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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

To: Members, Committee on Small Business
From: Committee Staff
Date: March 14, 2016
Re: Full Committee Hearing: "SBA Management and Performance Challenges: The Inspector General's Perspective."

On Wednesday, March 16, 2016 at 11:00 a.m. in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet to receive testimony from the Small Business Administration's (SBA or Agency) Inspector General (IG) – Peggy Gustafson. Inspector General Gustafson will testify on the most serious management and performance challenges facing the SBA today, continuing an examination of this Agency by this Committee.

I. Background and the Inspector General Act

In 1978, Congress passed the Inspector General Act.[1] The Act and its amendments established an independent[2] IG in almost all government agencies.[3] IGs were granted broad audit and investigatory powers to examine agency activities, recommend policies to promote economic, efficient, and effective program operation, and root out waste, fraud, and abuse.[4]

The SBA's Office of Inspector General (OIG)[5] works to improve SBA programs by "identifying key issues facing the Agency, recommending corrective actions, and promoting a high level of integrity."[6] The OIG takes action by: conducting audits to identify wasteful expenditures and program mismanagement; investigating fraud and other wrongdoing; and recommending changes to increase the efficiency of SBA's operations.[7] By providing independent and objective oversight, the OIG seeks to "improve the integrity, accountability, and performance of the SBA and

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[1] 5 U.S.C. app. 3, §§ 1-12.
[2] Each IG is appointed by the President, confirmed by the Senate, reports only to the head of each agency, is not subject to removal by the head of the agency, and is free to investigate actions of an agency without interference from agency personnel including the head of the agency. *See NASA v. Federal Labor Relations Auth.*, 527 U.S. 229, 238-39 (1999). Thus, each inspector general could be considered independent of the agency in which the inspector general is located.
[3] At time of passage, only 12 agencies were named. In 1988, Congress amended the 1978 Act to incorporate almost all federal agencies, including the SBA. Inspector General Act Amendments of 1988, Pub. L. No. 100-504, § 102(c)(2), 102 Stat. 2515, 2515-16.
[4] *See NASA*, 527 U.S. at 240; *Winters Ranch Partnership v. Viadero*, 123 F.3d 327, 330 (5th Cir. 1997).
[5] The term IG refers to a specific person, the Hon. Peggy Gustafson. That individual leads OIG. For ease of reference for the reader, the terms IG and OIG will be used interchangeably in this memorandum.
[6] https://www.sba.gov/oig/category/oig-navigation-structure/about-us.
[7] OIG, SBA, SEMI-ANNUAL REPORT TO CONGRESS: FALL 2015, at 1 (2015), *available at* https://www.sba.gov/sites/default/files/oig/Fall_2015_SBA_OIG_SAR.pdf.

its programs for the benefit of the American people.[8] The OIG produces reports and audits to ensure that Congress has the information needed exercise oversight over the SBA.

II. Challenges within the SBA Identified by the OIG

Since Fiscal Year (FY) 2000, the OIG has provided a report to Congress which outlines SBA's management challenges. The FY2016 report highlights ten management challenges.[9] The Inspector General identified the following challenges facing the SBA: small business contracting data; information technology (IT) security; human capital; lender oversight; the 8(a) business development program;[10] loan agent fraud; loan management and accounting system; improper payments within the 7(a) Loan Program;[11] the disaster loan program; and acquisition management.[12] Along with the challenges, the report lists a series of recommendations for improving the effectiveness of SBA programs.

All these challenges represent ways in which the Agency is vulnerable to waste, fraud, and abuse. Given the extent of challenges, several of which are long-standing,[13] this hearing will focus on the following: Improper Payments; Loan Agent Fraud; Internal Controls for Preferential Contracting Programs; and Disaster Assistance.

A. Improper Payments

The IG designated the SBA's need to accurately report, significantly reduce, and strengthen efforts to recover improper payments in the 7(a) Loan Program as a significant management challenge. An improper payment is any payment that should not have been made (including issuance of a guarantee), or that was made in an incorrect amount under relevant legal requirements.[14] A payment also is considered improper if, among other things, it is made to an ineligible recipient or made for an ineligible good or service.[15] Finally, OMB guidance suggests that an improper payment is one for which an agency is unable to discern whether it was a proper as a result of insufficient or lack of documentation.[16]

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[8] *Id*.

[9] OIG, SBA, REPORT ON THE MOST SERIOUS MANAGEMENT AND PERFORMANCE CHALLENGES FACING THE SMALL BUSINESS ADMINISTRATION IN FISCAL YEAR 2016, *in passim* (Rep. No. 16-01) (2015) [hereinafter "FY 2016 Management Challenges"], *available at* https://www.sba.gov/sites/default/files/oig/FY_2016_Management_Challenges.pdf

[10] The 8(a) Business Development Program assists small, disadvantaged businesses to compete in the American economy through development of their capacity to obtain federal and non-federal contracts for goods and services.

[11] The 7(a) Loan Program is the SBA's most common loan program, and provides loans through financial institutions up to $5 million and guarantees ranging from 75 percent to 85 percent. In FY 2015, the loan volume of the 7(a) program reached an all-time high of roughly $23.5 billion. https://ww.sba.gov/sites/default/files/aboutsbaarticle/WebsiteReport_asof_09_30_2015.pdf.

[12] FY 2016 Management Challenges, *supra* note 9, at 1-11.

[13] For example, small business contracting data, IT security, human capital, lender oversight, the 8(a) business development program, and loan agent fraud were all first identified by the OIG as serious challenges over 10 years ago.

[14] Improper Payments Elimination and Recovery Act of 2010, Pub. L. No. 111-204, § 2(e), 124 Stat. 2224, 2227 (2010).

[15] *Id.*

[16] APPENDIX C, REQUIREMENTS FOR EFFECTIVE ESTIMATION AND REMEDIATION OF IMPROPER PAYMENTS (2014), to The OMB Circular A-123MANAGEMENT'S RESPONSIBILITY FOR INTERNAL CONTROL 7 (2014), *available at* https://www.whitehouse.gov/sites/default/files/omb/memoranda/2015/m-15-02.pdf

Despite the size of the 7(a) Loan Program, the SBA has a history of failing to prevent improper payments and, if they are identified, recover such payments. In FY2011, for example, the OIG determined that the SBA had significantly understated its improper payment rate for the 7(a) Loan Program, failing to adequately review loans, use proper sampling methodologies, or accurately project review findings. As a result, the SBA-reported 1.73 percent improper payment rate, or $40.7 million, could have been as high as 20 percent, or $472 million.[17] Furthermore, while the SBA reported no improper payments for 7(a) loan approvals, the OIG found that at least 1,996 7(a) loans administered pursuant to the American Recovery and Reinvestment Act of 2009 were not originated and closed in compliance with SBA requirements, thereby resulting in at least $869.5 million in inappropriate loan approvals.[18] A 2012 IG report found that improper payments were paid out as a result of limited reviews of lender underwriting performed during the guaranty purchase reviews, contrary to SBA procedures.[19] In a 2014 audit, OIG found that the SBA approved loans with material underwriting deficiencies which later defaulted, resulting in $4.8 million of unnecessary losses.[20] A 2015 report found further instances of high-risk loans being improperly granted, leaving taxpayers vulnerable to $1.8 million in losses.[21] Finally, time and again, OIG reports and audits have determined that the SBA has significantly understated reported improper payment rates, meaning the problem is even greater than the SBA has acknowledged.[22]

The Office of Capital Access (OCA) has made gradual progress in response to OIG recommendations in an effort to accurately report and reduce improper payments within the 7(a) Loan Program.[23] However, the OCA still has not demonstrated that these steps will succeed in ensuring an adequate and timely resolution for recovering improper payments.[24]

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[17] FY 2016 Management Challenges, *supra* note 9, at 9; *see also* THE SMALL BUSINESS ADMINISTRATION'S IMPROPER PAYMENT RATE FOR 7(a) GUARANTY PURCHASES REMAINS SIGNIFICANTLY UNDERESTIMATED 9-10 (2012) (Rep. No. 13-07), *available at* https://www.sba.gov/sites/default/files/Report%2013-07%20SBA's%20Improper%20Payment%20Rate%20for%207(a)%20Guaranty%20Purchases%20Underestimated_0.pdf.

[18] FY 2016 Management Challenges, *supra* note 9, at 9; *see also* ORIGINATION AND CLOSING DEFICIENCIES IDENTIFIED IN 7(a) RECOVERY ACT LOAN APPROVALS 2-3 (2011) (Rep. No. ROM 11-07), *available at* https://www.sba.gov/sites/default/files/ROM%2011-07%20Origination%20and%20Closing%20Deficiencies%20Identified%20in%207A%20Recovery%20Act%20Loan%20Approvals%20FINAL.pdf.

[19] FY 2016 Management Challenges, *supra* note 9, at 9; *see also* A DETAILED REPAYMENT ABILITY ANALYSIS IS NEEDED ON HIGH-DOLLAR EARLY DEFAULT LOANS TO PREVENT FUTURE IMPROPER PAYMENTS 3 (2012) (Rep. No. 12-18), *available at* https://www.sba.gov/sites/default/files/oig/AuditReport%2012_18_DetailedRepaymentAbility%20Analysis%20is%20Needed%20on%20High%20Dollar%20Early%20Defaulted%20Loans.pdf.

[20] FY 2016 Management Challenges, *supra* note 9, at 9; *see also* SIGNIFICANT OPPORTUNITIES EXIST TO IMPROVE THE MANAGEMENT OF THE 7(a) GUARANTY APPROVAL PROCESS 19 (2014) (Rep. No. 14-13), *available at* https://www.sba.gov/sites/default/files/oig/[c]%20Audit%20Report%2014-13.pdf.

[21] FY 2016 Management Challenges, *supra* note 9, at 9; *see also* THE OIG HIGH RISK 7(a) LOAN REVIEW PROGRAM RECOMMENDS $1.8 MILLION IN RECOVERIES 2 (2015) (Rep. No. 15-09), *available at* https://www.sba.gov/sites/default/files/oig/Evaluation_Report_15-09_OIG_High_Risk_7a_Loan_Review_Program_0.pdf.

[22] FY 2016 Management Challenges, *supra* note 9, at 9; *see also* SBA'S FY 2014 COMPLIANCE WITH THE IMPROPER PAYMENTS ELIMINATION AND RECOVER ACT 9-10 (2015) (Rep. No. 15-11), *available at* https://www.sba.gov/sites/default/files/oig/FY_2014_IPERA_Final_Report.pdf.

[23] FY 2016 Management Challenges, *supra* note 9, at 9.

[24] *Id*.

B. Loan Agent Fraud

The OIG also revealed improper payments within the 7(a) Loan Program occurring as a result of loan agent fraud. Fee-for-service loan agents assist small businesses with referrals or loan applications and were involved in approximately 15 percent of all 7(a) loans.[25] However, since 2005 there have been at least 22 cases of loan agent fraud investigated by the OIG, totaling at least $335 million.[26]

Even the SBA's efforts at regulating loan agents are problematic. Since 2000, the SBA has had its lenders provide information regarding loan agents on Form 159.[27] However, an OIG review of these records found that 37 percent contained critical errors which would limit the SBA from being able to conduct oversight.[28] Without the ability to effectively identify and track potential fraudulent activity by loan agents, the OIG believes that the SBA is unable to fully prevent these actors from taking actions that violate Agency regulations concerning participation in the 7(a) Loan Program.[29]

C. *Internal Controls for Preferential Contracting Programs*

Another significant challenge identified by the OIG has been the SBA's inability to implement internal controls for its contracting programs that provide preferential treatment for certain types of small business concerns. The SBA's failure often stems from its own inaction, including the timely implementation of statutory mandates. For example, the SBA has declined to utilize available tools to ensure its programs are only utilized by eligible firms.[30] Nor has the SBA promptly reduced size standards for certain categories of small businesses even when its own analysis demonstrated the necessity of doing so;[31] this enables business concerns other than small to obtain federal government contracts designated for small businesses.

The lack of SBA internal controls inhibits the ability of the SBA to determine whether federal agencies are achieving the procurement goals set out in the Small Business Act. The Small Business Act established a government-wide goal of awarding at least 23% of all prime contracts to

[25] *Id.* at 7. The SBA has regulations concerning loan agents and their ability to represent borrowers or banks in guaranteed loan transactions. *See* 13 C.F.R. Part 103. Those rules include powers to revoke the ability of loan agents from participating in the 7(a) Loan Program. *Id.* at § 103.3. However, as other hearings and Committee investigations have shown, the SBA rarely takes action to revoke the status of participants in the 7(a) Loan Program. Committee research was unable to uncover the number of enforcement actions taken by SBA under Part 103.

[26] FY 2016 Management Challenges, *supra* note 9, at 7; *see also* SBA NEEDS TO IMPLEMENT ITS OVERSIGHT OF LOAN AGENTS 3 (2015) (Rep. No. 15-16) [hereinafter "SBA Oversight of Loan Agents"], *available at* https://www.sba.gov/sites/default/files/oig/Report_15-16_SBA_Needs_to_Improve_Its_Oversight_of_Loan_Agents.pdf.

[27] SBA Oversight of Loan Agents, *supra* note 26, at 8. The form requires disclosure of a loan agent's role and any compensation. *Id*.

[28] SBA Oversight of Loan Agents, *supra* note 26. at 9. For example, the OIG found 19 different spellings of the same loan agent. If this loan agent were found to be committing fraud, the SBA is not able to provide assurance that the loans listed under a different spelling would be flagged for review.

[29] SBA Oversight of Loan Agents, *supra* note 26. at 9.

[30] The 2015 National Defense Authorization Act granted contracting officers the ability to award sole-source awards to firms in the Women Owned Small Business Federal Contracting Program, but required those firms to be certified. The SBA implemented the sole-source authority, but did not implement a certification program, exposing the program to abuse.

[31] FY 2016 Management Challenges, *supra* note 9, at 2.

small businesses.[32] Agencies can receive credit towards reaching this goal by participating in SBA's 8(a) and HUBZone[33] Programs. However, OIG audits, and investigations by the United States Government Accountability Office, have shown that ineligible firms often are receiving awards through these programs. In FY 2013, for example, over $400 million in contract actions may have been awarded to ineligible firms, and over $1.5 billion were awarded to firms that originally qualified but, after receiving the contract, left these programs.[34] Similar results were found in the 8(a) Mentor-Protégé Program,[35] where agencies were awarding contracts purported to be small business contracts, yet were unable to guarantee that the large business was not performing most of the work.[36] Thus, the economic benefits of the contracts were redounding chiefly to large businesses, yet agencies were counting them towards the 23 percent goal.[37] The SBA is ultimately responsible for ensuring that federal agencies provide small businesses with a fair and equitable opportunity to participate in federal contracts. The SBA cannot implement this statutory obligation without enhanced controls regarding access to its small business contracting programs.

D. Disaster Assistance

The OIG also identified disaster assistance as an area in which the SBA faces significant challenges. Disaster loans guaranteed by the SBA are particularly vulnerable to fraud for a number of reasons. First, in order to provide quick relief to victims of disasters, these loan transactions are often expedited. Second, the personnel hired in connection with a disaster declaration may lack sufficient training or experience (despite statutory requirements that such individuals have training to provide disaster loans). Finally, in the aftermath of a disaster, the sheer volume of loan applications often overwhelms SBA's resources, despite statutory obligations to ensure that it has the resources to handle significant disasters.[38]

The OIG has found that the SBA has not taken sufficient steps in preparation for future disasters.[39] It has not properly prepared or trained a new workforce to handle the increased volume of applications, preventing the SBA from providing timely assistance.[40]

As with internal controls for its procurement programs, some of the problems have arisen from the SBA's own lethargic implementation of statutory mandates. For example, it has failed to implement new guarantee disaster loan programs mandated by Congress in 2008 which would have

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[32] 15 U.S.C. § 644(g).
[33] The HUBZone Program assists small businesses located in economically challenged areas stimulate their local economies by giving them certain preferences in obtaining federal government contracts.
[34] *Id*, at 1; *see also* AGENCIES ARE OVERSTATING SMALL DISADVANTAGED BUSINESS AND HUBZONE GOALING CREDIT BY INCLUDING CONTRACTS PERFORMED BY INELIGIBLE FIRMS 7 (2014) (Rep. No. 14-18), *available at* https://www.sba.gov/sites/default/files/oig/Agencies%20Are%20Overstating%20SDB%20and%20HUBZone%20Goaling%20Credit.pdf.
[35] The Mentor-Protégé Program allows large "mentor" firms to partner with 8(a) participants in joint ventures.
[36] FY 2016 Management Challenges, *supra* note 9, at 1; *see also* Benefits of Mentor-Protégé Joint Ventures are Unknown: Robust Oversight is Needed to Assure Success and Avoid Abuse 18 (2012) (Rep. No. 13-03), *available at* https://www.sba.gov/sites/default/files/oig/Agencies%20Are%20Overstating%20SDB%20and%20HUBZone%20Goaling%20Credit.pdf.
[37] In addition, the lack of internal controls undermines the point of the mentor-protégé relationship which is that the protégé's activities in performance of the contract will help it provide goods and services in the future without the assistance of a larger enterprise. The absence of internal controls undermines the utility of the program to protégés.
[38] FY 2016 Management Challenges, *supra* note 9, at 10.
[39] *Id*.
[40] *Id*.

expedited the loan process in partnership with private sector lenders. The expedited process the SBA implemented in response to Hurricane Sandy (which was not specifically authorized by Congress) was unable to reduce loan approval times.[41]

As a result, the SBA has been unable to prevent waste, fraud, and abuse within the disaster loan program. In FY 2014, the default rate within the program was 15 percent, while the improper payment rate was 12 percent.[42] Out of the $585.6 million in program outlays, $70 million of the payments, nearly 12 percent, were improper.[43] This improper payment rate exceeds the 10 percent level required to remain in compliance with the Improper Payments Elimination and Recovery Act of 2010 (IPERA), as well as the threshold for significant improper payments ($10 million and 2.5% of program outlays).[44]

Sadly, the only times the SBA is able to show improved management within this program is in the aftermath of a disaster. This fact makes it all the more important for the SBA's Office of Disaster Assistance to plan ahead and prepare as well as possible to ensure that, should disaster strike, the SBA will be able to effectively and efficiently process loan applications while still protecting the American taxpayer from waste, fraud, and abuse.

III. Conclusion

It is clear that management and performance challenges facing the SBA inhibit the Agency's ability to effectively combat waste, fraud, and abuse. The OIG plays a critical role in identifying areas in which the SBA needs to improve the efficiency and efficacy of its programs. Implementation of the IG recommendations will improve SBA operations thereby reducing risks to small businesses and American taxpayers. This hearing will provide the opportunity for Members to hear directly from the IG regarding what steps can be taken to ensure a better-functioning SBA.

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[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] Improper Payments Elimination and Recovery Act of 2010, §2(a), 124 Stat. at 2224.