA and BLX *are not* aligned, and the theoretical risks created by BLX eliminating its ongoing stake have proven to have toxic consequences for the SBA and the taxpayers. In practice, BLX exploited this asymmetry by focusing not on the creditworthiness of its borrowers, but instead on increasing the volume of loans it originates. To that end, BLX has enriched itself at the taxpayers' expense by fraudulently and recklessly underwriting § 7(a) loans to unqualified and unsuitable borrowers.

The numbers are staggering. Over the six year period from 2001 through 2006, BLX originated approximately $1.775 billion in § 7(a) loans, selling "substantially all" of these loans in the secondary market. Based on Joan Sweeney's calculus, BLX earned more than $160 million in revenues in just the first year of these loans. What about the

SBA? The amount of fees the SBA earned in consideration for guaranteeing these loans pales in comparison to the amount it has paid to purchase the guarantees on BLX's defaulted loans. From 2001 to 2006, the SBA paid more than $272 million in guarantees on BLX's defaulted loans.

III. The Trail of Red Flags for the SBA

Anyone at the SBA who suggests that the SBA had no way of knowing the scope of fraud involved in BLX's business prior to this year has failed to look at the extensive record of BLX's fraud.

From 1999-2007, BLX's activities left a trail of red flags which were visible to anyone who looked closely at how it was conducting its SBA-related business. These red flags included (i) BLX's poor loan performance statistics; (ii) the criminal indictment of a BLX executive and the closing of BLX's Troy, Michigan office arising out of fraudulent loan practices; (iii) absent or misleading disclosures regarding BLX's business; (iv) lawsuits and allegations of corrupt practices by victimized borrowers; (v) various audits by the OIG; and (vi) information that others and I provided to the SBA and the OIG. Yet despite the evidentiary and statistical trail and warnings by outsiders, the SBA failed to take any appropriate disciplinary measures to punish and deter BLX for fraudulent lending. This lax oversight further emboldened BLX to continue to engage in fraudulent and abusive lending practices, secure in the knowledge that the U.S. taxpayer would pay the tab. The following is a non-exhaustive timeline of the red flags and significant events related to the SBA from 1999-2007:

- In 1999, an audit by the Farm and Credit Administration, on behalf of the SBA, identified many non-compliant SBA loans in Allied Capital Express's (Allied's small business lending platform) loan portfolio. Allied then bought BLC Financial and merged it with Allied Capital Express to form BLX in 2000. Allied retained 95% ownership of BLX and made it an off-balance sheet entity. This allowed Allied to shift fraudulent SBA loans from its balance sheet to BLX, while avoiding various reporting requirements with the Securities and Exchange Commission, concealing losses, and inflating its earnings during a period in which it sold hundreds of millions of dollars of stock to the unsuspecting public.

- On June 5, 2002, an individual named Jim Carruthers of Eastbourne Capital provided information to the OIG regarding fraudulent loans by Allied in Michigan.

- In June 2002, I provided to the OIG detailed analyses on Allied's and BLX's SBA loan performance, showing that BLX's loans had a default rate more than twice the national average.

- On September 17, 2002, Jim Carruthers informed Garry Duncan, the Director of the SBA's Credit Programs Group, about Allied's and BLX's fraudulent lending practices in Michigan.

- On September 30, 2002, the OIG issued a report that concluded "that the . . . significant deficiencies [in two of BLX's loans] were egregious acts and warrant SBA's action to seek civil fraud remedies against [BLX]." It instructed the SBA to "[c]onsider recommending suspension of [BLX's] preferred lender program status in [Georgia]."

- In December 2002, the Government Accounting Office reported on the ineffectiveness of the SBA's audits and loan monitoring.

- In August 2003, I provided to the OIG detailed research findings regarding BLX loan frauds in many states. These findings revealed numerous fraud techniques illustrated by specific BLX loans in multiple offices throughout the country, including loans originated by BLX's Michigan office. Other examples of fraudulent BLX loans in the report included an SBA-guaranteed loan to Hussein Chahrour, who had been indicted in the U.S. in connection with a terrorist financing operation for the terrorist group Hezbollah, and a loan to a motel drug den.

- On September 28, 2005, the OIG issued a report on BLX's improper practice of refinancing SBA-guaranteed loans with additional SBA-guaranteed loans. This report concluded "that [BLX] did not comply with SBA's [Preferred Lenders Program] processing restrictions for paying off existing SBA debt. . . ."

- In June 2006, the Department of Justice indicted several recipients of fraudulent SBA loans made by BLX in Michigan.

- In January 2007, five years after Jim Carruthers first notified the SBA about BLX's fraudulent and reckless lending practices in Michigan and nearly three and a half years after I submitted my detailed findings containing evidence of BLX's fraudulent Michigan loans, the Department of Justice indicted Mr. Harrington, the head of BLX's Michigan office, in connection with 76 fraudulent SBA loans in Michigan totaling over $76 million. On October 1, 2007, Mr. Harrington pleaded guilty to conspiracy to commit fraud and making a false statement to a grand jury. The Department of Justice indicated that there will be additional indictments.

- In March 2007, the SBA still permitted BLX to remain in the Preferred Lenders Program with modified terms. BLX falsely stated that its problems in Michigan were related to a rogue employee in a single office, and the SBA apparently concurred.

- In March 2007, the SBA settled with BLX for $10 million and a commitment by BLX to reimburse the SBA for any additional fraud.

- On May 8, 2007, the OIG issued a report on the ineffectiveness of the SBA's guarantee purchase review process. The report stated that "staffing problems and an overly aggressive emphasis on expediting and increasing purchase production at the [SBA] has adversely impacted the quality of purchase decisions." The report further noted that "[SBA] [m]anagement was generally non-responsive to the audit findings and recommendations."

IV. July 11, 2007 OIG Report

The July 11, 2007 report by the OIG (the "Report") thus followed many years during which the OIG had been provided information by multiple sources regarding BLX's frauds. This Report observed that "[d]espite recurring problems, SBA continued to renew BLX's delegated lender status and to honor the lender's guarantee purchase requests." The Report recognized what I have known to be true since 2002: The SBA knew of a host of deficiencies in BLX's lending practices and processes but nevertheless continued to guarantee BLX's loans and purchase the guarantees on those loans as a substantial number inevitably defaulted. One of the most disturbing reasons for the SBA's failure to adequately oversee BLX's participation in the § 7(a) loan programs was the apparent interdependence that had developed between the SBA and BLX throughout the years: "Because BLX has been among the top 10 SBA lenders since 2001, any actions that would appropriately mitigate BLX's risk, such as suspending its delegated lending authority, also would have been detrimental to achieving SBA's loan production goals."

Unfortunately, the full scope of the SBA's findings regarding BLX's fraudulent and reckless lending practices was not disclosed to the public. At the SBA's request, the OIG redacted the Report based on purported claims of the Deliberative Privilege and bank examination privilege. The SBA's decision to black-out large portions of the Report censored information that the public has a right to know and that Congress, and in particular, this Committee, *needs* to know, such as:

- What type of fraud did BLX commit?

- What consequences, if any, will BLX face?

- When did the SBA learn of the fraud?

- What did the SBA do once it realized that it was being defrauded by BLX?

- Who at the SBA had information on BLX frauds and failed to act?

- What were the total losses to the SBA as a result of the fraud?

- How did the SBA determine that a $10 million payment was sufficient to reimburse it for its entire loss due to fraud?

- What is the SBA doing to ensure that it recovers all the fraudulent guarantee payments made to BLX and to ensure that it does not honor future guarantee payment requests on fraudulent loans?

- How much taxpayer money could have been saved if the SBA had acted earlier?

- How does the SBA intend to ensure that this does not happen in the future?

- What is BLX's response to the criticism of its lending practices by the OIG?

It is up to Congress and this Committee to determine whether the answers to these questions will remain a secret. In concert with various participants in the § 7(a) loan programs and Bob Coleman, I urge this Committee and Congress to seek full public disclosure of the Report. Redaction of this and other information in the Report conceals highly relevant information that has been the subject of public discussion about BLX's fraud for years, enables further fraud, impairs proper regulatory oversight, and deprives United States citizens of open and honest government.

V. My Investigation

I offer to the Committee the findings of my investigation into BLX's § 7(a) loans (i) to fill in some of the redactions in the Report; (ii) to urge the Committee to obtain and publicize an unredacted version of Report; (iii) to identify the areas of the § 7(a) programs most vulnerable to fraud and abuse; and (iv) to provide policy prescriptions to address those vulnerabilities.

A. Preferred Lenders Program Loans

BLX participates in the SBA's Preferred Lenders Program ("PLP"). The SBA delegates to PLP lenders complete authority to make, service, and liquidate SBA-guaranteed loans without obtaining the prior specific approval of the SBA. Under the current regulatory regime, the SBA essentially provides PLP lenders with unfettered discretion to issue federally guaranteed loans.

PLP lenders certify, among a host of other things, that they have acted consistent with prudent lending practices in approving a borrower for a PLP loan and that the borrower exhibits reasonable assurance for repayment of the loan. PLP has essentially established a self-policing honor system, inasmuch as the SBA relies heavily on private lenders' investigations into and verification of borrowers' financial information. Given the huge and profitable incentives to cheat, it is critical that the SBA adequately oversee

and monitor the performance of each PLP lender's loans, and act quickly and appropriately when lenders fail to comply with the SBA's policies.

BLX has flunked the honor system and has disregarded whether its borrowers demonstrated the ability to repay loans. BLX has focused solely on garnering origination and servicing fees by generating an increasing number of loans that are virtually risk-free for it, but costly to the taxpayers. BLX has abused the authority delegated to it as a PLP lender in the following ways:

- Failing to verify, misrepresenting, or misstating borrowers' financial information, equity injection, and value of collateral;
- Illegally preparing loan applications for borrowers;
- Refinancing defaulted SBA-guaranteed loans with additional SBA-guaranteed loans;
- Using sham borrowers to circumvent the SBA's maximum loan limits to borrowers;
- Using sham borrowers to circumvent the SBA's restrictions on lending to borrowers who had already defaulted on a prior SBA-guaranteed loan;
- Concealing early defaulted loans by forestalling foreclosure proceedings, keeping failed loans technically "alive" in the eyes of the SBA.

BLX's reckless lending practices resulted in countless improper and outrageous loans which inevitably defaulted and caused losses to the SBA and the taxpayer. The 2007 indictment and guilty plea of BLX executive vice president Mr. Harrington spotlighted some of these practices in Michigan. However, BLX's fraud is not confined just to Michigan. Indeed, as I have reported to the SBA for years, it is much more widespread, including frauds in Arizona, Arkansas, Florida, Georgia, Illinois, Louisiana, Mississippi, Missouri, New York, South Carolina, Texas, and Virginia.

One of the most common occurrences in BLX's fraudulent PLP loans was the "flip fraud," whereby BLX would make a large SBA-guaranteed loan for the purchase of property at an inflated price. The inflated value of the property enabled BLX to make a larger loan to the borrower, resulting in BLX earning a larger fee for the transaction and a larger loss to the Government upon default. In just one of many of these pump-and-dump examples, BLX underwrote a $1,000,000 PLP loan to a borrower to purchase a gas station for $1,650,000. However, just four months earlier, the same property had been sold to a third party for approximately one-third of that price. No improvements had been made to the property; the increase in value was artificial. Had BLX acted as a prudent lender and followed the SBA's rules and standard operating procedures, BLX would have discovered the true value had been inflated and would not have underwritten

such a large loan. Instead, BLX, as it was incentivized to do, made the loan. In an all-too-familiar ending, BLX ultimately foreclosed on the property within 18 months of making the loan. BLX itself probably suffered negligible (if any) financial consequences from the default because of its practice of selling nearly the entire loan to the secondary market. This is just one of many examples.

BLX's dishonest and reckless lending practices run much deeper than financing flip frauds. For example, thanks to BLX, the SBA has guaranteed PLP loans used to purchase (i) a motel shut down by the Norfolk city police one month after purchase because it was as an ongoing "drug blight;" (ii) a gas station in Detroit associated with an individual who had been indicted by the Department of Justice for financing the terrorist organization Hezbollah; and (iii) a business situated on an environmentally impacted property owned by an individual with ties to organized crime.

Nevertheless, the SBA continued to renew BLX's PLP lender status, enabling BLX to continue to make additional reckless and fraudulent PLP loans at taxpayer expense.

B. Shrimp Boat Loans

BLX's fraudulent and abusive lending practices are not just confined to PLP. BLX also participates in the General Purpose Lenders Program ("GP"). Under GP, BLX is delegated less authority to approve, underwrite, disburse, and service loans. The SBA is supposed to play a greater role in analyzing borrowers' financial information to determine whether to guarantee a loan. Nevertheless, the SBA relies heavily on GP lenders for accurate and truthful information contained in GP loan applications.

Through its participation in GP, BLX originated hundreds of shrimp boat loans to shrimp fishermen along the Gulf Coast in Texas, Mississippi, Louisiana, and Florida. Many of these fishermen were Vietnamese immigrants who came to the United States in pursuit of the American dream and to build a better life for themselves and their families. They represent the very group of people whom Congress intended to benefit from the Small Business Act. To BLX, however, these immigrant fishermen – who for the most part were unsophisticated, poor, often did not speak English, did not have legal representation, and did not know how the "system" worked – represented a profitable opportunity for underwriting large quantities of SBA-guaranteed loans.

BLX unscrupulously preyed on these individuals, encouraging and convincing them to take on large loans that they could not repay. In many cases, BLX (i) filled out their loan paperwork; (ii) misstated their finances; (iii) mischaracterized items as equity injections; (iv) inflated the value of the shrimp boats that the loan proceeds were used to purchase; and (v) arranged for loans to shill borrowers for the benefit of shrimp fishermen who had already defaulted on other SBA-guaranteed loans originated by BLX. And BLX did this at a time when the industry already had too many shrimp boats and too many fishermen, making repayment of these loans even less likely.

Indeed, as the shrimp industry collapsed from 1999-2002, shrimp fishermen became increasingly vulnerable targets for BLX's practices. While prudent lenders recognized that loans to these shrimp fishermen were simply too risky, BLX – unconcerned about credit risk because of its practice of securitizing its loans – made even greater quantities of shrimp boat loans. By 2002, just one company, BLX, was responsible for 75% of all SBA-guaranteed shrimp boat loans.

The SBA's handling of BLX's shrimp boat loans unfortunately reflected an agency incapable of exercising independent judgment or effective oversight. It appears that the SBA violated its own standard operating procedures by failing to seek prior approval from the Department of Commerce's National Marine Fisheries Service before guaranteeing these shrimp boat loans. Moreover, the SBA consistently approved BLX's shrimp boat loans, even though there were signs that BLX was engaging in loan-churning. The SBA's inadequate oversight on these loans was extraordinary. At one point, the SBA approved 44 loans worth a total of $29 million to multiple borrowers using the exact same address in Biloxi, Mississippi. Not only did the SBA approve these loans, but it also dutifully and without question paid tens of millions of dollars in guarantees when many of these loans inevitably defaulted.

According to a December 2005 story in *The Wall Street Journal*, when the losses from BLX's shrimp boat loans jeopardized BLX's status as a PLP lender, the SBA simply decided to exclude the shrimp boat loans from its statistical analysis of BLX. As *The Wall Street Journal* put it, the SBA "moved the goal posts closer."

Incidentally, the SBA has made it harder for me to conduct my investigation into BLX's fraudulent conduct. In 2005, I sent several requests under the Freedom of Information Act ("FOIA") to the SBA to release BLX's statutory filings and the SBA's internal risk ratings relating to BLX. Even though most other government agencies make statutory filings and related information public, the SBA denied my FOIA requests on the ground that disclosure of such information "could be competitively harmful to [BLX]."

VI. Victims of BLX's Loan Practices

BLX's loan practices have resulted in untold losses to the SBA, and, ultimately, the taxpayers. BLX has used the § 7(a) loan guarantee programs to originate loans which it can sell for a premium in the secondary market, retaining virtually none of the credit risk and lining its pockets with substantial loan fees.

BLX has bankrupted borrowers and destroyed lives. Many of the borrowers purchase small businesses at inflated prices because BLX is willing to finance them. When the true values of the businesses become apparent, these borrowers suffer financial ruin. Amanda Le, a shrimper in Texas, is a perfect example. A Vietnamese immigrant who could barely speak English, Amanda Le received a $1,000,000 GP loan from BLX to purchase a shrimp boat. Shortly thereafter, Amanda Le defaulted on the loan and, in

2004, filed for bankruptcy. After emerging from bankruptcy, Amanda Le and her husband set out to rebuild their lives, planning to purchase a used shrimp boat and resume shrimping. Instead, a BLX loan agent convinced them to obtain a large GP loan from BLX to buy *two new* shrimp boats at prices almost twice what they were worth. The loan agent further encouraged Amanda Le to use her nephew as the nominal borrower for the loan, because his credit had not been tainted by bankruptcy. This second GP loan went into default and caused Amanda Le and her husband to declare bankruptcy for a second time. This is just one of many examples of the injury BLX has inflicted upon borrowers.

Other borrowers have been indicted and imprisoned for following the instructions of aggressive BLX loan agents to falsify information in loan applications.

VII. Conclusion and Policy Prescriptions

BLX is a case study of the problems that currently exist in the § 7(a) loan programs. When Congress passed the Small Business Act in 1953 and created federal loan guarantee programs, there was no secondary market for debt instruments that enabled loans to be securitized. Therefore, lenders and the SBA were forced to share credit risk on every loan that was underwritten. Today, however, lenders like BLX can jettison virtually all of this credit risk by selling the guaranteed potion of the loans in the secondary market and securitizing the unguaranteed portion. This creates an incentive for lenders to focus only on generating high volumes of loans without regard to the creditworthiness of the borrower or the likelihood of repayment. As evidenced by some of BLX's loans, when § 7(a) lenders no longer are "picky" about the character and creditworthiness of their borrowers, the SBA may find itself guaranteeing loans to uncreditworthy and unsavory individuals and organizations.

The Report makes an even more disturbing finding: The SBA has established a system in which the SBA does not take enforcement action, even against a lender like BLX that has engaged in fraud, if that lender is generating a high volume of loans, because the lender helps the SBA to meet its internal loan production goals. The OIG's findings in the Report suggest that this situation has caused the SBA to lose the independence, objectivity, and impartiality needed to provide the proper oversight and enforcement of its rules, regulations, and standard operating procedures.

The SBA considers itself to be a "lender friendly" agency. The effect of this has been to delegate the authority to sign the U.S. Government's name to billions of dollars of loans without providing any effective oversight to ensure that the taxpayer is not being taken for a ride.

In conclusion, I offer the following policy prescriptions to correct some of the problems in the § 7(a) programs highlighted by this case study of BLX. I am hopeful that the Committee will take them under advisement:

- The SBA should aim to guarantee quality loans to qualified and creditworthy small business concerns, rather than strive to meet internal loan production goals. This focus on quality, rather than quantity and volume, will ensure that the SBA maintains the independence, objectivity, and impartiality it needs to provide proper oversight and enforcement of its rules, regulations, and standard operating procedures. The SBA needs to separate its oversight function from its business development function.

- The SBA delegates underwriting authority to private industry, which saves costs. The SBA should allocate all or part of those savings to appropriate oversight, including (i) a significant review of loan eligibility when defaulted loans are submitted to the SBA for guarantee payment and (ii) transaction testing similar to what is performed in the banking industry. The SBA needs significantly more staffing and budgetary support properly to ensure compliance.

- The SBA's audits should focus on measuring the quality of lenders' underwriting decisions, instead of filling out "check-the-box," pro forma questionnaires and studying loan files for "completeness."

- For its own accounting purposes, the SBA should recognize losses when the losses occur and it pays a guarantee, instead of waiting for the final resolution of the loan before recognizing losses. "Final resolution" of a loan can be (and is) easily manipulated by private lenders, skews the statistics used to monitor the lending programs, and enables much of the fraud and abuse occurring in the SBA's loan programs.

- The SBA should develop objective criteria that lenders must satisfy in order to participate in its loan programs. Likewise, the SBA must enforce these criteria by disqualifying noncompliant lenders. The SBA must not turn a blind eye to violations of its regulations, standard operating procedures, and other directives by high volume lenders that it deems "too important" to disqualify from SBA loan programs.

- The SBA should make publicly available much more information about its lender performance, including the SBA risk ratings and participant regulatory filings. Regulators in other financial sectors routinely make this information available. For example, the Federal Deposit Insurance Corporation requires members to submit extensive financial information, from which the public can calculate risk ratings. Additionally, the risk ratings of insurance carriers are provided upon request.

- The newer § 7(a) loan programs, such as SBA*Express* and Community Express, should be eliminated. These programs, which focus on "getting smaller loans to even more people faster," do not work within the current framework. They have even less oversight and are rife with abuse.

I would like to thank the Committee for allowing me to submit written testimony to the record of this hearing on preventing loan fraud and improving regulation of lenders. At the request of the Committee, I would be happy to provide documentation in support of my testimony or help in any other way that the Committee deems necessary. I look forward to the Committee's recommendations.

RESOURCE CAPITAL
Real Estate Financing for Growing Businesses

December 5, 2007

Steve Suite
Chairman
NADCO
6764 Old McLean Village Dr
McLean, VA 22101

Dear Mr. Suite:

We have recently read Mr. Baird's testimony to the Senate Small Business Committee regarding 504 Loan Guaranty Program Lender Oversight and were troubled. In his testimony Mr. Baird made some broad brush innuendos which pointed a finger at California PCL lenders, stating they were violating many aspects of the SBA regulations and policies. We are requesting substantiation of who the offenders are and how they have violated SBA regulations:

> How are the PCL lenders not properly underwriting loans?
>
> How are the PCL lenders not following SBA regulation and policy in the area of environmentally impaired projects?

We find it disappointing that such accusations were made without being grounded in factual information; especially in light of the fact that many of the PCL lenders have been through thorough audits by OCRM with no mention of these concerns. Further, to make such allegations on the NADCO platform gives a false impression that the industry, as a whole, concurs with such statements, which is simply dishonest.

The comments presented are in drastic contrast to what we have experienced in our portfolio and with data that has been presented in the past. Until shown substantiation that reflects Mr. Baird's allegations, we can only assume it is misinformation promulgated by those struggling to compete.

Sincerely,

Frank F. Dinsmore
Chief Executive Office

cc: Bryan Hooper
cc: Senator Kerry
cc: Senator Snowe
cc: Administrator Preston

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