Singidunum University International Scientific Conference
Međunarodna naučna konferencija Univerziteta Singidunum

PAPERS FROM THE THEMATIC AREAS OF THE CONFERENCE
Banking
Original paper

UNVEILING FINANCIAL FRAUD: A CASE STUDY OF SMALL BUSINESSES AND THE PAYCHECK PROTECTION PROGRAM

Bogdan Vukolić[1]*,
Tijana Radojević[2]

[1]PhD candidate,
Singidunum University,
Belgrade, Serbia

[2]Singidunum University,
Belgrade, Serbia

Abstract:

The aim of this research is to demonstrate contemporary instruments of fraud in the banking industry that small businesses use by using a simple case study of the PayCheck Protection Program. Furthermore, modern lending institutions are having to move from traditional ways of financing and innovate based on globalization, digitalization, and internationalization processes. With the skyrocketing competition, lenders are facing challenges, whereas additional requirements and checks could cause them to lose business if the additional measures are not applied; there is a chance for potential fraud; hence, the lenders are left with a dilemma. Their choice is becoming more complex as there is a rising number of players entering the market, therefore creating substantial competition. Ultimately, there is an opportunity for fraud that can be relatively easily committed, and small businesses are presented as a byproduct of the contemporary economic conditions, impacting the need for even economic and social development.

Keywords:

small-business, lending, fraud, banking, paycheck protection program.

1. INTRODUCTION

In the contemporary business environment, particularly in developed countries, there are limited growth opportunities. Moreover, stable economies have already developed their markets as well as market players and strategies for particular industries. Although, it can be challenging for the developed economy to grow at the same pace as developing economies simply due to the number of opportunities to promote such growth. One such opportunity for all economies, especially developed ones, is the growth of small businesses. Due to their unique structure, small businesses are a limitless opportunity for growth and innovation. Contrarily, big corporations can only grow so much within the country and the industry, and there can only be so many of them in the market at a particular time. However, small businesses can quickly enter the market by taking a small share and growing therein. Taking that into consideration, small businesses in the United States are considered a valid investment opportunity due to their skyrocketing growth and profitability potential. There are numerous players who are interested in working with small businesses and providing them with various sources of funding nowadays. Besides banks, traditional lending institutions, and the government that works on economic development, some of the players in the market are venture capital and private equity firms, as well as investment banks and FinTechs. Throughout the years, there has been a massive interest in funding small businesses, and the market has consequently become more complex. Considering the fact that small businesses now have a plethora of choices to get funding that they need to start and/or further grow their business, and the intense market competition that is strong,

Correspondence:
Bogdan Vukolić

e-mail:
bogdan.vukolic.23@singimail.rs

DOI: 10.15308/finiz-2024-50-55

lenders and investors have to come up with innovative and unique ways to create a competitive advantage for the target clients. Such market conditions where lenders and investors are actually competing against each other in order to win over more clients than has been the case in the past, which causes the market to have different requirements for small businesses to get funding. When the market only consisted of one or two players, institutions such as banks could make their own rules and use all the processes and procedures that they considered prudent lending. Nevertheless, with the increased competition, there is a valid reason for a change, and traditional lenders need to adapt to new market conditions in order to stay relevant to the competition. Initially, banks were the ones that chose the best candidates to be their clients, but nowadays, clients are choosing the best lending institution to be their lender.

2. LITERATURE REVIEW

Banks represent a vital segment of financial markets in the modern economy (Perić & Barjaktarović, 2023). Traditionally, banks were the only option for obtaining financing, and in some countries, they still are. Banking products that include retail and corporate banking (Nóra & Bíró-Szigeti, 2023) face banks with a plethora of private and business clients daily. Moreover, such trust established between banks and their customers is inevitable due to the reputation of bank lenders and players in the financial markets. One of the primary forces driving the modern economy is globalization (Nebozhenko et al., 2023). As a byproduct of globalization, companies will no longer only be limited to the local markets but also include global markets, which would ultimately bring additional profitability, besides other benefits. Although, many of the banks are emerging into different markets and looking for growth opportunities (Tabash et al., 2024). Nevertheless, banks must follow trends of globalization in order to stay relevant in the market, hence offering innovative products to consumers and businesses. While improving the banking products and services that are offered to customers, globalization has also created multiple challenges for the banking industry, including banks having such a superior asset size that they cannot compete in the market. Similarly, local banks and credit unions, in that case, are suffering due to the sheer size of their competitors that operate globally. Also, banks are no longer limited to geographical territory, which allows for rapid growth (Radojević, 2019). Some of the banking products, however, are only applicable in specific markets. Further, the banking industry has experienced major reforms in the business environment in which the business is conducted (Korneev et al., 2023). Traditionally, all bank operations and transactions took place in the physical location. In the contemporary business environment, the process of digitalization that encouraged the transfer of business activities from the physical to the digital environment has gained a skyrocketing importance (Singh et al., 2023). In addition to that, the COVID-19 pandemic has also played a significant role in speeding up the digitalization process for companies that have yet to transition to the online environment (Inascu & Barbu, 2023). Even before the pandemic, the need for digitalization has become apparent, as the digitalization and globalization processes are closely related and interconnected (Van Zeeland & Pierson, 2024). Similar to globalization, the digitalization process has brought a plethora of growth opportunities as well as cost reduction and operational efficiencies (Levy, 2022). for many of the already existing players in the market, but it has also enabled new players to penetrate the market and become direct competitors. As an example, FinTechs are a creation of the digital economy, and the name itself further suggests the immersion of the two, up until now, not connected industries – the financial industry and the technology industry (Garekwe et al., 2024). Finally, the digitalization process provides skyrocketing benefits not only in a time of need but also keeps providing numerous benefits to society and the economy daily (Chauhan et al, 2022). But at the same time, it has also provided base grounds for financial fraud in many different industries, including the banking industry, which has had colossal challenges navigating financial fraud attempts and dealing with their consequences (Mangala & Soni, 2023).

3. US BANKING PRODUCTS – COMMERCIAL AND SBA LENDING

In the United States, there is a plethora of different banking product options. However, the most valuable products for small businesses are commercial and SBA loans. Moreover, they will provide financing for businesses for different types of clients all across the country, no matter if the business is only being started when financing is being obtained, or the business has already been operating and needs additional funds for different purposes. Either way, such lending practices with a focus on various clients within the B2B market have a massive role in economic development and growth since not only does the bank benefit from the additional clients and/or loan facilities but also so are the businesses that are then contributing directly to the economy. Economic development as such is a viable target of all types of lending, not limited to commercial and SBA financing, but also including impact investing and private equities, as well as FinTech lenders and their sources of financing. Albeit, Commercial and SBA Lending are still the most valuable for the bank, and that is not only because of their profitability but also for the above-mentioned greater good that making loan facilities facilitates. On one hand, Commercial Loans are all loans that are not real estate (mortgage) originated, nor are they consumer loans. Furthermore, loans will include those that are fully secured or collateralized and those that are not. Some of the loans will be short-term, and some of them will be long-term, and all loans will require extensive documentation checks to include business and personal financial data. On the other hand, SBA loans represent a unique loan structure that is only present in the United States, where the private-public partnership will allow businesses that otherwise would not qualify for the commercial loan to still get access to the needed capital. SBA (Small Business Administration) is a government agency created in 1953 to protect and advocate for small businesses. Being relatively new, especially compared to traditional banking, which has been around for hundreds of years, small business lending has gained skyrocketing importance for the US economy. The private component of the partnership is found in banks that will source and process applications on the SBA's behalf in return for the SBA's guarantee on the loan processed. After the SBA approves the loan that a lender submitted, they promise to guarantee a major portion of the loan, that is, in all cases, above 50% and, in some cases, up to 90% but never 100%. As a byproduct of such a unique structure and public-private partnership, the credit box is more comprehensive and includes many more businesses that will further be a crucial asset in the contribution towards the greater good (promotion of economic development and prosperity) as well as profitability for both the agency and the bank facilitating the loan facility and doing a loan. SBA loans will also allow for not fully collateralized loans that are not as popular among commercial loans.

4 COVID-19 PANDEMIC AND THE US BANKING INDUSTRY

The start of 2020 was not great for the world since the COVID-19 pandemic had just begun. In early 2020, a pandemic was also declared in the United States (Bailey et al., 2022), followed by the shutdown of many businesses, including banks, therefore adversely affecting their profitability (Peerbhai & Kunjal, 2024). Customers were still able to use ATMs, but the business has been taken online. Traditionally, to open an account or get approved for a line of credit or credit, an individual would typically go to the local branch of the bank of choice to request such services. However, COVID-19 made it impossible to visit the actual location of the bank, forcing the banks to operate in a strictly digital environment. The digitalization process has, nonetheless, started way before the pandemic, but the pandemic itself made it obligatory for the institutions that did not allow digital processing to do so in the shortest timeframe in order not to lose customers and miss out on opportunities. Prior to the pandemic, there were only a certain number of banks that were operating strictly online, with the majority of the banks heavily relying on their geographical presence as their competitive advantage over their solely online competitors. In that sense, the banking industry was able to create additional value for customers so that they would be able to go to the physical location of the bank, aka the branch, and talk to someone in person. Such an advantage over competing industries, such as FinTech, has created a valuable position for banks and has further made it possible for both to operate in their market segments. However, due to the pandemic, banks were forced to switch their business model and become more like their competition – FinTechs. Processes were not digitalized to the full extent, and all operations were done remotely. From the credit application through the approval process and the loan closing, all steps were not remote, even if they previously were not. Again, some of the more advanced banking models and organizations following them have already had such models in place, making it easier for them to adjust to the newly created challenges caused by the pandemic. Applying the FinTech business model, banks faced a new set of challenges not only related to the digitalization process but also developed a greater sense of the issue that has been skyrocketing among the technology competitors, which is financial fraud. Moreover, financial engineering has always been present in the banking industry, and fraud was not an ambiguous term in the industry. Regardless of that, the traditional business model of banks, including the request of hard copies as well as wet signatures and other means of fraud prevention, was keeping the fraud levels under control for the banks. However, going digital created more opportunities for fraud in the banking industry and has caused banks to have to develop a new set of defense mechanisms against fraud that is now not only present in the traditional business environment, but now financial fraud is actually being used as an instrument of the digital economy as well.

4.1. PAYCHECK PROTECTION PROGRAM

During the shutdown, which varied in time by the state, many businesses were forced to change their business model and move the place of business to the online environment (Atkins et al., 2022). Some industries have not had any issues with the transition because they were in either of the following scenarios: already operating in the digital environment, or they were working towards that, again, thanks to the digitalization process. Nonetheless, industries such as restaurants, both limited and full service, have suffered a major loss because they were not able to translate their business model to the digital environment simply due to the nature of the business activities. There was a blatant increase in the demand for food-delivery services, but due to government restrictions, restaurants were not allowed to serve guests but rather only take to-go orders. Such issues were similar for many other industries that were operating by using a business model similar to that of restaurants, including but not limited to other hospitality-oriented businesses such as hotels and manufacturing and retail-oriented businesses. As a response, the US government issued the CARES Act that created the PPP Program (Kickul et al., 2021). PPP program was designed to be the most straightforward loan program that would use government contractors

Figure 1. Number of loans originated versus the number of loans forgiven.

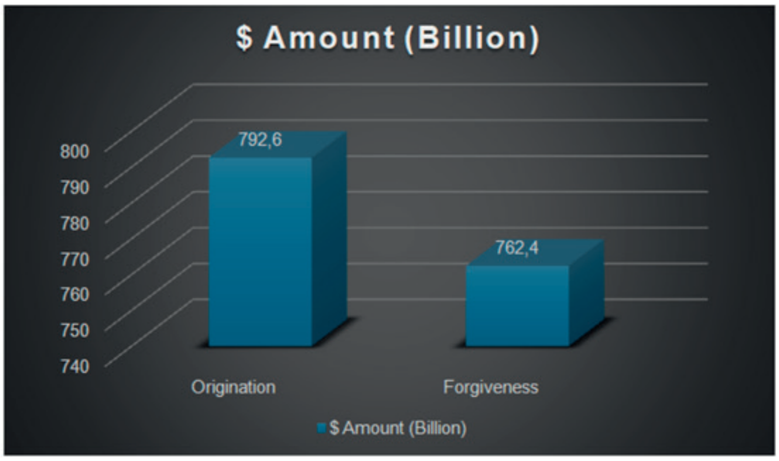
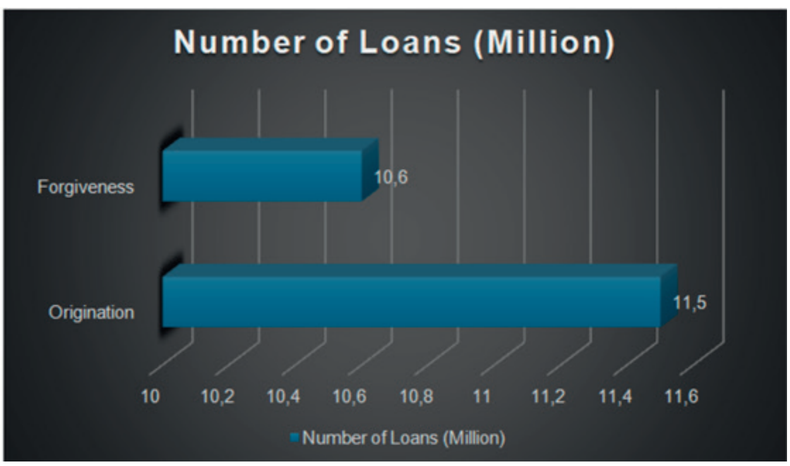


Figure 2. Number of loans originated versus the number of loans forgiven.

Figure 3. Dollar amount of suspected fraud in comparison to the total funds disbursed.



(banks) to source and approve applications on SBA's behalf (Bailey & Sokolowski, 2022), similar to the 7a or 504 programs. The amount to be received was determined by the monthly payroll times two and a half for regular businesses, and the businesses that suffered significant losses during the shutdown that under 72 NACIS code, including restaurants and hotels, qualified for three and half times their monthly payroll for each employee. Cap in terms of the loan amount was $2 million, and applications under $150,000 did not require any documentation, again highlighting the simplicity of the program. Loans that were made in the amount of over $150,000 required the borrower to demonstrate at least a 25% revenue reduction during the pandemic period, as well as to provide financials such as tax returns, financials and bank statements, and payroll statements. Lenders were also encouraged to verify business operations prior to the start of the pandemic, which was collectively marked as February 15th, 2020. Even though the program required SBA's approval (Li & Strahan, 2021), it did not require any collateral, which made it highly unique in the market and the most straightforward. Starting April 3rd of 2020, small businesses and sole proprietors filing under Schedule C were able to apply, followed by the independent contractors and self-employed individuals who were allowed to apply a week later. Since round one was a success, the program was renewed in 2021, starting from January, with fresh funds to be lent in the amount of $284 billion. With the exact requirements and speculations that the program will be renewed for the second round, the 2021 round can also be considered a great success and help small businesses not only to survive the pandemic but also to use the funds to reinvest, pay off any debts and reopen the business after the sanctions have been lifted. PPP loans were initially made to be forgiven if the loan proceeds were used towards eligible expenses, and they were never meant to be paid back or partially forgiven (Fairlie & Fossen, 2022).

5. DISCUSSION

One would notice the correlation between the simplicity of the financing and the level of fraud. Figures 1 and 2 suggest that not all the loans originated are forgiven - $30.2 billion was suggested as the outstanding amount. The primary reason for the loans not being forgiven is the application of the elements of financial fraud when applying for the loan. Consequently, Figure 3 illustrates that $64 billion is suspected of fraud, which represents 8% of the total amount. Even though 8% does not seem to be a high percentage, the dollar amount sounds completely different. Based only on the information currently available and only taking into consideration the loans that were reviewed, these numbers could be higher in the future as more investigations and audits are performed. Lastly, even though the program has provided numerous benefits to small businesses primarily due to the simplicity of the program itself, it has also allowed them a plethora of opportunities for fraud, as suggested in the above figures.

6. CONCLUSION

Even though the fraud level of the PPP program is only 8.8%, $64 billion is not an insignificant amount of money. Taking into consideration that the Office of Inspector General (dealing with financial fraud) cannot have the exact information on the fraud attempt numbers but rather can only report the fraud that was already discovered leaves room for the percentage growth in the suspected fraud. SBA is continuously reviewing all origination and forgiveness applications to try to identify any more fraudulent applications. Anyhow, the simplicity of the applications, scarcity of financial requirements, and lack of collateral for the loans have contributed to the fraud rate. On one hand, the government, as well as private institutions, such as banks, want to help small businesses grow and thrive, but on the other hand, with all that is currently offered to small businesses, there is a high chance of forging documents/applications in order to show numbers that are not realistic or even to create an entire set of false information to gain financial benefits, on the other hand. Lack of measures to check the information provided by small business applicants results in fraud, as the Paycheck Protection Program illustrated in mid-2020 and early 2021. Banks are also in a competitive market where they are no longer the only players in the lending business; therefore, private equities, investment funds as well as FinTechs are all targeting the same market segment, so the timing, as well as the complexity of the application process in addition to the requirements might result in one institution winning over the borrower and closing a loan. Although, banks are forced to have competitive incentives such as not requiring additional financial information that the competitors might not require or doing an unsecured loan where the risk to the bank is greater. Meanwhile, due to the complexity of the process and the timing issues, some of the small business applicants will use the opportunity to provide incomplete or false data that the lending institution might not be able to catch. As a byproduct, simple loan applications are still in the works and will need further development to ensure compliance and protect against fraud. The government is continuously working on reviewing past programs and how they affected the economy since, on one side, a plethora of small businesses were helped during the crisis period, by providing funds from the Paycheck Protection

Program, but on the other side there is ultimately at least $64 billion in fraudulently disbursed funds that could have been used where they were needed. Ultimately, as much as the opportunity to invest in small businesses in the US is significant not only for the contemporary economy but also for society, there is also a colossal threat of fraud and misuse of the funds.

7. LITERATURE

Atkins, R., Cook, L., & Seamans, R. (2022). Discrimination in lending? evidence from the paycheck protection program. Small Business Economics, 58(2), 843-865. doi: https://doi.org/10.1007/s11187-021-00533-1

Bailey, C., Brody, R., & Sokolowski, M. (2022). Fraudulent loans and the united states paycheck protection program. Journal of Financial Crime, 29(2), 519-532. doi: https://doi.org/10.1108/JFC-07-2021-0165

Bailey, C., & Sokolowski, M. (2022). Lender financial reporting incentives and loan prioritization during the paycheck protection program. Managerial Finance, 48(12), 1707-1725. doi: https://doi.org/10.1108/MF-11-2021-0530

Chauhan, S., Akhtar, A., & Gupta, A. (2022). Customer experience in digital banking: A review and future research directions. International Journal of Quality and Service Sciences, 14(2), 311-348. doi: https://doi.org/10.1108/IJQSS-02-2021-0027

Fairlie, R., & Fossen, F. M. (2022). Did the paycheck protection program and economic injury disaster loan program get disbursed to minority communities in the early stages of COVID-19? Small Business Economics, 58(2), 829-842. doi: https://doi.org/10.1007/s11187-021-00501-9

Garekwe, L., Ferreira-Schenk, S., & Dickason-Koekemoer, Z. (2024). Modelling factors influencing bank customers' readiness for artificial intelligent banking products. International Journal of Economics and Financial Issues, 14(1), 73-84. doi: https://doi.org/10.32479/ijefi.15238

Inascu, A. E., & Barbu, C. A. (2023). Digital Transformation in the Banking Sector: A pre-and Post-Covid-19 Analysis. Management Research and Practice, 15(3), 55-69. https://prx-herzing.lirn.net/login?url=https://www.proquest.com/scholarly-journals/digital-transformation-banking-sector-pre-post/docview/2866494408/se-2

Kickul, J., Griffiths, M. D., Robb, C. C., & Gundry, L. (2021). All for one? the paycheck protection program distribution disparity. [Paycheck Protection Program] Journal of Entrepreneurship and Public Policy, 10(3), 323-335. doi: https://doi.org/10.1108/JEPP-03-2021-0027

Korneev, V., Dziubliuk, O., Tymkiv, A., Antkiv, V., & Kucherenko, N. (2023). Banking Sector Stability and Economic Development: Assessment of Risks and Efficiency. Economic Affairs, 68(3), 1683-1692. doi: https://doi.org/10.46852/0424-2513.3.2023.33

Levy, S. (2022). Brand bank attachment to loyalty in digital banking services: Mediated by psychological engagement with service platforms and moderated by platform types. The International Journal of Bank Marketing, 40(4), 679-700. doi: https://doi.org/10.1108/IJBM-08-2021-0383

Li, L., & Strahan, P. E. (2021). Who supplies PPP loans (and does it matter)? banks, relationships, and the COVID crisis. Journal of Financial and Quantitative Analysis, 56(7), 2411-2438. doi: https://doi.org/10.1017/S0022109021000405

Mangala, D., & Soni, L. (2023). A systematic literature review on frauds in banking sector. Journal of Financial Crime, 30(1), 285-301. doi: https://doi.org/10.1108/JFC-12-2021-0263

Nebozhenko, T., Rassadnykova, S., Lvova, I., Palii, S., & Marushchak, S. (2023). Economic development of countries and formation of international business relations under the influence of globalization. Economic Affairs, 68(3), 1577-1588. doi: https://doi.org/10.46852/0424-2513.3.2023.24

Nóra, J. G., & Bíró-Szigeti, S. (2023). Examination of the brand archetypes of the hungarian retail banking sector and their correlations with consumer preferences regarding banking products. Periodica Polytechnica. Social and Management Sciences, 31(2), 120-134. doi: https://doi.org/10.3311/PPso.19926

Paycheck Protection Program (PPP). (n.d.). Pandemic Oversite. https://www.pandemicoversight.gov/data-interactive-tools/interactive-dashboards/paycheck-protection-program#:~:text=As%20of%20October%203%2C%202023,reported%20retaining%2089.6M%20jobs

Peerbhai, F., & Kunjal, D. (2024). The Impact of COVID-19 on Banking Sector Returns, Profitability, and Liquidity in South Africa. International Journal of Economics and Financial Issues, 14(2), 146-151. doi: https://doi.org/10.32479/ijefi.14950

Perić, M., & Barjaktarović, L. (2023) Korporativno upravljanje i upravljanje korporativnim promenama kroz transformaciju banaka u Republici Srbiji. Univerzitet Singidunum

Radojević, T. (2022). Međunarodna ekonomija. Univerzitet Singidunum

Singh, K., Goundar, S., Chandran, P., Agrawal, A. K., Singh, N., & Kolar, P. (2023). Digital banking through the uncertain COVID period: A panel data study. Journal of Risk and Financial Management, 16(5), 260. doi: https://doi.org/10.3390/jrfm16050260

Tabash, M. I., Elsantil, Y., Hamadi, A., & Drachal, K. (2024). Globalization and income inequality in developing economies: A comprehensive analysis. Economies, 12(1), 23. doi: https://doi.org/10.3390/economies12010023

Van Zeeland, I., & Pierson, J. (2024). Changing the whole game: effects of the COVID-19 pandemic's accelerated digitalization on European bank staff's data protection capabilities. Financial Innovation, 10(1), 29. doi: https://doi.org/10.1186/s40854-023-00533-y