



**STATEMENT OF**  
**PEGGY E. GUSTAFSON**  
**INSPECTOR GENERAL**  
**U.S. SMALL BUSINESS ADMINISTRATION**

**BEFORE THE**  
**COMMITTEE ON APPROPRIATIONS**  
**SUBCOMMITTEE ON FINANCIAL SERVICES AND**  
**GENERAL GOVERNMENT**  
**U.S. HOUSE OF REPRESENTATIVES**

**APRIL 10, 2013**

**PEGGY E. GUSTAFSON  
INSPECTOR GENERAL  
U.S. SMALL BUSINESS ADMINISTRATION**

---

**INTRODUCTION**

Chairman Crenshaw, Ranking Member Serrano, and distinguished members of the Subcommittee, thank you for giving the Small Business Administration (SBA or Agency) Office of Inspector General (OIG) an opportunity to discuss our oversight activities of SBA programs and operations.

The OIG was established within SBA by statute to promote economy, efficiency, and effectiveness and to deter and detect waste, fraud, and abuse in the Agency's programs and operations. Every year, our staff of approximately 104 employees—which includes criminal investigators, auditors and program analysts, attorneys, and support staff—conduct criminal investigations, audits, and other reviews, resulting in numerous indictments, convictions, and monetary payments of fraud perpetrators and many recommendations to the Agency for improvement and elimination of wasteful or inefficient practices.

During Fiscal Year (FY) 2012, the SBA OIG operated at an enacted budget level of \$17.3 million, which included a \$1.0 million transfer from the SBA Disaster Loan Program Account. Approximately 84 percent of our expenditures are attributed to payroll expenses for our 104<sup>1</sup> employees. The OIG issued 22 reports containing 126 recommendations for improving SBA operations, reducing fraud and unnecessary losses, and recovering funds in FY 2012. In addition, OIG investigators obtained 59 indictments and 59 convictions of subjects who defrauded the government. In all, OIG efforts resulted in more than \$90 million in office-wide dollar accomplishments during FY 2012.

**OVERSIGHT PRIORITIES**

The SBA was established to maintain and strengthen the nation's economy by protecting the interests of and assisting small businesses, and by helping families and businesses recover from disasters. While SBA's programs are essential to strengthening America's economy, the Agency faces a number of challenges in carrying out its mission, including fraudulent schemes affecting all SBA programs, significant losses from defaulted loans, procurement flaws that allow large firms to obtain small business awards, excessive improper payments, and outdated legacy information systems. The Agency also faces significant management challenges.

---

<sup>1</sup> Includes positions funded from supplemental appropriations—the American Recovery and Reinvestment Act of 2009 and the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act of 2009.

In accordance with the Reports Consolidation Act of 2000, the OIG released its *Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in FY 2013* in October 2012. This report represents our current assessment of Agency programs and/or activities that pose significant risks, including those that are particularly vulnerable to fraud, waste, error, mismanagement, or inefficiencies. Our report is based on specific OIG, Government Accountability Office (GAO), and other official reports, as well as our general knowledge of SBA’s programs and operations.

**Summary of the Most Serious Management and Performance Challenges Facing the SBA in FY 2013**

	Challenge	Color Scores					
		Status at End of FY 2012				Change from Prior Year	
		Green	Yellow	Orange	Red	Up ↑	Down ↓
1	Small Business Contracting	1		2		1	
2	IT Security		3	2			
3	Human Capital		1	3		1	
4	Loan Guaranty Purchase		1				
5	Lender Oversight	1	1	1		1	
6	8(a) Business Development Program		1	1	1		
7	Loan Agent Fraud	1	1			1	
8	Loan Management and Accounting System		1		3	1	3
9	Improper Payments – 7(a) program		2	2		1	
10	Improper Payments – Disaster Loan program		1				
11	Acquisition Management (NEW)						
	<b>TOTAL</b>	<b>3</b>	<b>12</b>	<b>11</b>	<b>4</b>	<b>6</b>	<b>3</b>

Overall, in FY 2012, the Agency made improvements across all the challenges, with the exception of one of the recommended actions under Management Challenge #6 and three of the recommended actions under Management Challenge #8. Specifically, Management Challenge #6—The Section 8(a) Business Development program needs to be modified so more firms receive business development assistance, standards for determine economic disadvantage are justifiable, and the SBA ensures that firms follow 8(a) regulations when completing contracts—remains at a rating of Red or no progress. Management Challenge #8—SBA needs to modernize its Loan Accounting System and migrate it off the mainframe—was downgraded from a rating of Orange, or limited progress, to a rating of Red, or no progress.

Despite these two Management challenges, the progress on all other Management Challenges was notable. The effort made by Agency staff and leadership throughout FY 2012 on the recommended actions demonstrated commitment to improving the Agency's programs and operations. The Agency's efforts are reflected in the overall elevation of Management Challenge ratings.

Pursuant to P.L. 113-2, the OIG was appropriated \$5 million to provide effective oversight of the SBA's disaster response to Hurricane Sandy. This funding level is based on experience with major disasters in the past, such as the Gulf Coast Hurricanes in 2005. The supplemental funding will be used to support approximately 5 auditors and 5 criminal investigators and associated operating costs for a period of at least 4 to 6 years. Availability of funds for this timeframe is particularly important because many times fraudulent loans are not immediately identified, have a deferment period for repayment, and take years to default. There is a five-year statute of limitations (from the date of the last false statement) to prove a false statement to the SBA.

## **PLANNED ACTIVITIES**

In addition to conducting audits and reviews that are required by statutes and other directives, the OIG plans to focus on the most critical risks facing the SBA. Several areas of emphasis are discussed below.

### *Financial Assistance*

Over the last several years, losses in the SBA's loan programs have increased substantially. Some of the increase in SBA losses correlates to similar root causes seen in the mortgage industry, such as limited oversight of lenders and loan agents, poor lender loan processing, unscrupulous borrowers, and complicit brokers and lenders. The SBA also faces a heightened risk of losses and improper payments due to expedited loan processing initiatives and its considerable reliance on outside financial institutions over which the Agency does not always exercise adequate oversight.

The Agency's business loan programs include: (1) the Section 7(a) program, in which the SBA guarantees lender-originated loans to small businesses made by lenders; and (2) the Section 504 program, in which the SBA guarantees repayment of debentures that are sold by Certified Development Companies (CDCs) to investors to create funds for loans to small businesses. The majority of loans made under the 7(a) program are made with little or no review by the SBA prior to loan approval because the Agency has delegated most of the credit decisions to the lenders originating these loans.

Two recent developments in SBA's 7(a) loan guaranty program highlight the need for continued vigilance in the OIG's oversight of the Agency. First, SBA's

payments of guaranties on defaulted loans are significantly higher than a baseline of FY 2007—from \$1 billion in FY 2007 to \$5 billion in FY 2010, \$3.4 billion in FY 2011, and \$2.6 billion in FY 2012—however, it is noted these figures are moving in the right direction. Although some defaults are likely due, in part, to economic conditions, many OIG audits and investigations of loans that have defaulted early have identified problems with the loan origination, including lender negligence and fraud. Second, as a result of statutory changes in 2010, the size of loans that SBA guarantees more than doubled from \$2 million to \$5 million, thus dramatically expanding the potential exposure to the taxpayer. This exposure, combined with a swollen portfolio and limited Agency oversight, increase the possibility of future losses.

The OIG is using its resources to more effectively address the growing financial losses in SBA lending due to lender errors and various fraud schemes. The OIG is utilizing an Early Defaulted Loan Working Group to perform in-depth analyses of loans that default within 18 months of final disbursement. From this, the OIG either makes recommendations for loan guaranty recoveries, or if fraud is apparent, conducts criminal investigations to refer suspected fraud for prosecution. The OIG also assesses trends of lending problems. Despite past successes, such activities have been limited due to resource constraints.

The OIG's national initiative to detect fraud committed by loan agents, such as packagers and brokers, continues to be a priority for the office. A loan agent is sometimes hired by an applicant or lender to assist the applicant in obtaining an SBA loan. Although honest loan agents help small businesses gain access to capital, some dishonest ones have perpetrated fraudulent schemes involving tens of millions of dollars in loans. These fraudulent loans often default for non-payment, and the SBA is forced to use taxpayer funds to purchase the guaranteed portions of the loans. In a recent case, an OIG investigation led to the indictment of three loan brokers and their company for conspiring to provide false information to SBA in order to obtain SBA loans. This is a complex loan fraud scheme involving loans valued at approximately \$100 million. Over the past decade, the OIG has obtained convictions and guilty pleas on numerous cases involving loan agent fraud on SBA-guaranteed loans, totaling in excess of \$358 million.

The OIG recently has initiated a review of the examination process for the Small Business Investment Company (SBIC) program. In addition, the OIG will continue to conduct audits of business loans that default quickly because past work has shown such loans were not always properly originated and that effective controls and procedures were not in place to prevent improper payments. Future OIG efforts will focus on: (1) SBA's loan origination process to determine its compliance and effectiveness; (2) SBA quality control programs to determine the extent to which programs are mitigating the risk of loss; (3) SBA's management of certain loan programs; and (4) the reliability of data in the Agency's Loan Accounting System.

OIG audits related to disaster loans will continue to focus on loan origination, disbursement, repayment, servicing, and liquidation activities. Such audits may assess whether the SBA processed homeowner and business loan applications in accordance with the Agency's procedures, verified uses of loan proceeds before loans were fully disbursed, and appropriately identified duplicate benefits. Future efforts will focus on the loss verification process and analyzing, through cross cutting projects, whether there are redundancies among agencies providing various forms of assistance to disaster victims. Such efforts would focus on determining whether there is potential to reduce costs across agencies while streamlining and consolidating processes for disaster victims. The OIG also will continue to investigate allegations of unauthorized use of loan proceeds; overstatement of financial losses; material false statements in the application process; false/counterfeit supporting documentation; and false assertions regarding primary residency in affected areas at the times of the disasters. As of September 30, 2012, the OIG had 26 open cases involving disaster loans with potential dollar losses of over \$12.8 million.

In response to the increase in fraud following Hurricanes Katrina, Wilma, and Rita, the OIG and other law enforcement organizations established the National Center for Disaster Fraud. From FY 2006 through FY 2012, the OIG, in conjunction with other law enforcement agencies, has produced 86 arrests, 95 indictments, and 91 convictions related to wrongdoing in SBA's Disaster Loan program for these three hurricanes. Investigations for these disasters— to date— have resulted in over \$6.6 million in court-ordered restitution and related recoveries, as well as the denial of nearly \$4.5 million in loans to potentially fraudulent borrowers. In addition, the OIG has investigated fraud related to 2008 Hurricanes Ike and Gustav.

#### *Government Contracting and Business Development*

The SBA directs significant efforts toward helping small businesses obtain Federal contracts and providing other business development assistance. The SBA's Office of Government Contracting and Business Development is tasked with helping small businesses obtain a fair proportion of Federal contracting opportunities and helping small, disadvantaged, and women-owned businesses build their potential to compete more successfully in a global economy. Oversight of the Government Contracting and Business Development programs, including investigating allegations that ineligible companies are fraudulently benefitting from these programs, remains a key priority for the OIG. As of September 30, 2012, the OIG had 62 open government contracting cases, with potential dollar losses of over \$1.5 billion based on the total dollar value of the contracts.

The OIG has in the past year received a significant increase in the number of qui tam False Claims Act suits that have been filed by private sector parties alleging

fraud in SBA government contracting programs. In light of increases in qui tam claims that the government has experienced over the past several years, the OIG expects the volume of this work to increase. This will require expenditure of additional resources to investigate these allegations.

Aside from these issues, there are other reasons to be concerned about government contracting programs.

- There has been a high level of congressional interest in small businesses receiving a fair share of Federal contracts. The OIG will continue to assess whether the SBA is taking adequate steps to ensure the integrity of small business contracting, with an emphasis on issues such as the accuracy of reporting small business contract activity, large businesses being classified as small businesses, adherence to regulations to protect small businesses, training of government contracting personnel, deterring fraudulent acquisition of government contracts, and bundling of contracts.
- The Section 8(a) Business Development program continues to be susceptible to major vulnerabilities. These include limited program oversight; inequitable distribution of contracting opportunities among participants; a lack of reasonable, measurable, consistent, and mandatory criteria pertaining to economic disadvantage; a lack of implemented criteria defining business success for purposes of program graduation; and misrepresentation by companies as small, minority-owned, or disadvantaged businesses to gain an unfair advantage in the Federal marketplace. The OIG will continue to review these issues and the SBA's management of the Section 8(a) program.
- The Historically Underutilized Business Zone (HUBZone) program provides Federal contracting assistance to small businesses located in economically distressed areas with the intent of stimulating economic development. The Service-Disabled Veteran-Owned Small Business (SDVOSB) program provides more opportunities in Federal contracting for disabled veterans who own small businesses. The GAO has identified significant control weaknesses in these programs that have allowed ineligible firms to receive millions of dollars in contracts. The OIG will examine the SBA's claim that it has implemented a more rigorous HUBZone certification process in the hopes of preventing ineligible firms from achieving certification. In addition, the OIG plans to review the HUBZone decertification process once the SBA completes its reengineering of this process. The OIG also will continue to pursue prosecution, civil fraud recovery, and debarment of contractors who improperly obtain HUBZone, SDVOSB, and other preferential contracts.

### *Financial Management and Information Technology*

The OIG will continue to oversee the audits of the SBA's financial statements, as well as Federal Information Security Management Act (FISMA) and Federal Information Systems Controls Audit Manual (FISCAM) reviews, which are conducted by an Independent Public Accountant under a contract with the OIG. The OIG also will continue its review of the SBA's compliance with the Improper Payments Elimination and Recovery Act (IPERA). The OIG anticipates that the scope of financial statement audits will continue to expand as a result of growing direct and guaranteed loan portfolios. The OIG plans to review SBA's actions to implement the requirements of the GPRA Modernization Act of 2010. The review will survey the sources and use of performance information in program decision-making and evaluate the effectiveness of corrective actions deployed to address long standing challenges, needs, and problems.

The OIG also will continue to monitor systems development activities related to improvements to the SBA's Loan Management and Accounting System, a system that is critical to SBA's ability to administer its loan portfolio, which in FY 2012 totaled over \$102 billion. OIG efforts will include determining whether adequate System Development Lifecycle Controls are in place as the SBA endeavors to move its batch COBOL systems from the mainframe to a new hosting environment. As threats to disrupt cyber-based systems continue to escalate, the Agency must take steps to improve controls to prevent outages and loss of sensitive data and to ensure the continuity of mission critical operating systems. The OIG will conduct audits to assess the security of the SBA's computer operating system, network, and hosted applications by performing assurance reviews. The OIG also will review the sufficiency of SBA resources used to manage computer security, maintain systems, provide technical support, and administer security training.

### *Security Operations*

The OIG's Office of Security Operations (OSO) is responsible for processing name checks and, where appropriate, fingerprint checks to ensure that applicants meet certain character standards before participating in programs involving business loans, disaster assistance loans, Section 8(a) certifications, surety bond guarantees, SBICs, and CDCs. As a result of OIG referrals during FY 2012, SBA business loan program managers declined 54 applications totaling over \$37.2 million, and disaster loan program officials declined 26 applications totaling over \$2.1 million, due to character issues of loan applicants. In addition, the Section 8(a) program declined 31 applications for admission. Over \$300 million in loans have been declined during the last 10 years due to character problems identified by the OIG, thereby making credit and SBA assistance available to otherwise eligible applicants. The OSO also is responsible for performing required background investigations for covered SBA employees and adjudicate SBA employees/contractors for issuance of PIV cards pursuant to HSPD-12



background investigation requirements. During FY 2012, the OIG initiated 333 background investigations and issued 49 security clearances for SBA employees and contractors.

#### *Review of Proposed Regulations and Initiatives*

As part of the OIG's proactive efforts to promote accountability and integrity and reduce inefficiencies in SBA programs and operations, the OIG reviews changes that SBA is proposing to make to its program directives such as regulations, internal operating procedures, policy notices, and SBA forms that are completed by the public. Frequently, the OIG identifies material weaknesses in these proposals and works with the Agency to implement recommended revisions to promote controls that are more effective and deter waste, fraud, or abuse. During FY 2012, the OIG reviewed 136 proposed revisions of program management or SBA reorganization documents and submitted comments on 79 of these initiatives.

#### *Debarment and Administrative Enforcement Actions*

As a complement to the OIG's criminal and civil fraud investigations, the OIG continually promotes the use of suspensions, debarments, and other administrative enforcement actions as a means to protect taxpayer funds from those who have engaged in fraud or otherwise exhibited a lack of business integrity. The OIG regularly identifies individuals and organizations for debarment and other enforcement actions and submits detailed recommendations with supporting evidence to the responsible SBA officials. During FY 2012, the OIG sent 45 suspension and debarment referrals to SBA. Most OIG administrative referrals involve the abuse of SBA's loan and preferential contracting programs. When appropriate, the OIG recommends that the SBA suspend the subject of an ongoing OIG investigation given program risk presented by the continued participation of those individuals and entities.

#### *Fraud Awareness Briefings*

The OIG continues to conduct briefings on topics related to fraud in government lending and contracting programs. During FY 2012, the OIG provided 24 fraud awareness presentations for more than 1,100 attendees, including SBA and other Government employees, lending officials, and law enforcement representatives. Topics included types of fraud; fraud indicators and trends; and how to report suspicious activity that may be fraudulent.

### **CONCLUSION**

The SBA OIG continues to focus on the most critical risks facing the SBA. Our resources are directed at key SBA programs and operations, to include financial assistance, government contracting and business development, financial

management and information technology, disaster assistance, Agency management challenges, and security operations. We also will continue to partner with the Agency to ensure that taxpayer and small business interests are protected and served well by reviewing proposed regulations and initiatives, pursuing debarment and administrative enforcement actions, and providing fraud awareness briefings. We value our relationship with this Subcommittee and Committee, and with the Congress at large, and look forward to working together to address identified risks and the most pressing issues facing the SBA.