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U.S. SENATE COMMITTEE ON
SMALL BUSINESS AND ENTREPRENEURSHIP
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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.
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> 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.