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# INTRODUCTION

Chairman Cardin, Ranking Member Ernst, and distinguished members of the Committee, thank you for inviting me to testify before you today and for your continued support of the Office of Inspector General (OIG). I am proud of the dedication and hard work of the men and women of OIG to not only oversee SBA programs and services, but also to detect, deter, and combat fraud.

Our office provides auditing, investigative, and other services to support and assist U.S. Small Business Administration (SBA) in achieving its mission. OIG's oversight efforts provide recommendations to SBA leadership to improve the performance of SBA's programs and services for the benefit of the American people. The office's investigations pursue evidence of wrongdoing in SBA programs, bringing fraudsters to justice. For the past 2 years, the office is ranked as the top OIG in the federal government as a Best Place to Work by the Partnership for Public Service.

OIG provides taxpayers with an exponential return on investment, rooting out fraud, waste, and abuse in SBA programs. In the past 2 years alone, OIG's work has resulted in more than $9 billion in dollar accomplishments and published 49 reports. Our work also has played a major role in the return of more than $30 billion in pandemic relief funds from borrowers and financial institutions. Dollar accomplishments include investigative recoveries, fines, and forfeitures, as well as review findings of disallowed costs.

OIG strives to continue to deliver on these oversight duties, but we are dependent on the availability of sufficient budgetary resources to address fraud within SBA pandemic response programs. The President has put forward a Fiscal Year (FY) 2024 budget request for OIG to ensure continued oversight of SBA's pandemic response and its vital flagship programs supporting the nation's small businesses. The President also has sought $100 million in supplemental appropriations for OIG, in addition to other measures, for a whole-of-government response to the massive fraud in the nation's pandemic response programs. Absent the total budgetary resources requested for OIG in the 2024 Budget, we will not have sufficient funds to combat the fraud within SBA programs and to provide effective oversight over the agency's flagship programs.

Among these flagship programs is SBA's 7(a) loan program. SBA is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government guaranteed loans. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures. The Paycheck Protection Program (PPP) was created under section 7(a) of the Small Business Act to deliver vital financial assistance to mitigate economic damage resulting from the pandemic.

## LEVERAGING THE 7(a) LOAN PROGRAM TO EXTEND CREDIT

The 7(a) loan program was created by Congress to help eligible small business owners and entrepreneurs who are unable to qualify for conventional financing secure funds to meet certain business goals, with the overall goal of strengthening and diversifying the American economy. The 7(a) loan program has been adjusted to meet the nation's needs during difficult times, using lenders designated by SBA to finance the program with the backing of the government guaranties in case of borrower default. Though this program is an important resource to American entrepreneurs, with maximum loan amounts up to $5 million, guarantees up to 90 percent, and an annual lending amount of about $35 billion, the program presents significant risk of loss to taxpayers. OIG has a robust body of work to inform Congress and the SBA Administrator of these risks. OIG offers recommendations to improve the efficiency and effectiveness of the program.

SBA has taken steps through pending final rules to expand Non-Federally Regulated Lenders' participation in the program. It is anticipated these lenders will use financial technology companies in a similar way that we saw in the PPP. Financial technology provides these Non-Federally Regulated Lenders and Small Business Lending Companies, which are collectively referred to as SBA Supervised Lenders, with the capacity to reach underserved markets. Highly regulated depository institutions (such as banks or savings associations), which are the backbone of the 7(a) loan program, also use financial technology in making services available to anyone with access to the Internet. With robust internal controls, oversight and monitoring, and enforcement by SBA, risk of loss and costs to taxpayers can be significantly mitigated. OIG's past and ongoing work can inform critical decisions to plan and deliver the 7(a) loan program.

## INTERNAL CONTROL ENVIRONMENT

SBA is amending its business loan program regulations to lift the moratorium on licensing new Small Business Lending Companies. The agency plans to add a new type of lending entity called a Community Advantage Small Business Lending Company. SBA also is removing the requirement for a loan authorization in the 7(a) and 504 loan programs. The 504 Certified Development Company Loan helps qualifying entrepreneurs who cannot find traditional financing purchase or renovate real estate or buy heavy equipment for a small business.

In conjunction with removing this loan authorization requirement, SBA is amending various regulations governing SBA's 7(a) loan program and 504 loan program, including regulations on use of proceeds for partial changes of ownership, lending criteria, loan conditions, reconsiderations, and affiliation standards. The

goals of these changes are to expand access to capital to small businesses and drive economic recovery. The amendments to affiliation standards are intended to apply to the Microloan Program, Intermediary Lending Pilot Program, Surety Bond Guarantee Program, and the Disaster Loan programs, excluding the COVID-19 Economic Injury Disaster Loan (EIDL) Program.

OIG's oversight work affirms SBA must take intentional steps to design, implement, and operate an effective internal control system as it lifts the moratorium on new Small Business Lending Company participation and adds the Community Advantage lending companies into the 7(a) loan program. Efficiencies sought through the various regulation changes increase risk, which may be mitigated by an internal control system that is fully considered within policy and procedures that implement the rules.

When SBA placed a moratorium on approving additional Small Business Lending Companies in 1982, it did so to reduce the administrative resources needed to prudently regulate and oversee non-depository lenders with a nationwide 7(a) lending platform. These non-depository lenders are supervised by SBA. As recent as 2020 (Final Rule, *SBA Supervised lenders Application Process*, December 4, 2020), SBA stated it does not have the administrative resources needed to increase the number of lending companies beyond 14 or to oversee their participation in a nationwide 7(a) lending platform.

We believe our white paper *Risk Awareness and Lessons Learned from Prior Audits of Economic Stimulus Loans*, published on April 3, 2020, which sought to inform the policy decisions in implementing the PPP, must be considered in context of the actions set forth in the lending company expansion and affiliation rules.

In this Risk Awareness and Lessons Learned White Paper, we acknowledged that SBA has significantly improved its internal control environment in recent years to reduce improper payments and implement quality assurance in its processes. However, recognizing the size and scope of the PPP, we proposed several key considerations for mitigating financial loss when expediting loans to eligible small businesses. The expansion of SBA Supervised Lenders within the 7(a) loan program also requires these considerations. SBA should:

- issue clear requirements and ensure timely communication to lending partners;
- establish and monitor specific outcome-oriented performance measures;
- ensure public communication from SBA officials is appropriate and consistent with the established requirements;
- establish proper controls in the loan approval phase to ensure eligibility of participants and to mitigate the risk of loan default;
- establish a quality assurance plan to prevent and detect improper payments;

- oversee the program to ensure it is implemented as intended and that program goals and objectives are met; and
- modify existing loan systems to track program data to support accurate program measurement and reporting.

OIG believes its body of oversight work, to include oversight of SBA's pandemic response is vital to SBA's approach to implementing these rules. OIG annually publishes its report *Top Management and Performance Challenges Facing the SBA* in accordance with the Reports Consolidation Act of 2000. The management challenges represent areas OIG considers particularly vulnerable to fraud, waste, abuse, mismanagement, or which otherwise pose significant risk to the agency, its operations, or its credibility. Each management challenge generally has originated from one or more reports issued by OIG or the Government Accountability Office. Although we view all challenges as critically important to SBA operations in the upcoming year, we placed COVID-19 economic relief programs first on the list in the 2021, 2022, and 2023 reports.

OIG has identified oversight of high-risk lending participants, and improper payments in the 7(a) loan programs as top management challenges. In 2023, these challenges are noted as follows:

> **Challenge 4: SBA Risk Management and Oversight Practices Need Improvement to Ensure the Integrity of Loan Programs**
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> Why this is a challenge: SBA's Office of Credit Risk Management (OCRM) manages credit risk for the agency's loan portfolio, and this includes the remaining outstanding loans made through the PPP. SBA's lack of internal controls in PPP led to significant fraud risk and vulnerabilities. Additionally, we found that SBA did not have an organizational structure with clearly defined roles, responsibilities, and processes to manage and handle potentially fraudulent PPP loans. We noted OCRM has the principal responsibility in overseeing such risks within the portfolio. Many PPP loans were originated by lenders and other companies that often have a low degree of expertise in SBA loan program requirements, which was identified as an ongoing challenge for FY 2023.
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> Lenders often rely on the services of fee-based and other third-party agents to help originate, close, service, and liquidate SBA loans. Most traditional SBA-guaranteed 7(a) and 504 Certified Development Company loans are originated by lenders with delegated approval authority. Generally, these lenders are subject to only limited SBA oversight and quality control unless a borrower default on a loan.

Our previous audits have found SBA has not adequately recognized or managed significant lender weaknesses. In an audit of SBA's oversight of high-risk lenders (Report 20-03), we identified additional internal control weaknesses in lender oversight.

Previous OIG audits have also shown that SBA did not effectively identify and track third-party agent involvement in its 7(a) and 504 loan portfolios. Tracking such agents is crucial in managing the portfolios because many lenders rely on the services of fee-based and other third-party agents to help originate, close, service, and liquidate SBA loans.

**Challenge 6: Identification of Improper Payments in SBA's 7(a) Loan Program Remains a Challenge**

Why this is a challenge: OIG audits and reviews have identified 7(a) loans that were ineligible, given to borrowers who did not have the ability to repay, or were not properly closed, resulting in improper payments. Improper payments occurred in part because SBA did not adequately review related loans, which is why this remained a management challenge this year.

In FY 2021, the dollar amount of SBA's 7(a) loan approvals totaled $36.8 billion. Most of these loans were made by lenders with delegated approval authority. When a loan goes into default, SBA reviews the lender's actions on the loan to determine if it is appropriate to pay the lender the guaranty, which SBA refers to as a "guaranty purchase." "Guaranty" is a variant of "guarantee" used in financial terminology.

About 8 years ago, OIG established a High-Risk 7(a) Loan Review Program to evaluate lender compliance with SBA requirements for high-dollar, early defaulted 7(a) loans. High-dollar, early defaulted loans are $500,000 or more and default within the first 18 months of initial disbursement. The 7(a) loan program has been the agency's largest financing program for general business needs; therefore, it is vital that SBA identify and reduce the risk of improper payments in order to meet its objectives for the program.

## KEY RISK CONSIDERATIONS OF SMALL BUSINESS LENDING COMPANY EXPANSION

SBA has stated that the lending company moratorium has been in place principally because of the administrative resources needed to administer and regulate an expansion beyond the existing 14 Small Business Lending Companies. Such concerns are well founded, especially in context of increased risks that are associated with lending authorities available within the 7(a) loan program, which

presently are not authorized by the Community Advantage Pilot program. Removal of the Loan Authorization as part of loan origination also gives rise to a concern within our Risk Awareness and Lessons Learned White Paper —it is necessary for SBA to issue clear requirements and ensure timely communication to lending partners. Clear guidance and program requirements will enable lenders to participate in the program with confidence that guarantees are secure if terms and conditions are met.

OIGs oversight, such as in this situation, helps guide SBA in its efforts to institute a robust internal control environment.

*Risk of Default*

OIG's Report 20-08, published in March 2020, found the default rate for Community Advantage Pilot Program loans approved between FY 2011 and 2016 exceed 14 percent. Over the same period, the default rate for similarly sized non-Community Advantage 7(a) loans was 8.7 percent. SBA has proposed for lenders to rely more heavily on credit scores, as opposed to more stringent underwriting. Additionally, SBA has proposed reliance on lender credit policies in lieu of an SBA standard. Concerns noted during the rulemaking effort were offset by SBA comments that it reviews credit policies as part of application to become an SBA lender.

*Risk of Loss through Increased Maximum Loan Amounts*

The Community Advantage Pilot has a maximum loan amount of $350,000. SBA's pending rule is silent on the maximum loan amount. Aligning the Community Advantage Small Business Lending Company program requirements with 7(a), absent any specified restrictions, would allow for loans up to $5 million. Increased dollars equates to increased risk to the taxpayer, particularly since the basis of SBA's 2020 Small Business Lending Company rulemaking sought to address loan loss reserve concerns associated with such large loans.

*Risk of Insufficient Oversight and Monitoring*

SBA Supervised Lenders are regulated by SBA, as opposed to banking regulations and insurances. OIG Report 23-05 has highlighted staffing within the Office of Credit Risk Management (OCRM) as an area of risk, which is especially significant in context of the stated basis of the 40-year moratorium—necessary administrative resources. Such resources also would be needed in lender application reviews relative to credit policies and continuing oversight of this important program aspect.

> OIG Report 23-05 identified factors that could impact the 7(a) loan program and should be considered in SBA's program risk strategy. Specifically, in FY 2021, the total amount of loans increased to $31.4 billion from $19.4 billion in

FY 2020 (62 percent increase) and $20.6 billion in FY 2019 (53 percent increase), as did the average loan amount. Loan approvals decreased in FY 2020 and returned to pre-pandemic levels in FY 2021. Default and charge-off rates also significantly declined after implementation of the Coronavirus Aid, Relief, and Economic Security Act.

Oversight staffing levels within OCRM decreased from 42 to 26 employees, or by 38 percent. This staff reduction could affect SBA's FY 2023 goal for oversight reviews, which help ensure lender compliance with program requirements. The relief payments likely attributed to declining default and charge-off rates. Small businesses also had access to additional support during the COVID-19 pandemic, which included the PPP, the Restaurant Revitalization Fund, Economic Injury Disaster Loans, and deferred 7(a) loan payments. However, variable interest rates for 7(a) loans increased because the base prime rate increased from 3.25 percent to 6.25 percent in 2022. The effects of the pandemic combined with the rising interest rates could increase the risk for subsequent defaults and charge-offs. These program trends could increase SBA's liability and have a negative impact on its ability to achieve its zero-subsidy rate goal.

Finally, OIG offered key considerations for SBA. To ensure 7(a) loan program integrity, reduce the risk of financial loss and facilitate meeting its zero-subsidy rate goal, SBA should consider potential risks related to higher loan amounts, rising interest rates, staffing shortages, delayed defaults, and charge-offs in its 7(a) risk strategy.

*Risk of Other Than Small Businesses Accessing Credit Programs*

SBA's pending affiliation rule indicates, "The determination of affiliation is necessary to ensure that an applicant is 'small' for purposes of eligibility for SBA financial assistance and to ensure that the applicant (including affiliates) does not exceed the maximum guaranty amount available." However, SBA's rule is specifically removing the principle of control of one entity over another as a separate basis for finding affiliation. The stated reason is "because the concept of control as it exists requires understanding and expert consideration of business entity relationships well beyond what is owned by the applicant business or its owners."

OIG's Report 18-13 found that 7(a) loans made to chicken growers did not meet regulatory and SBA requirements for eligibility. The large chicken companies (integrators) in our sample exercised such comprehensive control over the growers that our office believes the concerns appear affiliative under SBA regulations. Therefore, SBA and lenders approved 7(a) loans that were apparently ineligible under SBA size standard regulations and requirements.

> We found integrator control exercised through a series of contractual restrictions, management agreements, oversight inspections, and market controls. This control overcame practically all of a grower's ability to operate their business independent of integrator mandates. As a result, from FY 2012 to FY 2016, SBA guaranteed approximately $1.8 billion in loans that may be ineligible.

OIG's findings in this review hinged on the concept of affiliation through control, and in the SBA pending final rule, this affiliation criterion is removed. Without a requirement to consider control as an affiliative component, a lender potentially would simply view the chicken grower as the owner, absent any subsidization that the 7(a) loan would provide to the operations of the large companies that are controlling the chicken grower's business.

The rule also removes being a franchise as an element to consider as a basis to assess affiliation. The rule states SBA is removing pre-approved franchises that do not have affiliation as determined by SBA. SBA's approved franchise list assisted lenders by not having to conduct a control assessment on a loan-by-loan basis for identified franchises. Our Report 13-17 found that franchise loans are a high-risk segment of the portfolio, and our recommendations focused on portfolio risk management by SBA.

## TECHNOLOGY

Data analytics has been essential to OIG's pandemic oversight efforts. In the fall of 2022, OIG took a significant step by establishing its Technology Solutions Division, which aligns with our objective of "leveraging technology and employee experience to improve OIG methods in carrying out our mission." Through intentional investments in data analytics, OIG's data analytics team has been able to use machine learning and artificial intelligence to identify outliers in the portfolios for investigation, as well as employing traditional data analytics to develop investigative leads for our special agents working in tandem with task force partners.

Our enhanced data analytics capabilities allow OIG to use data matching to expose potential fraud rings rather than investigating potential fraud on a case-by-case basis. To date, OIG's data analytics have identified billions of dollars in potential fraud in SBA's pandemic response lending programs, and this capability is central to our ongoing work to identify the emerging fraud landscape. Additionally, with the hundreds of thousands of allegations of wrongdoing reported to the OIG Hotline and through our data analysis efforts, our ability to handle them is only possible through robust data analytics tools. Of the more than 240,000 Hotline complaints we've received, our data analytics team identified more than 86,000 actionable leads, which alone represents more than 100 years of investigative case work.

Such technology can be equally powerful in establishing a robust internal control environment for program management and the program responsibilities of monitoring and oversight, and regulatory enforcement. Such efficiencies can force multiply the impact of limited resources. However, such tools can be limited by the availability of data. Although SBA and OIG have statutory and regulatory access to loan files, corresponding loan information within SBA's Capital Access Financial System, which includes E-Tran for loan origination and servicing is not comprehensive. To effectively employ artificial intelligence, comprehensive and reliable data must be available and be current. Where data limitations exist, it is vital that internal controls also are not absent and are calibrated in a manner that provides necessary assurance.

As an example, our pandemic response oversight found a concern where reliance on technology resulted in improper payments and potential fraud.

> OIG's Report 22-17 evaluated SBA's controls to flag or prevent potentially fraudulent COVID-19 EIDL applications submitted from foreign Internet Protocol (IP) addresses. Although the agency implemented several layers of controls to prevent or reduce fraud from foreign countries, individuals at foreign IP addresses were able to access the COVID-19 EIDL application system. SBA received millions of attempts to submit COVID-19 EIDL applications from foreign IP addresses and stopped most of them; however, the agency processed more than 233,000 of these applications from March 20, 2020 to November 12, 2021, our review period. Of this amount, SBA approved and disbursed 41,638 COVID-19 EIDLs, advances, and grants for $1.3 billion.
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> The numerous applications submitted from foreign IP addresses are an indication of potential fraud that may involve international criminal organizations. OIG has ongoing investigations into international organized crime operations that applied for and stole pandemic relief funds. SBA officials were aware of and concerned about the potential fraud from overseas. We recommended that the agency examine controls related to foreign IP addresses and ensure these controls are more effective in future disaster processing systems among other recommendations for corrective action.

## CONCLUSION

OIG's prior work has identified areas of risk in SBA's 7(a) loan program. SBA has made significant progress in addressing the identification of improper payments in the 7(a) loan program and continues to make progress in risk management and

oversight practices within OCRM. OIG's ongoing oversight will continue to promote integrity, efficiency, and effectiveness it these areas.

SBA's pending final rules to rescind the new Small Business Lending Company moratorium, and to remove loan authorization and affiliation controls have associated risks. Our work has increased transparency on these significant risks and inform the program decisions under consideration today. Solid rules and regulations, strong internal controls, and an effective process for oversight and monitoring can mitigate risk and lead to efficiency and effectiveness.

OIG will continue to shine the light of transparency on areas of concern and will be the independent and objective voice in our service as a valued change agent. The President has put forward a FY 2024 budget request for OIG to ensure continued oversight of SBA's pandemic response and its vital flagship programs supporting the nation's small businesses. The President also has sought $100 million in supplemental appropriations, in addition to other measures, for a whole-of-government response to the massive fraud in the nation's pandemic response programs. Absent the total budgetary resources requested for OIG in the 2024 Budget, we will not have a sufficient operating budget to combat the fraud within SBA programs and to provide effective oversight over its flagship programs, which includes the 7(a) loan program.