

# Consumer Finance Monitor (Season 4, Episode 33): A Look at the Enforcement Challenges Facing Lenders Arising out of the Federal Paycheck Protection Lending Program (PPP), with Special Guest Louis Bruno, a Partner in EisnerAmper's Advisory Practice

Speakers: Alan Kaplinsky, Lori Sommerfield, Terry Grugan, and Louis Bruno

Alan Kaplinsky:

Welcome to the Consumer Finance Monitor Podcast, a podcast program sponsored by Ballard Spahr. During this podcast program, we explore important developments that relate to the world of consumer financial services. We've been doing this podcast now for more than, it's almost three years. And it's a weekly podcast show, it's available wherever you obtain your podcasts. It's on Spotify, Apple, Google, it's also on our website.

Alan Kaplinsky:

So, thank you all for downloading podcasts today. And let me in the few minutes describe for you what we're going to be covering today and who our guests are. So, we're going to be talking about enforcement concerns for lenders arising out of participation in the federal Paycheck Protection Program, or we'll be referring to it often as the PPP. And, of course this is a program that was put together by Congress and the SBA as part of the COVID relief package. In fact, it's fair to say that the PPP program was the very centerpiece of the financial relief package that was put together within the last 18 months or so to stave off what would have been very detrimental effects to the US economy arising from the pandemic and the shutdowns of many, many businesses as a result of that.

Alan Kaplinsky:

Nearly three quarters of a trillion dollars was lent to approximately 12 million small business borrowers through fully guaranteed loans from the SBA. That is, there are private lenders who lent money to borrowers who applied. And the repayment of the loans was fully guaranteed by the small business administration.

Alan Kaplinsky:

For many reasons, the rules and regs governing the PPP were incomplete and they evolved over time. And that presented significant compliance challenges for lenders. Compounding these difficulties, lenders were forced to grapple with how to comply with PPP requirements while satisfying existing laws and regulations. The PPP did not override any existing federal or state laws. So laws such as anti-money laundering, Bank Secrecy Act, fraud, fair lending, all of those laws still apply not to the PPP. These difficulties gave rise to concerns over how, and whether government regulators will pursue enforcement actions against lenders arising from their PPP lending practices and the significant number of fraudulent borrowers that were involved in the program.

Alan Kaplinsky:

You must remember, this program was put together very, very quickly because we had an economy that was failing very rapidly. I mean, things were a mess. And also, I think it's fair to say there were a lot of desperate borrowers who probably weren't thinking too much about what the potential repercussions could be if they filled out a fraudulent loan application, or if they thought forgiveness of these loans, which was part and parcel of the program, that if you use the proceeds of the loan for

proper purposes, principally to pay compensation and other benefits to employees, then at an appropriate time, the loans could be forgiven.

Alan Kaplinsky:

I guess it's not surprising to me that there has been a lot of fraud related to the application phase and also related to the repayment phase. PPP lending is complete, half the PB loans have already been forgiven by the SBA. We're going to explore today, the current state of enforcement against lenders. We're not going to be focusing on enforcement against borrowers. That's another problem. And there's certain to be a lot of that too, but today, the focus is on lenders.

Alan Kaplinsky:

So, let me introduce to you a very highly qualified roster of speakers today. First of all, let me introduce our very special guest and that is, we're joined today by Louis Bruno, who is a partner in EisnerAmper's advisory practice. He has more than 20 years of experience in assisting banks with strategic and regulatory compliance initiatives. His expertise includes regulatory compliance, operational risk management, policy and control frameworks. And importantly, for purposes of the podcast today, he leads EisnerAmper's CARES Act compliance team, which is in the process right now of reviewing thousands of PPP loan forgiveness applications on behalf of SBA lenders. So Louis, a very warm welcome to you.

Louis Bruno:

Thank you.

Alan Kaplinsky:

Let me introduce our two speakers from Ballard Spahr, my colleagues. First, let me introduce Terry Grugan and he is a partner or a member of the firm's white collar defense and internal investigations and securities litigation and corporate governance practice groups. He's also co-leader of our firm's anti-money laundering practice team. He has significant experience advising individuals and entities on issues related to government regulation and enforcement including issues relating to implementation of the Bank Secrecy Act requirements, as well as the securities laws. He's an experienced trial lawyer, having represented individual clients in criminal proceedings in state and federal court and corporate clients in court and arbitration proceedings. A warm welcome to you also Terry.

Terry Grugan:

Thank you, Alan.

Alan Kaplinsky:

And, last but certainly not least is Lori Sommerfield. Lori is of counsel and a member of the Consumer Financial Services Group, a practice group, which I chaired for many years until the end of last year. And, Lori is located in our Minneapolis office. She is a seasoned consumer financial services' attorney, has practiced at consumer finance law for over 20 years in federal government, in-house and in private practice. And Lori has a particular expertise in the area of fair lending and responsible banking and the Americans With Disabilities Act. For purposes of our program today, she also provides legal advice to clients on COVID-19 related legal matters, including garnishment and offset issues related to the PPP, economic impact payments and advanced child tax credit payments. So welcome to you, Lori.

Lori Sommerfield:

Alan, great to be with you today.

Alan Kaplinsky:

So, first question I have in our pocket today is for you Terry. What I want to know is, what are the compliance concerns that you have that give rise to enforcement actions against PPP lenders?

Terry Grugan:

Some of this you touched on in the introduction. The PPP for a number of reasons, involves significant compliance challenges for participating lenders. Those challenges arose from really a convergence of several factors. First, the CARES Act generally and PPP specifically were developed and implemented in an amazingly short period of time through the emergency nature of the pandemic. This meant that legislators didn't have sufficient time to craft legislation that provided certainty and the administrative bodies implementing the PPP and with responsibility for oversight of the program, hence participants didn't really have sufficient time to produce implementing regulations that would address all the nuances that the lenders would ultimately face and all the concerns participants would have with the program before it was rolled out.

Terry Grugan:

Second, the fundamental purpose of the program was to get cash out to as many recipients as possible, as quickly as possible. And the idea really was to get money to people emphasizing making these loans. And the CARES Act contained provisions intended to meet this goal such as streamlining customer onboarding and application review and approval. The CARES Act also allowed for non-traditional financial institutions to participate in lending program.

Terry Grugan:

However, appropriately, the CARES Act also provided that participating lenders must still meet all applicable requirements under the Bank Secrecy Act including having and implementing an adequate anti-money laundering program. In turn, an adequate anti-money laundering program involves among other features, crafting a risk assessment that takes into account for the financial institutions' business and customer base, systems in place to conduct thorough customer due diligence, processes for monitoring customer accounts for signs of money laundering or fraud. And these are all statutory requirements for financial institutions and those are all requirements that PPP lenders in turn had to face. They just had to figure out how to meet those requirements in this short period of time in this lending context.

Alan Kaplinsky:

So, Terry, are you saying that, I mean for banks that probably is not a big deal, right? Having AML policies because they've got them already. Maybe they have to review them, to tweak them here or there to make the PPP program applicable. But, is the concern really non-bank lenders that were involved in this program? Many of them would not otherwise worry about AML?

Terry Grugan:

That's a terrific point. The answer really is yes and no. So yes... Well let me address the no first and deal with traditional financial institutions first. So yes, they have mature, robust anti-money laundering policies in place, they do. But at the end of the day, a written policy is a written policy, whether it's AML or whatever it may be. It's implementation that is the most important thing. So the issue and the challenge that even traditional lenders would face is when you have this real crush of new potential customers try to seek emergency funds in an emergency circumstance, how do you implement that existing policy to ensure that you're adequately vetting customers and then monitoring their account activity?

Terry Grugan:

So in that respect, having the policy, no, that's not a problem for traditional lenders. Implementing it certainly was, but yeah, you touch on exactly the issue that we're seeing emerge, that these non-traditional lenders who are permitted to participate in the PPP, they had to create an AML policy from whole cloth. Like I said, create a policy, it's a document it's a 25, 30, 40 page document. You can do that quickly. Implementing it, knowing how to implement it and having the people and the resources to do so, that is not so easy. And, some alternative lenders we've seen, their business went up by thousands of degrees. They

go from a small FinTech company to a multi-billion dollar lender almost literally overnight and you need to have a compliance program in place to deal with the billions, not the smaller part of the business. And so all this comes-

Alan Kaplinsky:

Some of these lenders under PPP, were some of them not even in the lending business, they are involved in completely unrelated things.

Terry Grugan:

Yes. They're involved in the financial services industry in some form or another, but not as a lender and certainly not as an SBA authorized lender. And so in order to then participate, they had to craft these programs. And so what we were finding in practice was that, many of the larger lenders and traditional lenders work primarily with existing customers, because it presents a lower risk. Presumably you know who you're working with and you can make the loan. Now that creates its own problems too that I'll get to in a moment, but, that dynamic left new customers to pursue loans through alternative lenders.

Terry Grugan:

Now, to think about this dynamic and how it worked out, these borrowers who don't have existing banking relationships, they're less mature businesses, there have less operating history, they necessarily present higher risks. So you have higher risk borrowers going to alternative lenders that have less mature compliance programs. So it's created kind of a perfect storm here. At the same time, in a lot of ways, these specific borrowers who are the ones that PPP was intended to benefit the most, they were the ones who suffered the greatest consequences of the pandemic and the shutdown, because they're less mature businesses with less operating history. So they face the brunt of the pandemic, they had fewer banking options, and they're left to go to lenders who had less mature compliance programs in place. That created a perfect storm for compliance failures.

Alan Kaplinsky:

Right. Wow. So let me stay with you for right now, Terry. Are we seeing any evidence of regulators pursuing investigations, meeting these concerns? And I'd like you to talk about congressional investigations and Department of Justice investigations. What do you see?

Terry Grugan:

Yep. We definitely are. We're starting to see activity there focusing on lenders. The question really is whether lenders efforts to thread these compliance needles that we talked about and their failure to do so in compliance areas have resulted in loss to the government and might mature no enforcement actions.

Terry Grugan:

First, I think we must note that the government recognized that this was going to be a challenge for lenders. They weren't left out on a branch with no recourse here. The CARES Act and follow up legislation contained a fairly robust hold harmless provision that, pardon me, that protects lenders against the enforcement actions related to PPP lending, where the lender relied in good faith on certain borrower certifications. It's really a reliance provision. If you rely on good faith and what your borrower said, you could be free from potential enforcement action, but then the caveat of course is, so long as you otherwise complied with all applicable federal, state, local laws. That right there brings in BSA, that brings in fair lending laws. That means that there's a whole host of other generally applicable regulations that banks had to meet. So the hold harmless while robust does not completely hold all lenders harmless.

Terry Grugan:

And so, the two real areas that we've seen action from an enforcement side have been in fraud detection and monitoring, and then fair lending, which Lori can discuss. Back in March of this year, the House Select Committee on coronavirus crisis responded to initial findings of billions of dollars in fraud and the PPP by demanding records on PPP implementation policies,

BSA, AML compliance policies from a number of the larger financial institutions really citing those two concerns, fraud, and fair lending. That signaled strongly Congress's interest in finding out whether PPP lenders made too few loans to intended recipients as I discussed earlier, or, extending loans to borrowers who shouldn't have gotten them or fraudulent borrowers.

Terry Grugan:

Recently, just a few months ago, Representative Clyburns' committee followed this up by announcing further investigation specifically into the role of FinTech lenders in the PPP. And as we discussed earlier, whether they had adequate measures in place to protect the program against fraud and to vet out fraudulent borrowers. Now around the same time, this is May of this past year, as Representative Clyburn released that statement and announced that investigation it became public, the Department of Justice is also conducting investigations into specifically FinTech lenders. And again, here focusing in two areas.

Terry Grugan:

One, whether or not they conducted sufficient diligence on loan recipients. They were finding that FinTech lenders were making hundreds of millions of dollars in loans to completely non-existent borrowers and just failed to perform any kind of vetting on the front end. And then also whether they accurately calculate a loan amounts. So a lot of these lenders had automated systems in place that would just kind of process data and then calculate the loans and whether or not they were appropriately accounting for certain expenses that had to go into the loan amounts.

Terry Grugan:

So those are just two DOJ investigations that we know of. And I should note that the Department of Justice does not always announced everything it's investigating so we can be sure there's probably more happening that we're not aware of. But we're also aware of the SBA inspector general constantly analyzing this program, releasing findings and pursuing potential actions, whether it's auditing borrowers or then using those audit results to follow up with lenders.

Terry Grugan:

And, it also kind of bears noting that these investigations pertain specifically primarily to the 2020 PPP, the 2021 PPP was reauthorized in 2021, and that reauthorization introduced an entirely new host of problems for lenders in that now for the first time prior applicants and prior loan recipients were allowed to reapply for a PPP loan. What this means from a BSA/AML perspective is now SBA and lenders have PPP specific information on these specific borrowers. So now, you can rely on borrower certifications realm and more in that, no, now we have specific concrete information and SBA has been providing lenders with red flags, with certain compliance checks indicating that certain borrowers were not in compliance with the program. And that puts another affirmative obligation on lenders to vet these borrowers and then to affirmatively certify that they've done.

Terry Grugan:

So, more information creates more risk in an odd way for lenders in this circumstance, because they really have to make sure that they are conducting appropriate diligence. And so I think that these investigators are just the tip of the iceberg.

Alan Kaplinsky:

Yeah. With the PPP loan program closed at this point and forgiveness well under way, is there reason to think enforcement will definitely continue into the future Terry?

Terry Grugan:

Yeah, I really think that there is. I've thought about this problem. It's a problem that the lenders themselves face. We discussed how lenders on BSA are obligated to conduct a risk assessment based on their business. You would think that the risk assessment, it would probably have to include the PPP, but the PPP's at most a two year thing, the loans are two years before

maturity and then it's gone. It may be a large part of their business, but it's a short term part of their business. And so I know there's maybe a sense that investigations won't outlive the PPP, but I think even though the COVID pandemic was hopefully a once in a lifetime event, the government stimulus was not. We have historical analogs we can look to. Specifically we can look to the financial crisis, 2008 financial crisis and the government's response there. The TARP program, the Troubled Asset Relief Program was rife with fraud as we found out. Billions of dollars was spent by the government to acquire bad debt and bad assets and that program had significant amount of fraud.

Terry Grugan:

The government to this day, the Special Inspector General for TARP is still to this day, investigating TARP related fraud and crimes. Most recent prosecution was just a few months ago by the SIGTARP or announced by SIGTARP. And we know that the CARES Act Inspector General is really modeling their approach on SIGTARP. It's a huge program and the government's going to spend the time and the resources to look at this, to analyze the program as much for fraudulent activity and seek as much recovery as they can. And these actions involve, in many cases, some recovery of funds. So the government's always going to have an interest in trying to recover money that it feels was stolen from it.

Alan Kaplinsky:

Yeah. Let me turn now to you, Lori. I know I mentioned during your introduction that you spend a lot of your time consulting with clients on fair lending issues and in particular, the Equal Credit Opportunity Act. So tell me Lori, we know that in addition to the other regulators, the CFPB and the federal banking agencies may be looking at disparate outcomes in terms of PPP loan decisions that may violate the fair lending laws. Did the CFPB or the prudential regulators issue any fair lending guidance after the CARES Act was enacted, or any of the other subsequent federal laws that reauthorized PPP loan funding?

Lori Sommerfield:

No. And interestingly, neither the CFPB nor any of the federal banking agencies issued any specific fair lending guidance, although the OCC and the CFPB did issue some general guidance about the PPP loan program that I think might be worth discussing briefly.

Alan Kaplinsky:

Yeah, sure.

Lori Sommerfield:

So, early on in the pandemic, and this was about in the April timeframe, the OCC issued bulletin 2020-45 in which the agencies strongly recommended that national banks and federal savings associations prudently document their implementation and lending decisions. And in that guidance, the OCC actually suggested specifically tracking PPP lending in low and moderate income census tract areas, as well as distressed areas, underserved areas and monitoring that PPP lending data.

Lori Sommerfield:

The OCC also encouraged institutions to document their implementation decisions about how they were rolling out the PPP lending program, including any business justifications or alternatives they might've considered in setting things like eligibility criteria, establishing application processes and in approving or denying PPP loan applications. So they were really kind of first out of the gate.

Lori Sommerfield:

The CFPD though has also taken a pretty active role in issuing guidance in conducting examinations on the topic of PPP lending. And this is where I think it gets very interesting. So first in the same timeframe, April, 2020, the bureau issued a blog post that encouraged small businesses to file a complaint with the bureau if they suspected any sort of lending discrimination that had occurred with PPP lending. And again, discrimination has to be on a prohibited basis, right? So it has to be

discriminating against women or minorities or the elderly, something of that nature. And this would be businesses that are owned by these types of people.

Lori Sommerfield:

In that blog post, the CFPB stated that its intent was really to focus on denials, where small business applicants had met advertised standards, but then were denied or the institution offered high rates or worse terms and conditions than they actually advertised as well as any sort of indicia of discouraging credit applications, because that's also a way in which you can violate ECOA.

Lori Sommerfield:

The CFPB also subsequently issued an FAQ that underscored the need to provide an adverse action notice under regulation B, which implements ECOA in connection with any PPP loans. So they wanted to make sure that lenders were abiding by the usual laws that come into play, even with PPP lending to ensure that they were conducting the PPP loan program in a non-discriminatory manner.

Lori Sommerfield:

But I think most importantly, the CFPB conducted prioritized assessments during 2020. And those were basically kind of a high-level offsite exam that the bureau came in and did based on offsite data. And they released a special edition of their supervisory highlights publication in which the bureau revealed that they had actually looked at fair lending risks from participation in the PPP.

Lori Sommerfield:

So, examiners observed that in implementing the loan program, multiple lenders went beyond CARES Act requirements and SBA directives by restricting access to PPP loans to businesses that had a preexisting relationship with the bank and in some cases to businesses that did not have a pre-existing relationship, but then became bank customers before applying for the PPP loan. So they basically alleged that banks or non-banks were leveraging that customer relationship or kind of strong arming non-banks or banks to then become bank customers.

Lori Sommerfield:

So, also an important point here, I think, is that examiners determined that existing relationship restriction, while it seems sort of neutral on its face, actually could have a disparate impact on a prohibited basis and thus could violate ECOA or Reg B. And the bureau did acknowledge that lenders did provide business justification for using that restriction. Like the fact that existing customers had already met the AML know your customer requirements or for fraud prevention reasons or even operational reasons like just managing an extremely high volume of credit applications. But since the bureau basically didn't have time to conduct a full examination or analysis of institutions use of these restrictions, it really didn't come to a conclusion about whether there were any actual violations of ECOA or Reg B. So I think the jury is still out on that topic Alan.

Alan Kaplinsky:

So Lori, I take it that the concern of the regulators is really when you talk about fair lending issues is very much focused on disparate impact, not intentional discrimination. Am I right about that?

Lori Sommerfield:

Well, it could be both Alan, but I think there's more of a concern about disparate impact. The fact that facially neutral policies or practices were put into play that had a disproportion adverse income on small businesses that were owned by minorities or women.

Alan Kaplinsky:

Right. Now, that's a controversial subject in and of itself. I mean, we could do another podcast, I think we probably already have done a podcast, maybe more than one dealing with the viability of the disparate impact theory. There's arguments, I guess, that could be made on both sides. There is a regulation or official staff commentary, I guess that got issued by the fed years ago that the CFPB adopted where it blessed the disparate back theory. But yeah-

Lori Sommerfield:

Under ECOA.

Alan Kaplinsky:

Under ECOA, but yet then you have the Supreme Court in a fair housing case, I think to a great extent, eviscerating the doctrine under the Fair Housing act. So I think it's important to just flag that issue, that if you're being investigated for a fair lending violation, if it's based on disparate impact, that doesn't mean that that's the end of the ball game, that you're in trouble, but you've got a potential defense, right?

Lori Sommerfield:

Agreed Alan. Yes. Just to create a juxtaposition hear, the Fair Housing Act actually has more explicit language allowing a disparate impact type of analysis, but ECOA does not.

Alan Kaplinsky:

Right. Yeah. Thank you. That's an important point. So let me ask you about horizontal exams. In the past the CFPB and I think the banking regulators certainly the OCC have conducted the so-called horizontal exams, where they look at a particular issue to see if there's a violation. Do you know whether the OCC or the CFPB has already conducted horizontal exams pertaining to PPP issues or that they're planning on doing that? What do you know about that?

Lori Sommerfield:

So I'm uncertain about the plans that the prudential regulators have, but as I mentioned, the CFPB has conducted these prioritized assessment that looked at fair lending risk in a PPP lending context. But we also know that recently the CFPB has been issuing what they're dubbing an inquiry that is extremely large in scope that is looking at how regulated institutions have handled COVID-19 related payments that have been basically promulgated under these three major pieces of legislation since the CARES Act. There's also been the Consolidated Appropriations Act in December of 2020, more recently the American Rescue Plan Act of 2021 that was enacted in March of this year.

Lori Sommerfield:

So, this, what I'm calling monster inquiry from the CFPB has been received by several banks that we are aware of, and it focuses at least to date on economic impact payments and also unemployment insurance compensation payments, that is that federally enhanced component of them that were added to state compensation payments during the pandemic. The CFPB hasn't really made any direct inquiries that we're aware of yet with regard to PPP loan proceeds and how those were handled and protected from garnishment or offset, but we do expect that that could be the next volley, the next round of inquiry.

Lori Sommerfield:

I am viewing this as a type of horizontal review, the issuance of these inquiries by the CFPB, but they could actually, I think, snowball into more the nature of a targeted exam across the industry, looking again at PPP loan proceeds and how those were handled or protected.

Alan Kaplinsky:

Okay. I have one other question for you Lori before we move on to Louis and that is, what are some of the key, fair lending risks that lenders should be aware of and what, if anything, can be done to mitigate them now that the active PPP lending program is largely over?

Lori Sommerfield:

Well, I think there are a few key fair lending risks that are presented here, even at this stage of the PPP lending program. First of all, there's several lawsuits that have occurred that have alleged that certain lenders have limited the availability of PPP loans to existing customers as I mentioned or prioritized processing larger PPP loan applications received through particular lines of business in some cases. So limiting PPP loans to existing customers is viewed really as a form of credit overlay, similar to the way that lender credit overlays work in terms of FHA loans, like requiring increased credit scores. And those have been viewed as disfavorable by regulators for many years. So I guess that the important point here is that if you used any types of these credit overlays or only prioritized existing customers, you should make sure that you have a written business justification for why you did so. That is very useful and refuting any claims of disparate impact.

Lori Sommerfield:

And, the justification can be based on things like being able to process applications from existing customers faster, because they've already passed the KYC requirements or, just simply operational capacity, but it's really important to make sure that you have a written business justification. Having one that was contemporaneous when you actually rolled out those policies and practices is more viable. It's going to be more persuasive than one that you create now, but hopefully, you have a written trail of documentation about why your lending institution made the decisions it did.

Lori Sommerfield:

Another issue to consider from a fair lending risk perspective is that you want to make sure that there was a consistent approach to both accepting applications and decisioning them across lending channels. That's another important thing to look at in your lookback review. Because again, lawsuits have alleged that lenders with multiple lines of business or multiple application channels use different policies and procedures to determine eligibility for PPP loans or the way that they process those applications. So that led to ultimately prioritizing PPP loan apps from larger customers.

Lori Sommerfield:

So, those kinds of channel differences can lead to allegations that lenders treated similarly situated applicants differently based on a prohibited factor and the channel they came in from. So again, here written business justification is really helpful to refute any sort of discrimination allegations based on channel differences.

Lori Sommerfield:

And finally, I just want to mention use of discretion in the lending process. That is just a historical area of regulatory scrutiny and that's whatever you allow lenders to exercise discretion in terms of the way that they decision applications or price loans. Fortunately I think the eligibility criteria and also the pricing for PPP loans are pretty much set by the SPA and fixed so, lender's responsibility is really to verify information necessary to prove eligibility.

Lori Sommerfield:

But in some cases that could lead to use of discretion. So for example, whether the applicant had adequately documented payroll expenses. Lenders also exercise discretion in deciding which applications to prioritize, or even in the level of assistance that they were providing to certain applicants. So these are all things that regulators are going to look at when they do a look back review. So to the extent that you can point to policies and procedures, that limited discretion, or that your institution closely followed the SBA criteria, that's going to be very beneficial in refuting any sort of allegation that there was disparate treatment or disparate impact. So take a look at your training, your policies and procedures to make sure that you've got that sort of button down the use of discretion that is.

Alan Kaplinsky:

So, the next question I have is for you Louis and this is the question. We know that lenders were not able to keep up with the speed of originating new PPP loans, and it's certain that policies and procedures weren't always followed. Where do you see the risks, and are the risks limited to noncompliance with existing policy, or is it possible the lenders didn't have the right policy in place to begin with?

Louis Bruno:

Yes, thanks Alan. And you're right. I mean, this speed is absolutely unprecedented. And so for many of our clients, it was all hands on deck to review and approve these loan applications as fast as possible during phase one. And then really with little time to breathe, they had to turn and start and do everything again during phase two of the PPP lending. And so really, phase two presented some additional risks because many lenders took on new clients and originated loans for these new clients.

Louis Bruno:

So, in terms of the risks and further to Terry's comments regarding to BSA/AML implications, we've seen gaps within the compliance program specifically related to KYC and client due diligence. The lenders were not really able to conduct what would be a standard level of due diligence on new borrowers because of the fact that everything was moving so fast. We know that FinCEN issued the FAQ's indicating that the PPP loan was made to an existing customer, and the customer was previously verified that you don't need to re verify. But again, because of the phase two or just in general on onboarding new clients, we've seen a lot of gaps there with the verification. And again, given the need for speed so to speak in many cases, verification standards were not accurately applied which is expected of a BSA/AML program.

Louis Bruno:

The other area of risk that we see quite a bit is on the monitoring side. So specifically in fraud monitoring. Many lenders didn't have the time and quite honestly, many of the red flags were not really defined as the program was underway. It was only after the loans were issued and first forgiveness requests came through the door that some of the red flags came to light. Now we see lenders doing look backs to then go back and try to identify these red flags and retroactively trying to incorporate them into their monitoring program. All of this of course has an impact on the risk assessment for the BSA/AML program.

Louis Bruno:

On the origination side, we've heard a lot of different types of frauds. There's been quite a bit of in the news obviously of some of the blatant abuse, but there's definitely some less apparent fraud that can be identified specifically with insufficient loan documentation. That is a key risk that banks need to consider or lenders need to consider when evaluating their risks.

Louis Bruno:

The other area of risk that again, is overlooked in some cases is on the loan forgiveness side. Some examples of fraudulent red flags are the amount of evidence that had to be provided and reviewed by the bank wasn't accurately pre-reviewed, it may have not fallen into the bank's existing policies. Some of those red flags are certainly where you would receive applications for forgiveness that had more than one employee using the same Social Security number, or, what we've heard kind of referred to as ghost employees or falsification of time and employees that didn't have any reduction of their payroll taxes. Having the benefits of looking at a lot of different forgiveness applications for our clients, we've seen a lot of things that could be certainly inadvertently put down on the application, but, some things that maybe erroneously or misrepresented. And so there's a series of red flags that lenders need to consider for the loan forgiveness process as well. And without having-

Alan Kaplinsky:

Louis, I would say just as a foot note to your point on loan forgiveness, banks don't usually have to review forgiveness applications in connection with other loans that they make. So I take it for many of the banks, this is an entirely new process that they were unfamiliar with.

Louis Bruno:

That's right. And quite honestly, operationalizing something like that in a limited amount of time, pulling everyone from every corner of the bank to again, have the all hands on deck concept, we had people, we had bank tellers coming in, or, doing these reviews late at night and on the weekends, people who aren't necessarily trained to identify these types of gaps. So clearly all of that adds to the risks that should be considered.

Louis Bruno:

Lastly, a good point, and I think to that question of is it possible that there are some inherent risks that the right policy wasn't in place to begin with? Absolutely right. I mean, especially for non-bank lenders. Many bank lenders of course are familiar with, most of the case, the BSA/AML frameworks and have the policy and procedure in place. But again, many lenders have again, either inherent or known gaps and then many non-bank lenders didn't have the program in it at all.

Alan Kaplinsky:

Yeah. The other thing too, I assume was probably maybe not as big a problem is that I am aware of loans that were made to borrowers who didn't qualify for a PPP or at least didn't qualify in accordance with SBA requirements. Are you finding that also is an issue?

Louis Bruno:

That's right. And, you can imagine that checklists were put together on the fly. Again, same concept of individuals who may not be within the credit group or have the origination expertise were then asked to go through and validate the checklist and again, mistakes were certainly made.

Alan Kaplinsky:

Yeah. Yep. I have another question for you Louis. Banks are most likely familiar with the requirements to maintain a defensible anti-fraud compliance program, but many non-bank lenders may not be aware of regulators expectations. What are the standards for a compliance framework?

Louis Bruno:

Yes. Another focus obviously is on all of these non-bank lenders that, quite honestly the FinTechs that would put together to produce the amount of loans that were expected and, quite honestly to reach the large amount of population of borrowers had no idea of what it meant to agree to a standard BSA/AML compliance framework. And so since FinCEN obviously it has the standard that is most well-known in the industry and so they have a BSA/AML compliance framework that's defined by five pillars, and it would take us quite a bit of time today to go through the whole thing and multiple podcasts or a separate podcast for sure to talk about that.

Louis Bruno:

But, at a high level, the pillars address internal controls and the responsibility of the BSA/AML officer, the training program, independent testing and verification of the compliance program, and then a unique last pillar that was actually relatively new to the framework but talks about the requirements for customer due diligence. This is one that is probably identifies the most amount of challenges in general to banking institutions. But, further, it's one that would impact the PPP program as well, where this requires financial institutions to identify and assess the risks associated with the customer and truly to catch abnormalities which again, just by kind of stating that pillar as it stands is exactly where we think the risks lie.

Alan Kaplinsky:

Mm-hmm (affirmative). Okay. Let me now ask all three of you one final question and that is, do you have any additional tips for best practices concerning risk mitigation that you could share with our listeners? And why don't we start this time with you Terry?

Terry Grugan:

Sure. Thank you Alan. At this point, we're well past the lending phase of the PPP and well into this forgiveness phase, it's still a good time for lenders to conduct look backs of their AML programs and ensure that they had proper practices in place to examine their customers and to monitor their account activity and ensure they're fully in compliance.

Terry Grugan:

Another area that is really going to be vital is making sure that banks had their record keeping or banks maintained the records adequately. This is an area where they could really start to see not only problems from failure to have properly maintain records during the process, but something that could then trigger further investigations. For instance, you can imagine a scenario where the Department of Justice would subpoena a bank for records of a bar where they're investigating and the bank did not properly maintain the records at the time, and that will then trigger a look into the bank itself. So examining where their program was, and if there were any gaps that may have allowed problems to occur through the lending process, and then making sure to correct them now as they continue through the forgiveness process and, recognizing that a lot of these bars are going to continue to be customers. So it doesn't hurt to continue to go back and examine the practices they had in place to make sure that you've maintained compliance.

Alan Kaplinsky:

Yeah. Lori, do you have any best tips?

Lori Sommerfield:

I've got several ideas about risk mitigation that kind of pick up on this concept that Terry mentioned about conducting a look back of your PPP lending program. I guess the idea is that I would touch on are around documentation and data integrity of long files, as well as the potential for fair lending testing which should be approached cautiously I might add the latter topic.

Lori Sommerfield:

But, first of all, I think you'd want to make sure that your PPP lending strategy processes and any business justifications for it are thoroughly documented, including any additional restrictions that your institution might have applied to existing customers for example. This was the advice from the OCC bulletin that we previously discussed about the need to document implementation strategies, as well as any lending decisions,

Lori Sommerfield:

For example, if you prioritized underserved borrowers or rural markets, you should make sure that you documented how and why you did that. You'll also want to make sure that your loan files are accurate, complete and up to date. If the SBA selects a loan for review, your institution is going to be expected to provide those loan files within five days, but it doesn't give you much time. Bank regulators will also review loan files. So it's imperative to ensure that that loan file information is accurate.

Lori Sommerfield:

And, speaking of data integrity, it's also a good idea to do a comparison against the SBA release of the PPP loan data to make sure that it comports with the information in your loan files. There've been some issues, since the SBA released that data about data inaccuracy, but it's a good idea to compare that information and the SBA released your loan files to make sure that you have appropriate data integrity.

Lori Sommerfield:

It's also a good idea to monitor PPP loan performance closely if you haven't been doing so already, including keeping an eye on the number of loans in low or moderate income areas or underserved areas. This could be an area of regulatory scrutiny. And also make sure that you're monitoring any consumer complaints on an ongoing basis that might allege discrimination in

PPP lending practices and make sure that you're promptly responding to them. As the audience knows, regulators frequently use consumer complaints as a roadmap to future inquiries, investigations, or examinations.

Lori Sommerfield:

And then on the testing concept, I just wanted to mention that, you should consider potentially doing some lookback testing for compliance with the Equal Credit Opportunity Act and the Community Reinvestment Act. But I'd like to note that any testing should be done by a qualified independent consultant in consultation with legal counsel in order to protect the results under attorney client privilege. This type of testing really requires know-how and there are only certain consultants out there that really know how to do this type of testing.

Lori Sommerfield:

An example of testing could be something like conducting a geographic penetration analysis to see where your PPP loans ended up being distributed, and whether your PPP lending actually helped small businesses in lower moderate income areas, or majority or minority census tracts. Often we see institutions are considering use of proxy data to base this testing upon in either the PPP credit applications or the forgiveness applications so that could be used in either looking at it from an underwriting perspective or even looking at it from a forgiveness perspective. But again, don't try this on your own, if you decide to do this type of fair lending testing, but makes sure you engage a really knowledgeable econometrician and legal counsel for that.

Alan Kaplinsky:

Yeah. Lori, you've mentioned a couple of times the need to keep track of loans that were made to borrowers in low and moderate income neighborhoods. Is that because of something in the PPP program itself, or is that because a lot of lenders want to get CRA credit Community Reinvestment Act credit for the PPP loans? Is that why you mentioned that?

Lori Sommerfield:

Yes. It's not actually required by the PPP statute, but it's something that lenders can get credit for under the CRA. And there's also this expectation that the banking regulators and the CFPB may look back to see how your lending actually played out. So it was more of a proactive measure to make sure that you were trying to at least benefit some aspect of LMI communities where small businesses are located.

Alan Kaplinsky:

It was really sort of a neat thing for a bank because they could lend the money to a business in a low and moderate income neighborhood and not worry about repayment because they knew they had the SBA guarantee beyond the loan. So, there really was incentive I would think, that given the limited amount of loans that a bank could make to try to get CRA credit for them, right?

Lori Sommerfield:

Yes. And also, I seem to recall that the SBA regulations actually preclude lenders from being able to show preference or prioritize small business applications from minority owned businesses. That may change going forward, but that's just something else to bear in mind in this equation.

Alan Kaplinsky:

Right. Louis, in addition to the things that you already mentioned, do you have anything more that you'd like to add on best practices?

Louis Bruno:

Yeah. I would just say off of Lori's comment, having the right people on the team to do your risk assessment is extremely important. I would say engage your internal audit group as soon as possible, follow their standards. It's an expectation of the frameworks that I explained earlier to have that as a third line of defense is internal audit involved in the assessment. So I would definitely say that there are some clear best practices when doing this.

Alan Kaplinsky:

Yeah. Okay. Thank you very much. Well, we're going to have to wrap up our podcast today on this very interesting subject, a subject that we may want to revisit in about a year or so to see whether some of the predictions that were made today by my guests have come true.

Alan Kaplinsky:

So, I want to of course thank Terry, thank Lori. In particular, thank our very special guest, Louis Bruno and I really want to thank all of our listeners who took the time to download our podcast today and listen to it. And I did mention at the outset that we did a webinar on this subject on July 12th. If you're interested in getting the recording or the slides from the webinar, you can contact any of us at Ballard Spahr, but also probably your best contact would be Julianne Garrity. That's [garrityj@ballardspahr.com](mailto:garrityj@ballardspahr.com). She runs and administers our webinar and webcast program and she'll be happy to provide that to you.

Alan Kaplinsky:

With that, I'm going to wish everybody a very good day. Thank you again.