

SBA Information Notice



TO: All SBA Employees

CONTROL NO.: 9000-1793

SUBJECT: Detecting Fraud in Small Business
Administration Lending Programs

EFFECTIVE: 4-7-2009

This Notice provides information, tips and recommendations to detect and deter fraud in the Small Business Administration (SBA) business loan programs. All District Offices and Centers are asked to forward this Notice on to lenders and Certified Development Companies in their area as lending officials are often the first line of defense in identifying and reporting fraud to the SBA Office of Inspector General (OIG).

Every year, the OIG obtains multiple convictions of borrowers and loan agents that have committed fraud in the SBA business loan programs. The OIG's concerns about potential fraud have increased in light of the recent passage of the American Recovery and Reinvestment Act, which implements new lending programs and is intended to expand significantly SBA loan volume.

Detecting and reporting fraud is in the best interest of all program participants. Fraud undermines public confidence in the public benefits of SBA lending programs, which support economic opportunity, small business growth and job creation. In addition, fraud can lead to higher program costs for borrowers and lenders, alike.

The SBA OIG would like to make you aware of fraud patterns that we continue to see in our loan fraud investigations so you can be on the lookout for such fraud. Lenders and other program participants are urged to exercise a high level of diligence if there is suspicious activity and to report suspected fraud to the OIG through the contact information at the end of this Notice.

Listed below are some of the most common types of fraud identified in SBA loan fraud investigations.

A. Loan Agent Fraud

A prospective borrower or a lender sometimes pays a loan agent (e.g., loan brokers/packagegers) to prepare documentation for an SBA loan application and/or refer the borrower to a lender. Loan agents can provide a useful function in bringing borrowers and lenders together and facilitating loan transactions. However, OIG investigations during the past ten years have identified fraud schemes perpetrated by loan agents in the hundreds of millions of dollars.

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SBA Form 1353.3 (4-93) MS Word Edition; previous editions obsolete
Must be accompanied by SBA Form 58

When working with loan agents, we encourage lenders to consider the following potential fraud indicators:

- a. The loan agent has a record of early defaults,
- b. The loan agent controls all communication between the lender and the borrower,
- c. The loan agent threatens to “shop” the loan elsewhere,
- d. The loan agent provides a high number of “qualified” borrowers in a short period of time,
- e. The loan agent’s apparent ease in resolving seemingly difficult questions or problems with a loan,
- f. The loan agent steers the lender to specific appraisers or title companies,
- g. The borrower replies “no” when asked if a “packager” was paid to prepare the loan application, when it is known a loan agent is involved in the process,
- h. Multiple loan applications are submitted simultaneously to different lenders for the same borrower, as indicated in credit reports, and
- i. The loan agent charges excessive fees.

To protect against a potentially corrupt loan agent, lenders are encouraged to:

- ? Track loan agent participation in their portfolios to determine whether agents are bringing an unusually high number of loans that experience early defaults or other significant problems,
- ? Ask loan agents for references from officials at other lending institutions,
- ? Search public databases to identify problems (e.g. bankruptcies/revocation of business licenses) and check Better Business Bureau records,
- ? Communicate directly with borrowers about the loan and loan application, loan agent performance and fees, and
- ? Use a reputable appraiser and title company known to the lender (loan agent fraud has often been found to involve collusion with title and other companies).

B. Borrower Fraud

Borrowers, whether acting alone or in collusion with others, may intentionally provide false information to SBA and lending institutions during the loan application process as detailed below:

1. False Equity Injection

Based on OIG loan fraud investigations, false equity injection is a significant and recurring problem. False documents submitted to verify the required equity injection often include:

- a. False gift letters or gift affidavits,
- b. False promissory notes and standby agreements,
- c. False financial statements, or
- d. False bank statements and cashier checks.

Indications of fraudulent equity injection to watch out for include:

- a. Gift letters and gift affidavits (investigation often proves such “gifts” to be false – either the money does not exist, or it is never paid into the business, or it is subsequently repaid to the donor),
- b. Tax returns reporting income that does not seem to support the required equity injection,
- c. Bank statements that upon close inspection appear to have been altered,
- d. Bank account records showing a recent, unexplained, large dollar deposit into the borrower’s account, and
- e. Credit reports showing a poor credit history for a borrower who claims to have substantial cash.

There are many ways a borrower or loan agent may attempt to falsify the equity injection or conceal the actual source of funds. OIG investigations have often determined that the cash injected was actually borrowed, and that the related debt was not disclosed to the lender or SBA. As a reminder, lenders are expected to comply with the equity injection verification requirements contained in SBA Standard Operating Procedures (SOP) 50-10-5(A) Chapter 4, and SOP 50-51(C) Chapter 13. When lending officials are suspicious that equity injection verification documents may be false, it is suggested that lenders take affirmative steps to detect and deter such fraud such as the following:

- ? If a gift letter is involved, have both the donor and the borrower sign an affidavit detailing the alleged gift and stating that the gift does not have to be repaid or returned, and request that the borrower provide a copy of a bank statement showing the injection was made prior to disbursement,
- ? If funds are being transferred by wire (especially from a foreign country), request a copy of the wire transfer and include it in the loan file, and
- ? If an inheritance is cited, verify that the funds exist by obtaining a copy of the inheritance bank statement showing the funds exist prior to disbursement.

Once obtained, these documents should be carefully reviewed.

The OIG encourages lenders to take proactive steps in order to reduce fraud, including such measures as having borrowers sign a certification at closing detailing the equity injection requirements for the SBA loan, and specifically how they have been met, and verifying with bank records that the equity injection is actually put into the business prior to disbursement, and used by the business.

2. Other Types of Borrower Fraud

Lenders should also be aware of these significant types of borrower fraud found in OIG investigations:

- a. Overstating income,
- b. Understating or failing to disclose liabilities and debts,
- c. Overvaluing collateral,
- d. Failing to disclose criminal record,
- e. Making false claims of U.S. citizenship,
- f. Failing to disclose true ownership of the business,
- g. Using false Social Security numbers to conceal poor credit histories,
- h. Submitting altered tax returns,
- i. Providing fraudulent standby agreements, and
- j. Creating false work histories.

Lender Internal Controls to Deter and Detect Fraud

The vast majority of lending officials are honest, and the SBA OIG has identified very few instances of fraud by loan officers and other lender employees. However, even one corrupt lending official can damage the institution's reputation and profitability as reflected in the recent conviction of a loan officer for fraud involving approximately \$85 million in SBA-guaranteed loans. Therefore, vigilance is needed to prevent fraudulent practices within the lending community. Although many lenders have undoubtedly implemented processes to identify potential fraud and improper activities, the SBA OIG recommends consideration of the following practices and internal controls to deter and detect suspicious lending activity:

- a. Development of sufficient management oversight of loan approvals, including the use of multiple "eyes" reviewing the underlying documents that are used in generating credit approval memoranda, at least on larger dollar loans,
- b. Policies (such as a Code of Conduct) to require business development officers and other lender personnel to disclose the involvement of loan agents in generating or packaging loans,
- c. Limits on commissions and other internal inducements that provide incentives for loan officers to concentrate on loan volume at the expense of loan quality,
- d. Internal review and auditing functions to examine the reasons why a particular lending official may have an unusually high number of loans that go into early default or experience other significant problems,
- e. Internal review and auditing functions to examine the reasons why a particular lending official may have a significantly higher loan volume than his/her colleagues, particularly if that lending official is known to work with a particular loan agent or agents, and
- f. Policies to require a higher level of due diligence in reviewing change of ownership transactions as numerous OIG investigations have identified fraud on these type of loans.

Reporting Fraud

The OIG encourages all SBA employees and lenders to be on the lookout for fraud. If you suspect fraud, please report it to the OIG immediately by contacting the OIG Hotline at 1-800-767-0385 or OIGHotline@sba.gov. Or, if you prefer, you may directly contact the OIG office in your geographical area. A map of OIG regions and contact information is attached to this Notice for your information and convenience.

Peter L. McClintock
Acting Inspector General

SBA OIG REGIONAL OFFICES

