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Verifiable Fraud in the Payroll Protection Program

June 5, 2020

Criminals historically seek to defraud federal government assistance programs, especially in a time of national emergency. The Small Business Administration's Payroll Protection Program (PPP) has heightened risk due the magnitude of $650B+ in allocated funding, scale of applicant volume with more than 4.4M approved loans, and the speed of execution by nearly 5,000 lenders, many newly approved by the SBA in its new program. "SBA processed more than 14 years' worth of loans in less than 14 days," SBA Administrator Jovita Carranza and U.S. Treasury Secretary Steven Mnuchin said in a joint statement.

PPP Certain to Experience Fraud

Fraud will be found with business owners inflating the size of payroll to obtain larger loan amounts, deflating employee counts to quality as a small business, and fabricating reports of employees and salaries that never existed. Proceeds will be misused for personal purchases and speculative business investment. In many cases, investigations will be required to differentiate the inadvertent mistakes of unsophisticated small business owners from willful deceit and fraud committed by bad actors.

> **PPP will face various forms of fraud**, from illegitimate applications to illicit use of loan proceeds for non-business purposes. Fraud that is not obvious is more difficult and costly to identify and prosecute.

The most obvious form of PPP fraud is found in the criminality of the business owner. Absent credit underwriting, each PPP applicant is required to self-certify that its material owners have not been convicted of a felony within the last 5 years, nor plead guilty, nolo contendere, placed on pre-trial diversion or parole or probation to felony crime. Applicants are ineligible if they cannot self-certify. Verified criminal fraud represents the most directly and immediately actionable category of fraud available for prosecution.

Technology Enables Cost-Effective Solutions to Mitigate Fraud

ClearForce worked with an existing customer, a global financial services leader and SBA approved lender to identify and mitigate verified criminal fraud within its program. That customer provided a sample of 131,000 owners of companies that either had a PPP loan funded in the first ~$350B tranche of congressional authorized funding or an application pending in the second ~$300B tranche of funding. On average, there was between 1 and 2 owners per business. The transfer of information was encrypted in transit and at rest; processed securely to protect the identity and confidentiality of the owners' information.

ClearForce applied an initial quality assurance review of the owners' name, date of birth and social security number (when available). ClearForce performed a biographic screening of the owners using commercial national criminal databases, as well as the National Sex Offender Registry (NSOPW). Filters were applied to capture only felony crimes that occurred in the prior 5 years, including convictions, nolo contendere, parole and probation. Strong confidence match criteria on name and date of birth was used to limit false positives.

The sample of 131,000 loans resulted in approximately 1,518 (1.2%) potential felony hits or "pointers" to felony crime with the 5-year period. The use of a commercial criminal database is an effective, yet incomplete, component to identify verified felony crime. In order for prospective fraud to be actionable, it must also be validated in order to remove inaccurate and/or incomplete information. To authenticate the initial pointer data, ClearForce processed each of the 1,518 hits against verified source information, leveraging industry leading quality assurance technology and operations, and searching for both federal crimes and state/county court records. Exact match criteria for name and date of birth was used in the final verification step.

ClearForce sampled 100 of the verified fraud owners for additional statistical analysis and confirmed:

- *46% of underlying felony crimes were directly associated with fraud and theft*
- *60% served time in jail*
- *30%+ had multiple felony counts on record*
- *54% of the felonies occurred in the most recent 36 months.*

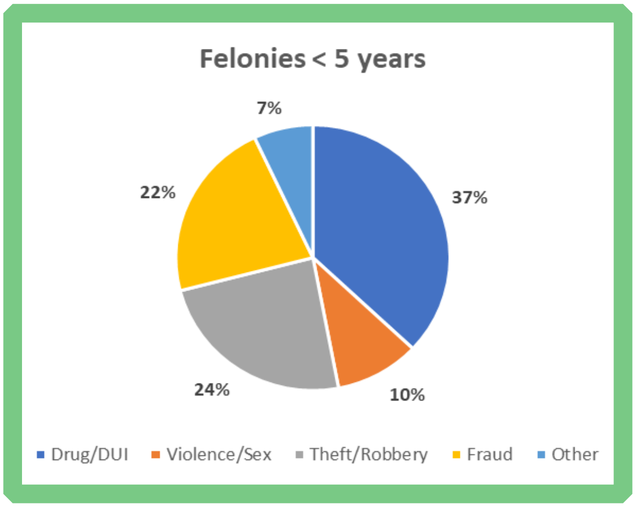
Examples of verified felony crimes included:

- *Armed Robbery/Discharge/Harm*
- *Assault with intent to do great bodily harm less than murder*
- *Aggravated assault with deadly weapon without intent to kill*
- *Felony going armed terror of the people*
- *Criminal sexual contact 4th degree victim 13-16*
- *Child porn/possess photo/victim less than 13*
- *Welfare fraud for public aid $200 or more*
- *Grand theft third degree*
- *Burglary in the 2nd degree (dwelling)*
- *Identity theft*

Analysis Reveals at Least $1 Billion in Fraud from Known Criminals and Felons

The final validation identified 181 owners as verified fraud with a felony in the prior 5 years. This verification rate of 12% (181 of 1,518) conforms to the industry average for commercial employment background checks at 10% to 20%. Extrapolating the results of this sample to the overall PPP program would estimate the number of verified frauds at 6,079 and based on an average loan of $147,000, equated to total verified fraud of $894M.

Due to the large number of PPP lenders (~5,000), ClearForce believes our customer's scale and experience in the business lending market position its loan program execution as more advanced/sophisticated (including existing KYC compliance) than the "average PPP lender". As a result, ***it is reasonable to estimate that the actual amount of verified fraud in the PPP program exceeds $1 Billion.***



As explained in the PPP Interim Final Rule, lenders are required to confirm receipt of borrower certifications; confirm receipt of information demonstrating that a borrower had employees for whom the borrower paid salaries and payroll taxes on or around February 15, 2020; confirm the dollar amount of average monthly payroll costs; and follow applicable Bank Secrecy Act requirements. However, lenders were not required to verify criminal activity of owners, and instead were permitted to rely on borrower certifications and representations.

Current Background Check Process Too Expensive & Lengthy

The SBA likely steered away from verification of criminal certification due to concerns over commercial viability to complete the verification process. Background checks are expensive, FBI databases require fingerprints and public criminal databases are fraught with inaccurate and incomplete data making them non-actionable.

However, in addition to proving actionable verified fraud, ClearForce was also able to demonstrate commercial viability for two other important metrics: turnaround time and cost efficiency.

Of the verified fraud, 92% was completed from original receipt of loan files to full verification in less than four (4) business days. The remaining 8% required more extensive validation (e.g., court runners, courts closed or reduced hours due to COVID-19 pandemic.)

The SBA compensates lenders a percentage of each loan amount to process the loan application: 5% for loans under $350K, 3% for loans $350K to $2M, and 1% for loans over $1M. Assuming an average lender fee of 4% and an average loan of $147,000, the average lender fee earned would be $5,880 per loan. This fee is likely to have thin margins for many lenders; therefore, running a traditional background check for each applicant at a low-end industry price of $15 per report is not economically practical.

ClearForce, through the use of commercial data, automation and process efficiency confirmed the economic viability to deliver a verified ***fraud screening and validation at a cost of less than $0.75 per applicant owner; less than 0.01% of the average $5,880 loan fee.***

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Conclusion & Next Steps

Commercial solutions can provide an economical and actionable means to detect and mitigate verified SBA applicant fraud, ensuring essential funding for U.S. small business is not wasted and misdirected to fraudulent applicants.

In order to:

- Protect U.S. taxpayers from fraud and abuse of essential federal government assistance
- Reduce reputational risk for SBA programs and approved lenders
- Enhance lenders' Know-Your-Customer compliance (KYC)
- Facilitate the creation of Suspicious Activity Reports (SARs)
- Avoid potential funding of terrorism or organized criminal activity
- Support SBA disqualification from loan forgiveness and its prosecution of fraud

The Small Business Administration should consider issuing a rule change to require lenders to verify criminal self-certification.

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