104

SMALL BUSINESS ADMINISTRATION'S DISASTER LOAN PROGRAM

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT PROGRAMS

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, MAY 25, 1995

Printed for the use of the Committee on Small Business

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SMALL BUSINESS ADMINISTRATION'S DISASTER LOAN PROGRAM

THURSDAY, MAY 25, 1995

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT PROGRAMS,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:05 p.m., in room 2359–A, Rayburn House Office Building, Hon. Peter G. Torkildsen (chairman of the subcommittee) presiding.

Chairman TORKILDSEN. The subcommittee will come to order.

It is my pleasure as chairman of the Small Business Committee, Subcommittee on Government Programs, to welcome our guests today. This hearing is one in a series of hearings, reviewing the Small Business Administration Programs. It is timely and appropriate that we are looking at this program today, in light of the recent disasters occurring across our country.

As we look toward the future of small business, we must consider those programs that are support in a time of need. The purpose of this hearing is to examine the workings of the disaster assistance loan program and how it aides small businesses as well as individuals after disaster.

In the wake of hurricanes, floods, earthquakes, tornadoes, and other disasters, the SBA can play a major role. Disaster loans are the primary form of Federal assistance for nonagricultural and private sector disaster losses. The program is the only form of SBA assistance not limited to small business. These loans help homeowners, renters, businesses of all sizes and nonprofit organizations to rebuild. They are a critical source of economic stimulation for ravaged communities.

The SBA provides this much needed assistance in the form of loans, thus reducing the Federal disaster costs compared to other forms of assistance, such as grants. All loans are repaid to the Treasury Department and are available at low interest rates for extended terms.

By all accounts, this program has been a success over the years. After the Northridge earthquake, 125,000 loans were approved for over $4.1 billion in fiscal year 1994. In the aftermath of the Midwest floods, the LA riots, and Hurricanes Andrew and Iniki, the SBA approved another 58,644 disaster loans for $1.67 billion during fiscal year 1993.

It is important to note that since the inception of this program in 1953, the SBA has approved over 1,274,000 disaster loans for over $22.4 billion. In light of the recent Oklahoma bombing and flooding in Missouri and Louisiana, I am sure the SBA is working diligently to approve a number of new loans to victims in these areas.

Despite this success the program must be examined and several critical questions asked. Two of the most important are: How can we continue the growth of this program with the ever-shrinking dollars and the need to balance the Federal budget? More specifically, what figures are available regarding default and repayment rates on these loans?

We have a slight change in the program today from our witness list. Bernie Kulik, who is the assistant administrator, had wanted to be here, but in doing what was well beyond the call of duty in his job, he encountered his own disaster yesterday. He is on the mend, and we all wish him a speedy recovery.

Very fortunately, Jim Hammersley and James Rivera are here to speak in his place. We appreciate their testimony. Mr. Hammersley is the acting deputy associate administrator for the Office of Disaster Assistance at the SBA, and Mr. Rivera is senior loan officer for the Small Business Administration.

Our second witness is Mr. Bud Iannazzo. Mr. Iannazzo is the administrative program manager of the Massachusetts Emergency Management Agency. He will be discussing his agency and how it interfaces with FEMA and the SBA in a disaster situation. We appreciate your travelling all the way from Massachusetts to be with us today, Bud.

Our final witness is Karen Lee. Ms. Lee is the Deputy Inspector General for the SBA. She will be discussing reports of fraudulent activity within the program and the administration's effort to prevent this. I would like to start off with Mr. Hammersley, if you would care to summarize your testimony.

Each witness has been scheduled for up to 10 minutes of time. You will not offend us in the least if you use less than your 10-minute allocation. Summaries are appreciated. Your written statement will be printed in the record in its entirety. I would now like to call on Mr. Hammersley for his testimony.

[Chairman Torkildsen's statement may be found in the appendix.]

TESTIMONY OF JIM HAMMERSLEY, ACTING DEPUTY ASSOCIATE ADMINISTRATOR, OFFICE OF DISASTER ASSISTANCE, U.S. SMALL BUSINESS ADMINISTRATION; ACCOMPANIED BY JAMES RIVERA, SENIOR LOAN OFFICER, U.S. SMALL BUSINESS ADMINISTRATION

Mr. HAMMERSLEY. Thank you, Mr. Chairman. I am James W. Hammersley, the Acting Deputy Associate Administrator for Disaster Assistance at the Small Business Administration. With me is James Rivera, Senior Loan Officer associated with the Disaster Program. We are here at the request of Mr. Bernard Kulick, who as you said, encountered his own disaster yesterday and was unable to be here today.

I would like to just read a brief summary of my remarks and then have them entered into the record, if that is appropriate.

Again, I want to thank you for providing the opportunity to discuss the Disaster Assistance Program, a program that Administrator Lader refers to as "The SBA Nobody Knows." Although this is a little known function of the Agency, it is one of our major efforts and plays a role, a key role, in all 50 States in helping victims of natural disasters recover from the devastation and put the pieces of their lives back together.

SBA does not provide immediate emergency relief. The Agency is involved in a long-term recovery effort. SBA disaster loans are the primary form of Federal assistance for nonfarm, private sector disaster losses. SBA can provide long-term low-interest loans to cover those losses not covered by insurance.

The Disaster Loan Program, as you said, is not limited to small businesses but helps homeowners, renters, and businesses of all sizes. SBA's disaster loans are often the lifeline in disaster-ravaged communities, helping to spur employment and stabilize the tax base.

SBA's Disaster Loan Program helps reduce Federal disaster costs compared to grants. When disaster victims need to borrow money to repair damage, SBA loans are tailored to each borrowers ability to repay. Moreover, providing disaster assistance in the form of loans rather than grants avoids creating an incentive for property owners to underinsure against risk.

As a condition of collateralization, disaster loan agreements require borrowers to maintain appropriate hazard and flood insurance, thereby reducing the need for future disaster assistance.

The Disaster Program is SBA's largest direct loan program and is available to all entities except governmental units and agricultural enterprises. There are two basic types of disaster loans: A physical disaster loan is a primary source of funding for permanent rebuilding and replacement of damaged property. An economic injury disaster loan helps provide necessary working capital to businesses until they can resume normal operations. Economic injury loans are limited just to small businesses with no credit available elsewhere.

SBA disaster assistance is not a giveaway; the loans must be repaid. The Agency will only approve loans to applicants having a reasonable ability to repay the loans.

A number of safeguards are built into the program to avoid fraud. Prior to making a loan, the SBA verifies the applicant's income with IRS filings. SBA employees independently verify disaster damages and repair costs, and SBA collects social security numbers and examines credit reports for all applicants. As a processing safeguard, SBA uses the "rule of two," which requires that each loan must be approved by, first, a processing loan officer and, second, a supervisory loan officer.

In addition, the Agency takes whatever collateral is available for a loan, preferably real estate, and the loan proceeds are dispersed serially as the funds are needed by the disaster victim.

The law gives SBA several powerful tools to make disaster loans affordable including low interest rates, long-terms, and the refinancing of prior debt. Currently, the interest rate cap for a borrower without credit elsewhere available is 4 percent, and the cap is 8 percent for a borrower who has credit available elsewhere. Over 90 percent of SBA's disaster loans are made to borrowers without credit available elsewhere.

You have summarized in your opening remarks the recent disaster activity, so I will pass over that and tell you a little bit about the Disaster Loan Program and how it is staffed.

Because of the unforeseeable peaks and valleys in its activities, SBA's disaster loan-making function is a separate unit in the Agency that is responsible only for making disaster loans. There is a small headquarters staff and four area offices. There are only eight full-time, permanent employees.

The mainstay of the program is a group of employees known as the disaster cadre who are permanent employees but are only guaranteed 6 months of work each year. This group is made up of loan officers, loss verifiers, attorneys, and other support staff. They have the expertise to do the job in smaller disasters, and they can do the training and supervising when the disaster staff has to be expanded.

This permits almost instant expansion of the staff using temporary employees. In fact, in the past 5 years the number of temporary employees has ranged from a low of 280 to a high of 3,300.

In all major disasters declared by the President, FEMA is the lead agency responsible together with the State for coordination of Federal efforts for both emergency needs and for recovery. The working relationship between SBA and FEMA is excellent, due in major part to the efforts of the current FEMA Director, James Lee Witt. The SBA is a member of the Federal Disaster Response Team and cooperates at all stages of a disaster. When a declaration is requested, SBA participates in the joint Federal/State preliminary damage assessment made to determine the severity and extent of the damage.

When a disaster is declared, FEMA activates its teleregistration hotline, located in Denton, Texas, and Berryville, Virginia. The SBA has staff at each center to answer questions concerning the loan program and to help advise registrants. At a disaster site, SBA will co-locate with FEMA in a Disaster Field Office and any other on-site locations.

Given rising Federal costs, resulting from the tremendous level of disasters experienced over the past few years, the administration plans to work with the Congress to reform the way the Federal Government plans for and responds to disasters.

Accordingly, the Agency is proposing to reduce the subsidy rate for disaster loans in 1996 from its current level of 32 percent down to 8.5 percent. This reduction would permit SBA to make $407 million in disaster loans, with the requested subsidy authority of $34 million, as opposed to only $110 million of loans if the current subsidy rate is used.

In addition, the Agency has made many changes to simplify the program and make it more user-friendly. Among the changes are: One, we have simplified home loan filing requirements. The SBA now requires certain information only after the loan is approved. We have simplified the filing process and the requirements for disaster business loans by cutting the application form in half.

Two, we have increased the disaster loan limits from $100,000 to $200,000 for real estate damage and from $20,000 to $40,000 for personal property damage.

And three, we are also grateful to the Internal Revenue Service for their invaluable assistance in helping us simplify the task of completing loan applications. Instead of asking our victims to locate copies of the tax returns to supply to SBA, victims are now authorizing the IRS to provide information directly to us. The IRS has been extremely cooperative in providing rapid turnaround to our requests so that we can expedite processing.

As a result of the efforts of Reinventing Government, we are exploring some exciting possibilities. Specifically, we are reviewing the possibility of having just one verification of the damage for a disaster victim and just one application form. The information on that form would be supplied to all agencies.

In summary, we are proud of the work done by "The SBA that Nobody Knows." We believe our efforts over the past few years have demonstrated our ability to deliver services in the face of many and diverse needs of our customers. The Agency has shown its ability to adapt to unanticipated situations, and we have demonstrated the flexibility needed to keep this program responsive to changing circumstances.

I thank you, Mr. Chairman. I will be happy to answer any questions you have.

Chairman TORKILDSEN. Thank you, Mr. Hammersley. We will wait until all witnesses have testified for questions.

Does Mr. Rivera have any prepared statement?

Mr. RIVERA. No, not at this time.

Chairman TORKILDSEN. In that case, I will ask Bud Iannazzo, from Massachusetts, to please proceed with his prepared statement.

[Mr. Kulick's statement may be found in the appendix.]

TESTIMONY OF QUIRINO "BUD" IANNAZZO, ADMINISTRATIVE PROGRAM MANAGER, MASSACHUSETTS EMERGENCY MANAGEMENT POLICY

Mr. IANNAZZO. Thank you, Mr. Chairman, for the invitation to testify before the subcommittee in support of the Small Business Administration. I would officially like to send my regrets that director Rodham, from the Massachusetts Emergency Management Agency, was not able to be here today. He sends his regrets.

As Administrative Program Manager for the Massachusetts Emergency Management Agency, I welcome this opportunity to address the subcommittee and to offer recommendations and other data concerning the SBA and its loan programs.

Since 1991, the Massachusetts Emergency Management Agency has developed a strong working relationship with the Small Business Administration. Working as partners, the interaction has produced some very real results for the citizens of the Commonwealth of Massachusetts.

The results, I believe, prove the effectiveness of your investment in the Small Business Administration. Let me cite some examples of how effective one SBA Program, physical disaster loans, is. In November 1991, the "no-name hurricane" raked the Massachusetts shoreline with high winds and rough seas, causing extensive damage to our fishing fleet.

In total, more than 2,400 applicants were received in its wake. Of those, more than 200 were from the fishing boat owners and lobstermen whose craft and equipment, specifically lobster pots, were damaged by the storm.

The SBA was able to assist with the loans these fishermen needed to keep their livelihoods. Please note that these were not handouts or bailouts, they were loans made to the fishermen so they could remain economically viable.

The result of this investment in the fisherman was that our fishing and lobster industry remained economically viable. They were able to remain contributors like so many other small business people who form the backbone of this great Nation's economy.

There is more to this, though. Like other small business people, the fishing boats usually had several people aboard, the captain and crew members. Thanks to the SBA loan programs all of these folks were able to remain responsible contributing citizens as well.

Loans resulting from major disasters are not the only assistance the SBA has provided to the Commonwealth. Through its Economic Injury Disaster Loans for Small Businesses Program, SBA, has been able to help businesses where the situation is limited in scope, perhaps to a single building or facility housing many businesses.

If five or more businesses experience 40 percent losses in business, then the program applies and owners can receive assistance in rebuilding. For Massachusetts this program has meant that many businesses in Palmer and Peabody remain viable. It is a key link in our economic chain in that it helps business people and their employees to help themselves.

In seeking this funding, MEMA was proactive. As soon as the local disasters occurred, we sought to assist the owners in their rebuilding. MEMA built the bridge to the SBA that helped local business owners receive aid.

I believe that bridge MEMA provided indicates the extent of our partnership with the SBA's Regional Office in Boston and the Disaster Area I Office in Niagara Falls, New York. The SBA has developed a capable professional staff in the Regional Office that is a real credit.

The field staff is also a credit to the SBA. On-scene, staff members listen patiently to each request and find the best possible solution. Sometimes a loan is not the best option, and SBA staff will refer victims to the Federal Emergency Management Agency, FEMA.

FEMA has a series of assistance grants for those who do not qualify for SBA help or the referral may be to one of the many volunteer organizations represented by VOAD, Voluntary Organizations Active in Disasters.

Since 1991, there have been more than 3,356 applications for loans under the Small Business Loans Program in Massachusetts. The applications followed 14 SBA Disaster Declarations from coastal storms to hurricanes and numerous fires.

Storms were not the only problems that business people faced. They also had to contend with local disasters such as fire. In each case the SBA was there to help out. Rather than leaving empty, burned out store fronts and businesses in the Western Massachusetts town of Palmer or in the coastal city of Peabody, or having fishermen and lobstermen sitting idle in port, the SBA loans ensured that businesses impacted by storms and fires were able to rebuild. The Small Business Loan Program has approved more than $50 million in loans to the hardworking business people of Massachusetts.

I would like to ask you to think about this for a moment. Without that $50 million in loans—and remember that loans are repayable—the affected businesses would likely not have been able to rebuild and, as a result, their contributions to the State's economy would have been lost.

Taking this a step further, if those businesses and equipment had not been rebuilt and replaced, then it is quite likely that hundreds of citizens would have had to turn to the Government for other assistance. This would have increased costs in several Federal Programs at a time when we could have ill-afforded those increased costs. The resulting costs would have been far more of an investment than has been made by the SBA.

Small business owners are central to the economic foundation of any State. I remember talking with a professor in a business class more than a few years ago. I do not remember exactly the contents of the conversation, but I do remember the theme, which was that small businesses are the country's engine of growth. It was just that simple. Businesses with 50 or fewer employees provide the backbone of our country's economy.

The SBA's Loan Programs are powerful economic tools that use low-cost interest loans to provide funds that businesses need to rebuild and remain productive, employing the thousands of hardworking people who are the bedrock of the community. These are the people who are often ignored in the media, but who go about their private lives—Is that my timeframe?

Chairman TORKILDSEN. Your timeframe is the green light in front of you. That is the House of Representatives, which appears to be adjourning.

Mr. IANNAZZO. Sorry for the interruption. Do I get this time back?

This is the type of investment in our country that our Founding Fathers valued. It has a lasting value that cannot diminish in time. However, as with every program, there are some areas that we could see some improvement. Specifically, I would like to see more flexibility in the thresholds SBA uses to determine the loan program when it begins.

As it stands now, the Disaster Loan Program begins when it has been determined that 25 businesses have sustained the damage that will cause a 40 percent loss of income, uninsured income that is. It seems to us that a 20-business number would provide greater flexibility in the program.

Another area where we would like to see improvement is the turnaround time from Washington. Normally, the Regional Field Office in Boston to which our applications are sent will act in a speedy manner. Also, within a day or less of a disaster declaration, field personnel from Disaster Area I Field Office in Niagara are on the scene and "open for business." They also handle our requests and applications just as speedily.

The slowdown occurs in Washington where things can markedly slow down. A matter that should take just a few days can take weeks or longer to move from Washington to Boston to MEMA, even though it is expedited at the start. We would ask that some guidelines be instituted as to an acceptable timeframe for application review, so that those who suffer losses can become productive as quickly as possible.

The Small Business Administration-MEMA partnership is one that works. It works for businesses; it works for people; and it works for the State and the Nation. SBA's Disaster Loan Program helps people and businesses help themselves. It is not a bailout program. It is a profit-maker in more ways than one. We fully support the SBA Program and would ask the honorable members of this subcommittee to continue their support.

Thank you, Mr. Chairman, for the opportunity to testify in support of the Small Business Administration. MEMA urges continuing support of this important program. I am available for any questions.

Chairman TORKILDSEN. Thank you, Mr. Iannazzo.

Now we would like to hear from Ms. Lee for her testimony.

[Mr. Iannazzo's statement may be found in the appendix.]

TESTIMONY OF KAREN LEE, DEPUTY INSPECTOR GENERAL, U.S. SMALL BUSINESS ADMINISTRATION

Ms. LEE. Thank you, Mr. Chairman. I am Karen Lee, the Deputy Inspector General of the Small Business Administration. I am a relative newcomer to the SBA. Because the Inspector General is on personal leave, he asked me to represent the Office of Inspector General today.

Chairman TORKILDSEN. Yes, Ms. Lee, if I could ask, could you bring the microphone toward you?

Ms. LEE. Certainly.

Chairman TORKILDSEN. Yes. Thank you.

Ms. LEE. To my left is Tim Cross, who heads our Inspection and Evaluation Division; next to him is Steve Marica of our Investigations Division; Pete McClintock of our Auditing Division; behind them is Phyllis Fong, who is the head of our Management and Legal Counsel Division. With us also is the newly appointed head of our Atlanta office, Jim Hudson. He is the one who is going to be overseeing our audit work in the Southeast.

Chairman TORKILDSEN. Thank you for explaining the large attendance we have at the hearing today.

Ms. LEE. I would like to highlight some of the things in the prepared statement and then answer any questions that you might have. In fiscal year 1994, we received supplemental funding from the Congress of $2.5 million targeted at disaster fraud. We received an additional $500,000 out of the President's "Unanticipated Needs Account." In response, we prepared a management plan on the use of those funds which is attached to our formal statement.

I will mention some of the things we are doing under that plan as I speak to the various work we have underway. We have seen a significant increase in fraud referrals out of the Disaster Assistance Program. I think this is only natural, given the substantial increase in the loan activity over the past 5 years with all of the major disasters that have occurred.

Prior to 1989 we were using about 5 percent of our investigative resources on Disaster Program fraud; we are now up to about 22 percent, and we do not see any decline in that in the near future.

Since 1990, we have initiated 148 criminal investigations involving 533 subjects and approximately $64 million in potential losses. To date, the testimony says 76 individuals have been indicted. We had 3 more this morning, so the number is up to 79. We have recovered about $5.3 million as a result of those indictments and prosecutions. Our current inventory is 65 active cases, 414 subjects, and $45 million in potential losses.

The two major things I would like to highlight here is the loan packager and false tax return problems. We think we have the false tax return problem under control because we are requiring individuals to sign a waiver form which allows us to go to the IRS and verify the tax for other financial information they submit to SBA. Consequently, have seen a significant decline in the number of referrals involving false tax returns.

Another problem which we have found involves "loan packagers," people who prepare loan applications for a fee. These packagers have become very adept at putting together fictitious financial statements, tax returns, and other false documents. We have had, as a result, some improper loan approvals and disbursement of funds.

As an example, in Los Angeles we recently had indictments of two brothers, who specialized in packaging disaster loans, and 17 of their clients. One brother is awaiting trial and one is a fugitive. Seventeen of the clients have all pled guilty. We have about another 130 applications that we are still reviewing from this particular investigation.

There is currently no Federal registration of loan packagers. The SBA Administrator has appointed a fraud prevention task force which is looking at that problem. We are hoping that by the end of September we will have some concrete recommendations to the administrator as to what we might do to minimize it.

Among the other things we are doing, we have designed and put on for the Disaster Assistance Program a specialized training program to help them better identify the red flags—fraud indicators—in loan applications. This training has been strongly supported by the Disaster Assistance Program management. We believe it has been successful, for 61 percent of our referrals come from disaster assistance employees.

We have also tried to get publicity for what we are doing in an effort to deter people, to let folks know that we are out there and if they file false information with the SBA, we are going to find them and prosecute.

We have a fraud poster with our 800 hotline number for referrals. We think this has been fairly successful, because about 17 percent of our cases have been initiated as the result of referrals on that hot line. We also have had excellent cooperation from the Disaster Program managers and employees. They do a marvelous job in helping us out.

As an example, in San Francisco, they have established a special section that is responsible for evaluating and preparing case referrals through our LA office. In the past 2 years, this group has referred over 100 cases, and we have indicted 25 individuals so far.

Under our disaster plan, we have hired five temporary criminal investigators, two of those are in Atlanta, three are in Los Angeles. We anticipate that they will be kept very busy. As the defaults set in, the fraud referrals tend to increase, and we are anticipating that we are going to keep those folks busy as long as we have money to pay them.

In the auditing area, again as part of our disaster plan, we have placed four people in Los Angeles, two in Atlanta, one in headquarters. In Los Angeles, our auditors have already been busy helping our investigators in producing evidence, databases and so on, to help in the prosecution of cases.

They also did, at the request of our Administrator, a special study to determine whether or not applications filed up to 10 months after the earthquake were really valid, and why people filed so late.

We concluded that, indeed, there were actual damages; people did have some legitimate reasons for why they were filing so late. We were a little concerned, however, that the late filings made it a bit more difficult to ascertain if the damage truly was the result of the earthquake.

In Los Angeles, our auditors now are focusing on loans in default to see if we can find any ways that the default could be prevented. We expect that out of that audit we will have more cases being referred to our Investigation Division. We hope we will also have some recommendations for improvements for the program managers.

In my testimony we have outlined some results of a December 1992 inspection done by our Inspection and Evaluation Division which identifies the extent and types of characteristics of some of the fraud that we have found in the past. There is a lot of statistical data there, and I will not take the time to review it.

Another area in which we made recommendations in the 1992 report was in the improvement of the data systems within the SBA to allow the disaster loan processors to determine whether or not any of the applicants had previously defaulted on other SBA loans. Those data systems are being improved, and there are plans for even more improvement.

With that I will be happy to answer any questions.

Chairman TORKILDSEN. Thank you, Ms. Lee for your testimony.

[Ms. Lee's statement may be found in the appendix.]

Chairman TORKILDSEN. Before I begin my questioning of the witnesses, I would like to defer to my colleagues on the panel.

Congresswoman Kelly, would you have any statement or questions?

Mrs. KELLY. No. None, Mr. Chairman. Thank you.

Chairman TORKILDSEN. Thank you.

Congressman Chrysler?

Mr. CHRYSLER. No, Mr. Chairman.

Chairman TORKILDSEN. For Mr. Hammersley a few questions. In his prepared statement, Mr. Kulick addressed the issue of bringing temporary employees into a disaster area, which you have mentioned. My concern is, has there ever been any study done about the benefits for cost of temporary permanent employees? Do you always send in temporary employees? Is there a permanent staff on board that you would use first, and once they are at their maximum usage then you hire a temporary? Could you just talk about that in a little bit more detail?

Mr. HAMMERSLEY. Yes, Mr. Chairman. There is a "permanent" staff—and I put the word "permanent" that handles small disasters and that we use until we can no longer meet the demand with those people. They are known as our "disaster cadre employees. "

Now, these people are permanent Government employees, but they are only guaranteed 6 months' worth of work in the course of a year. If we do not have enough work for them, then we lay them off. We purposely keep that number low to try and maintain that work force and give them 1 year's worth of employment in a given year, to try to keep their interest in the program and also keep our level of expertise up.

If that number of people, which I believe right now is around 280, is not enough to meet demand, we staff up with temporaries. The Northridge earthquake being the most recent and certainly the biggest example of that, where at one point we had over 3,000 people out there, most of them temporaries.

The "cadre people" are responsible for training these temporary employees and for supervising them. When we do not need all of these people on board, we do not have them; when we need them, we have got the expertise to train them and to monitor them.

Chairman TORKILDSEN. Thank you.

Also, in the testimony there is mention of the SBA's Reinventing Government proposal and mention of focus groups that were held after the Northridge earthquake. There are two issues that I would like you to elaborate on: One was the SBA, and I believe you mentioned this briefly in your testimony, working to have one verification of the damage to a disaster victim rather than several; and, two, the SBA working toward a standardized application that a victim can submit to all agencies. Could you talk about those points in a little more detail?

Mr. HAMMERSLEY. Yes, sir. We have had substantial discussions with FEMA on the idea of one verification, and it looks very promising. We will work with FEMA and decide who should do the verification, and what would be involved. As you know, one of the differences between us and FEMA is we verify for business and for home damage, whereas FEMA tends to focus mainly on home damage. The verification idea has a lot of promise to it, as I said.

The second idea has presented us with a few more complicated challenges. The idea being that the disaster victim would provide information one time, and then that information would be distributed to the agencies that provide assistance.

The challenge that we face here is to try to get enough information for SBA to make a business or home loan decision, whereas some other agencies do not need that level of information. We are just at the beginning stages of looking at a new process. We are hoping that with the use of technology, we can streamline to the maximum extent possible the process of obtaining disaster assistance.

Chairman TORKILDSEN. If I could just bring Mr. Iannazzo in on this. Has there been any desire at the State level to have a standardized form through MEMA, or is it working out reasonably well in its current form, from your experience with the "no-name" storm and other disasters?

Mr. IANNAZZO. The application process has worked out reasonably well for us. We assigned a full-time person to work with SBA and with the individuals who are applying.

Chairman TORKILDSEN. Could you speak into the microphone too.

Mr. IANNAZZO. To repeat, the application process as existing has worked out fine for us. We assigned a full-time person to work with the SBA and to go to the application center to work with the citizens that are coming in and filling out the process. The second part of the application process is where we are working with the business people directly to ascertain their level of damage.

Chairman TORKILDSEN. OK.

Mr. IANNAZZO. It has worked out sufficiently.

Chairman TORKILDSEN. It is good to know on the State level. Certainly, we would be appreciative of being kept apprised of success in trying to standardize or unify the paperwork requirements at the Federal level. Also, the administration's fiscal 1996 budget proposal calls for bringing interest rates charged for these loans more in line with current market rates.

Could you explain a little bit more about the administration's proposal and how they hope to accomplish this, especially with the recent rate hikes that the Federal Reserve has put on loans in the private sector?

Mr. HAMMERSLEY. Yes, Mr. Chairman. As I mentioned in my testimony, the program has gotten very expensive, due to the tremendous level of natural disasters that the country has sustained in the last several years. In a way to try to stretch the resources, we have looked for ways to lower the subsidy rate.

Of the current 32 percent subsidy rate, approximately two-thirds of it is attributable to the interest rate subsidy that is inherent in a 4 percent loan versus what is closer to a market rate loan.

The administration's proposal of Treasury plus two in today's market would provide interest rates, using the 15-year Treasury as an approximate benchmark of 6.7 percent in today's market. This would leave the borrower with a rate of about 8.7 percent.

We have a great deal of flexibility in determining the term of the loan. It is our belief most of the applicants would still qualify for a loan; although the term may, in fact, be a little bit longer than it is with a 4 percent interest rate.

Chairman TORKILDSEN. Thank you.

Then, finally, could you please address the loss/default rate on these loans as they are repaid? Could you provide us with any information in that area?

Mr. HAMMERSLEY. Yes, sir. Since the beginning of the program, the overall loss rate is a little under 11 percent. It is 10.67, if you are looking for an exact number. As I said, that is a historical number.

The currency rate for the program—and we define "currency" as borrowers that are less than 30 days past due—the currency rate has continued to climb over the past several years. In fact, it is now a little over 90 percent. We are pleased with that.

We have extensive collection efforts. We have four servicing centers specifically set up for disaster collection activities. These are automated centers, staffed by people whose sole function is to collect these loans. We are making every effort we can to collect. Again to summarize, the overall loss rate runs about 11 percent.

Chairman TORKILDSEN. Could you provide any breakdown either by fiscal year or calendar year for, say, the last 5 years? Would that be possible?

Mr. HAMMERSLEY. If I could submit that for the record, I would be glad to do that.

Chairman TORKILDSEN. That would be fine. Thank you very much, Mr. Hammersley.

Mr. Iannazzo, just a couple of questions about your testimony. You mentioned the turnaround time for application review from Washington and asked that some guidelines be instituted as to an acceptable timeframe for that review. What do you think your best estimate on a turnaround time is now? What would you think an acceptable timeframe would be, and any suggestions about speeding that process up?

Mr. IANNAZZO. In the last five instances where we have worked due to the local fires in some of the local communities, it appears for some reason it takes pretty close to almost a month, 30 days, for the application process to go through. Now, that is once it gets signed, the declaration request gets signed, by the governor and goes through the process through our offices, and it looks like it is about 30 days.

The problem here is that the local communities are after our office, where do we stand, how fast is that application going to be approved. We are constantly on the phone to expedite this process. If that could be cut in half, that would be a tremendous asset. Fifteen days does not seem unreasonable from our end; but of course in light of some of the information we are hearing here, there are other safeguards that have to be put in place.

Chairman TORKILDSEN. Are you talking calendar days or working days?

Mr. IANNAZZO. Calendar days.

Chairman TORKILDSEN. Calendar days.

Mr. IANNAZZO. Calendar days.

Chairman TORKILDSEN. Before we continue on this line, let us go back to Mr. Hammersley. Is it something you think might be feasible, cutting down that turnaround time, or is that outside of your purview?

Mr. HAMMERSLEY. If I could just get a clarification. Are you talking about the turnaround time for the disaster declaration itself?

Mr. IANNAZZO. Once the application process has been filed.

Mr. HAMMERSLEY. For the turnaround time of a declaration versus for a specific loan?

Chairman TORKILDSEN. Right.

Mr. IANNAZZO. Correct.

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Mr. HAMMERSLEY. We do our best, Mr. Chairman, to try to expedite these things through the process. It is one of those situations where, in some cases, the backlog of work is just a little bit more than others. We will certainly endeavor to try to meet a tougher standard than 30 days.

Chairman TORKILDSEN. Yes, if you could include that with the additional information you are providing, I certainly would certainly appreciate it. I think all of the States would appreciate it if that could be sped up. Obviously, there are certain processes that have to be gone through, but certainly in circumstances States are facing in these disaster declarations, I think any speeding up would be much appreciated.

Mr. Iannazzo, also in your testimony you specifically mention that you would like greater flexibility in the thresholds SBA uses to determine when a loan actually begins. I believe you mentioned a number of 20 for businesses. Could you just mention how you arrived at that number and what type of flexibility would you be looking for?

Mr. IANNAZZO. It was a number that we arrived at on our State level. We seemed to get frozen at the 22, 23, or 24 level to find that 25th applicant. Again, it is conducive to the type of industry that has been damaged and the records that have to be secured like IRS records, et cetera.

Specifically, in the problem we have in the fishing industry, we had 200 applications that were approved, but it was a significantly tough road to get to that 25 threshold number. But once we were able to secure that 25 number, then the other 200 applicants were able to come in.

It seemed like that we were stuck at the 22 or 23 figure, and there was a tremendous amount, again, of work on the State's behalf to continue the process of going through all the applications to get to the 25 threshold.

Chairman TORKILDSEN. I understand.

Mr. IANNAZZO. We were just looking at greater flexibility at the number 20.

Chairman TORKILDSEN. In that area, Mr. Hammersley, any comment? Anything that you think might be changeable here to address those concerns?

Mr. HAMMERSLEY. Mr. Chairman, I understand that the 25 threshold is in the law.

Chairman TORKILDSEN. It is in the statute.

Mr. HAMMERSLEY. It is in the statute. Whatever is in the statute is what we will use.

Chairman TORKILDSEN. That perhaps is something for us to look at, then, further.

Ms. Lee, I much appreciated your testimony and the detail you provided. You submitted extensive testimony on the problem with loan packagers and the inability to track them. It is an unfortunate problem as it makes the public vulnerable to the abuses of certain—and granted these are only a few, but certain individuals.

This is of special interest to me, as I may revisit this issue in a future hearing. You stated that those that have been prosecuted were done so at the State level, because there are no Federal regulations, no certification process, no licensing requirements, or even an ethical code in place that applied to these individuals.

I understand that the individual area offices keep a running list, but is there no way to set up a system that would give access to a master nationwide list of fraudulent loan packagers? Is there anything at all that you could see so people would not have to worry that someone who was convicted of fraud in one State had not fled to another State and set up their own shop there?

Ms. LEE. That is one of the things that we are looking at as part of this loan fraud prevention task force; that is to see if there a way that we can develop a process of registering in some way individuals who are helping applicants put together their loan application.

In many instances, we have a lot of very honest people out there helping applicants. For somebody who's just experienced a natural disaster and is not familiar with all of the Government forms and the range of information that needs to be provided, and who has lost many of their records, they look frequently to get such personal help.

While we do not want to deny anyone the assistance, but we want to figure out a way of protecting them from the unscrupulous folks out there. We are looking at the feasibility of requiring anyone who wishes to work as a loan packager for SBA loans to go through some kind of registration process.

If we could do that, we could identify a roster which would be available in all of our SBA offices and all of our disaster sites, so that if an applicant wanted and needed help, they could perhaps contact the SBA office and say, "Hey, I need some help. Who can help me?" Or, "I have talked to this individual who says that he can help me. Is this person registered?"

It is possible, for example, that if we set up some kind of a registration process that a particular individual could have a certificate from the SBA which would identify them as being somebody who had gone through this registration process with us.

We have seen instances where these packagers have charged the applicants as much as 40 percent of the loan as part of their fee. That is another area under study. Is it reasonable, is it possible, should we think about establishing some kind of maximum fee structure, a percentage of the loan, a specified dollar amount? Is that a reasonable thing to do?

There is a whole range of things that we are exploring. On the one hand, we are trying to minimize additional Government regulation; however, we are also trying to figure out a way of protecting the public and the Government from people who are not entirely honest in the way they go about doing business.

As I mentioned, we hope to have specific recommendations. Our Administrator just this morning in an operations meeting, encouraged all of the staff to come up with any ideas they might have to develop solid recommendations to do something about this packager problems.

Chairman TORKILDSEN. Very good.

Ms. LEE. Coincidentally, I suspect that other Federal agencies who also have loan programs may experience some of the same problems that we do. If we can establish, perhaps, a pilot program to provide for some kind of registration or certification, then it is possible that our efforts may have applicability elsewhere in the Government.

Chairman TORKILDSEN. Do you have any numbers on what percentage of loans approved by the SBA for disaster loans are actually through packagers?

Ms. LEE. Packagers? I do not.

Steve, do you have any?

Steve Marica, who heads our Investigation Division.

Chairman TORKILDSEN. Please use the microphone.

Mr. MARICA. Thank you, Mr. Chairman. We did some studies on the packager problem last year when we had an initial meeting of the Loan Packager subcommittee of the fraud prevention task force. In both the disaster loans and the business loans, the consensus was that they are on the rise. Figures, that were not verified, suggest that probably over 50 percent of the loans in both programs are being prepared with the help of packagers.

Chairman TORKILDSEN. Thank you.

Ms. Lee, you mentioned that seven auditors were dedicated to analyze the potential problem areas in the Disaster Assistance Program—four were in LA, two in Atlanta, and one at headquarters. It is my understanding that the Atlanta survey has just begun. Do you have any feedback from the other five auditors at this time?

Ms. LEE. Yes. We are starting in Los Angeles, which is where we have done the most work. We have looked, so far, at about 40 loans in default. One of the problems we are encountering in some instances is locating the borrower. We have to track down the borrower.

We are working with California State officials to see what assistance they may provide to us. It is a little early yet to had hard results. The only comparison that I might make is to possible results out of our business loan audit. We are doing an audit in the 7(a) area, which may give us some insight as to what we might find in the disaster area.

In the 7(a) area, we are currently looking at 17 loans that went into default within 24 months after approval of the loan. Out of those 17, 9 have been referred to our Investigations Division as involving possible false financial statements, other kinds of false statements, or unapproved use of loan funds.

I am not sure whether or not that kind of finding is going to carry over into the disaster area. We will have a much better feel for that within the next several months as we get farther along on the audits that we are doing on defaulted loans in California.

Chairman TORKILDSEN. The subcommittee would appreciate being kept apprised of both your work on disaster as well as the 7(a) investigations.

Ms. LEE. We will certainly do that.

Chairman TORKILDSEN. You also made two very important recommendations that I would like to ask you to elaborate on as well: One, a training program focusing on fraud prevention; and, two, the need for a system that would require uniform information on all loan borrowers at the time loans are originated in order to detect previous borrower defaults. Could you expand on both of those points?

Ms. LEE. Yes. In 1992, when our Inspection and Evaluation Division did an inspection of some of the cases that we were then working, they looked at the kinds of fraud we were finding and identified a number of instances in which there was a red flag in the loan application if the individuals processing the loan application knew what to look for.

That is really the genesis of the training program that our Investigations Division put together, so that we can step through the process with the Disaster Assistance Program employees. We need to educate them as to what to look for in the financial statements and other application documents.

We also need to point out what to look for in terms of comparing, if they get a tax return, with other kinds of financial statements or net worth statements—"Do things look consistent? Do they look reasonable?"—other kinds of red flags.

So far, this program has been very worthwhile. In fact, we plan to expand it into the other loan programs offered by the SBA. We are also looking to expand it beyond employees to lenders. We believe it is important that people know what to look for, and we clearly have found that it has worked because of the number of referrals that we are getting.

In the other area, one of the things that we found in 1992, and there has been a lot of improvement since 1992, is that when a loan application is submitted to the SBA, there is a need to determine whether or not the particular applicant has defaulted on another SBA loan.

One would hope that you would have a computer database that you could query with perhaps the name of the company; the name of the principals in the company, if it is a business; social security number; taxpayer identification number, if it is other than social security number; date; zip code; a whole range of possible identifiers to see if this person has applied for an SBA loan in the past.

The Disaster Assistance Program has a good database going that enables them to do such searches within the Disaster Area Offices. For the rest of the Agency however, the SBA's Office of Financial Assistance is working on developing a more uniform database for all of the SBA Loan Programs. If you had a disaster loan application, you could query the system to see if the person had had a loan under the 7(a) Program and had perhaps defaulted in the past.

That systems development work is in process; it is not yet to the point where we would like it to be. When completed, it will be very important and very helpful to the loan officers as they are going about approving loan applications.

Chairman TORKILDSEN. Thank you. For a final question, you stated that disaster assistance cases now command 22 percent of your investigative resources. Looking forward, do you see that either increasing or decreasing due to time, and why?

Ms. LEE. Well, I would not see it decreasing, at least not anytime soon, for several reasons. We get a big workload in the applications stage. The loan officers and the Disaster Assistance employees, as they are processing the applications, they spot possible fraud and pass it on to us. When you are in the application phase, you are going to get a big workload.

Now, the worst of that is over in California. That workload should taper off, unless we get other major disasters. You know, if we get another big hurricane this summer or if we get major flooding in the Midwest, that is going to increase workload again.

Then, we see workload when the defaults start. It seems to us, and our initial audit work seems to bear this out, that the earlier the loan defaults, the more likely it is that there is some fraud involved with that loan. We will know more about that, as I suggested, once we have done more audit work in California; but that seems to be the pattern. The longer the loan goes, the more likely it is to be a solid loan and no fraud is involved.

We are now at about the stage where we are starting to see defaults out of California, particularly. That is what we are looking at now in terms of targeted audits to see if, indeed, the expected degree of fraud is truly there.

I believe the SBA has estimated there will be, roughly, 11,000 potential defaults out of Southern California. If we end up with any significant percentage of that with fraud potential, our workload is going to continue to be very heavy for the foreseeable future.

Chairman TORKILDSEN. Thank you very much.

Congressman Chrysler?

Mr. CHRYSLER. Mr. Chairman, I just have a process question, I guess. As you mentioned, the number of disasters have increased. Why don't we combine FEMA and SBA together, so the people who are looking at these disasters originally are the same ones that are saying whether they should receive loans or not to rebuild?

Mr. LEE. Would you like me to address that, or Mr. Hammersley?

Mr. CHRYSLER. Any one of you.

Chairman TORKILDSEN. Perhaps, Mr. Hammersley should start and others can testify.

Mr. HAMMERSLEY. Congressman, there are two major reasons why we believe that the SBA should continue in its current role and FEMA in its current role. First off, FEMA's responsibilities are immediate and emergency relief. They come in right as the disaster hits, and then they take care of the immediate needs of the community and then move on to other business.

Second, FEMA deals primarily in grants. The contrast there is SBA comes in for the long-term recovery of the area and we deal in loans, the loan being the primary instrument the Federal Government uses to assist citizens in long-term recovery. A loan is a much different thing than a grant to handle.

We have processing expertise, we have servicing expertise, and we have liquidation expertise. In fact, the same staff that work in the liquidation division for the 7(a) Loan Program also handle the Disaster Loan liquidations.

Mr. CHRYSLER. Any particular reason why it cannot all be done under one roof?

Mr. HAMMERSLEY. Well, that one roof would have to have an awful lot of capability that would essentially be overlapping. The liquidation function being the best example. It does not come in initially, but it comes down the pike. It is a specific type of expertise that is learned over a period of time.

As I mentioned, we use the same staff that liquidate 7(a) loans to liquidate the disaster loans. With our extensive field network, we have people on the site. Liquidation is very labor-intensive and you pretty much need to be near the borrower. It would be difficult to structure something like that differently than what we have already in place.

Mr. CHRYSLER. You do not think if you had FEMA in there early and looking at the disaster that happened they could better say, "Yes, these people here really need some long-term help" or "These people need the short term help," maybe it would cut down on some of the auditing process, maybe we would get a better bang for our buck, maybe it would expedite claims, and most of all maybe it would save us as a Government some money?

Mr. HAMMERSLEY. Well, under the current process, in order to qualify for a FEMA grant, for the most part you have to be turned down by SBA for a loan. If the SBA makes a loan, that is a lot cheaper for the taxpayers than a grant. We, in effect, feed FEMA, to handle the people that are not qualifying for loan assistance.

Chairman TORKILDSEN. Thank you.

Any further questions?

Mr. CHRYSLER. No. I will be here for at least 18 more months, so I will try to work on these things.

Chairman TORKILDSEN. Fair enough. Well, I would like to thank all the witnesses for their testimony. I would like to ask that you all be available to respond in writing to any questions, either from the members who attended the hearing today or other members of the committee, and that the record remain open to reflect both those questions and your responses.

If there is no objection, I also would ask that there be 5 legislative days for any member to submit an opening statement, if he or she wishes. With that, again I thank the witnesses for their testimony, and this hearing is adjourned.

[Whereupon, at 3 p.m., the subcommittee was adjourned, subject to the call of the chair.]

APPENDIX

OPENING STATEMENT

HEARING ON U.S. SMALL BUSINESS ADMINISTRATION'S DISASTER ASSISTANCE LOAN PROGRAM

Thursday, May 25, 1995
2:00 p.m.

The Committee will come to order.

Good Afternoon. It is my pleasure as Chairman of the Small Business Committee's Subcommittee on Government Programs to welcome our guests today. This hearing is one in a series of hearings reviewing the Small Business Administration's (SBA) programs. It is timely and appropriate that we are looking at this program today in light of the recent disasters occurring across our country.

As we look toward the future of small business in this country, we must consider those program that are supportive in a time of need. The purpose of this hearing is to examine the workings of the disaster assistance loan program and how it aides small businesses as well as individuals after a disaster.

In the wake of hurricanes, floods, earthquakes, tornadoes and other disasters, the SBA can play a major role. Disaster loans are the primary form of Federal assistance for non-agricultural and private sector disaster losses. The program is the only form of SBA assistance not limited to small business. These loans help homeowners, renters, businesses of all sizes and non-profit organizations to rebuild. They are a critical source of economic stimulation for ravaged communities.

The SBA provides this much needed assistance in the form of loans, thus reducing the Federal disaster costs compared to other forms of assistance, such as grants. All loans are repaid to the Treasury department and are available at low interest rates and for extended terms.

By all accounts, this program has been a success over the years. After the Northridge earthquake, 125,000 loans were approved for over $4.1 billion in FY 1994. In the aftermath of the Midwest floods, the LA riots, and Hurricanes Andrew and Iniki, the SBA approved another 58,644 disaster loans for $1.67 billion during FY 1993. It is important to note that since the inception of this program in 1953, the SBA has approved over 1,274,000 disaster loans for over $22.4 billion. And, in light of the recent Oklahoma bombing and flooding in Missouri and Louisiana, I am sure the SBA is working diligently to approve a number of new loans to victims.

But, despite this success, the program must be examined and several critical questions asked. Two of the most important ... How can we continue the growth of this program with the ever-shrinking dollars and the need to balance the Federal budget? And more specifically, what figures are available regarding default & repayment rates on these loans?

With that I will yield to the ranking member, Mr. Poshard, for any opening statement he might wish to make.

Congress of the United States
Washington, DC 20515

Committee on Small Business
Subcommittee on Government Programs
The House of Representatives

Opening Remarks
of
The Honorable Glenn Poshard

May 25, 1995

Thank you Chairman Torkildsen for holding today's oversight hearing on the Small business Administration's (SBA) Disaster Assistance Loan Program. The SBA's disaster loan program has proven to be a critical source of economic prosperity in disaster ravaged communities, helping to spur employment and stabilize tax bases.

The SBA provided important assistance to countless farmers, business owners, and communities in southern Illinois when the Midwest Floods of 1993 wreaked havoc with our already struggling rural economy. Without the SBA's financial assistance, I am afraid many of our communities would not have been able to rebuild. What impressed me about the SBA's program is that it requires borrowers to maintain appropriate hazard and flood insurance coverage, thereby reducing the need for future disaster assistance. As Congress works to balance the federal budget, it seems to me providing loan assistance is a much better alternative to helping victims of disasters, and at the same time we are encouraging personal and fiscal responsibility.

In closing, I would like to thank the members of today's panel for appearing before this Committee and for sharing your testimony with us. Thank you again Chairman Torkildsen for holding this hearing. I hope can leave this hearing today know what an important role the SBA's Disaster Assistance Loan Program plays in providing important financial assistance to countless disaster victims.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

APR 13 1995

John E. Goodlad
3125 Beaudry Terrace
Glendale, CA 91208-1709

Dear Mr. Goodlad:

Thank you for your letter of March 13, 1995 relating your experience in obtaining a Small Business Administration (SBA) disaster business loan for your rental properties following the Northridge earthquake. Although your letter indicates that your experience with the SBA disaster loan program was unsatisfactory, it nevertheless provides me with valuable feedback on the performance of the Agency. It also provides me the opportunity to address some of the important issues raised in your letter and clarify some of the misunderstandings which may exist.

The Northridge earthquake was the largest and costliest disaster in U.S. history. Because of the unprecedented number of applications received by our Disaster Area 4 Office following that disaster, it was necessary for us to hire and quickly train thousands of additional personnel to meet the unprecedented demands on the Agency. While experienced in their field, many had no prior experience with our program. This, unfortunately, may have resulted in some confusion, such as the numerous and multiple requests for additional information you mentioned.

As all of our literature makes clear, the SBA offers disaster business loans at two different interest rates depending on the financial strength of the business applying for assistance. In the case of the Northridge earthquake disaster, those rates were either 4% or 7.7%. Because these are subsidized loans using taxpayer funds, the SBA is obligated by law to make a determination whether or not the applicant business would be able to obtain credit elsewhere (from non-government sources without creating an undue hardship on the business). While the SBA will provide disaster loans to such firms, those businesses determined to have credit available elsewhere are charged the higher rate of interest and are limited by law to a maximum three year loan maturity. This is to encourage the disaster victim who is able to do so to make repairs utilizing their own resources. By far, we approve the majority of loans at the lower rate, however, we are unable to do so in all circumstances. In your case, based on the information provided with your application, we determined that the higher 7.7% rate was appropriate.

Your letter contains statements regarding the disbursement of the disaster loan which I would like to address. The SBA disaster loans are subsidized by the Federal Government and borrowers are subject to civil penalties for misuse of disaster loan proceeds. To avoid excessive costs and to insure compliance with the loan agreement, the SBA monitors the use of disaster loan funds. They are disbursed in increments and borrowers are required to submit information to verify SBA funds were used in accordance with the Loan Agreement. Once a borrower has accounted for the use of previously disbursed funds by submitting the appropriate material, additional disbursements can be made. Upon receipt of information from borrowers, verifying that funds disbursed to date have been spent on repairs, further disbursements are ordered.

With respect to interest accruals, I can only conclude that you were apparently misinformed. The SBA disaster loans are simple interest loans. While the loan payments are calculated based on the entire loan amount, interest accrues only on the outstanding principal balance. In your case, so far you have only been charged interest on the $25,000 which has been disbursed to you to date.

Finally, the SBA is permitted by law to loan funds only for damages which are not compensated for by insurance or other recoveries. Because we approved your loan for the full amount of your verified losses, we are required to take an assignment of insurance proceeds. In the possibility of an eventual insurance recovery, your insurance proceeds would have been used to pay down the principal balance of your loan. You would have thus had full benefit of those funds.

Thank you once again for taking the time to write to me. I apologize for any misunderstandings which have occurred and regret that your experience was not more positive. Let me assure you that your observations are appreciated and will help us in evaluating our continued efforts to improve our performance of delivering disaster loan assistance. I wish you well in recovering from this terrible disaster.

Sincerely,

(signed) James Rivera

for Bernard Kulik
Associate Administrator
for Disaster Assistance

ThePrudential
Stevenson Commercial
Real Estate
1025 North Brand Boulevard
Glendale, CA 91202-2976
Bus. (818) 956-7001
Fax (818) 502-1306

May 22, 1995

Hon. Peter G. Torkildsen, Chairman
Government Program Sub-Committee
B 363 Rayburn Building
Washington, D.C. 20515

Dear Congressman Torkildsen:

This is to relate an experience I had with the SBA disaster loan department. First of all, I am a commercial real estate agent and the SBA commercial-industrial loans are a God send to us. The disaster department is something else!

Some rental units were damaged in the January 1994 Northridge earthquake. We had earthquake insurance but the 10% deductible was higher than the damage, so it was of little help. I applied for an SBA loan and included the contractor estimates for each property (the rentals are older, single family houses, duplexes and two-on-a-lot houses). Then people from SBA in Sacramento started calling.

Each request was for more information from a different person who identified him or herself by first name only. They kept calling and requesting the same information - over and over. They wanted it faxed because they said they would never find it if it were mailed. Finally, the $95,400.00 loan was approved ... not at 4% amortized in 20 years as we had heard that others were getting.

Ours was at 7.7% all due in 3 years. Instead of receiving $95,400, we got a $25,000 check with the promise of another $25,000 when the initial $25,000 was properly spent and accounted for. The real joke was that SBA set itself up to collect interest on the whole $95,400 although only $25,000 had been disbursed to us. The SBA wants a return that would make a loan shark happy.

The next zinger was a letter telling us that we had to turn over any earthquake insurance payments to SBA. We took out the insurance and we paid for it before the earthquake. Why should those payments be assigned to SBA?

That was the proverbial straw that got the camel! We paid off the initial $25,000 SBA loan disbursement and found another source of funds!

Is everyone treated like this or just us?

Yours very truly,

John Goodlad

Enclosures (copies of note and repayment notice)

The Prudential
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March 13, 1995

Mr. Philip Lader, Administrator
Small Business Administration
409 3rd St., S.W., Suite 700
Washington, D.C. 20416

Dear Mr. Lader:

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Some rental units were damaged in the January 1994 Northridge earthquake. We had earthquake insurance but the 10% deductible was higher than the damage, so it was of little help. I applied for an SBA loan and included the contractor estimates for each property (the rentals are older, single family houses, duplexes and two-on-a-lot houses). Then people from SBA in Sacramento started calling.

Each request was for more information from a different person who identified him or herself by first name only. They kept calling and requesting the same information - over and over. They wanted it faxed because they said they would never find it if it were mailed. Finally, the $95,400.00 loan was approved ... not at 4% amortized in 20 years as we had heard that others were getting.

Ours was at 7.7% all due in 3 years. Instead of receiving $95,400, we got a $25,000 check with the promise of another $25,000 when the initial $25,000 was properly spent and accounted for. The real joke was that SBA set itself up to collect interest on the whole $95,400 although only $25,000 had been disbursed to us. The SBA wants a return that would make a loan shark happy.

The next zinger was a letter telling us that we had to turn over any earthquake insurance payments to SBA. We took out the insurance and we paid for it before the earthquake. Why should those payments be assigned to SBA?

That was the proverbial straw that got the camel! We paid off the initial $25,000 SBA loan disbursement and found another source of funds!

Is everyone treated like this or just us?

Yours very truly,

John Goodlad

John Goodlad

Enclosures (copies of note and repayment notice)

cc: Carlos Moorhead, Representative, 27th Congressional District, California
Diane Feinstein, Senator, California
Barbara Boxer, Senator, California

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Testimony of

BERNARD KULIK
ASSOCIATE ADMINISTRATOR
OFFICE OF DISASTER ASSISTANCE

U.S. SMALL BUSINESS ADMINISTRATION

Before

THE SUBCOMMITTEE ON GOVERNMENT PROGRAMS
COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

May 25, 1995

91-342 O - 95 - 3

Good afternoon, Mr. Chairman. I am Bernard Kulik, Associate Administrator for Disaster Assistance at the Small Business Administration (SBA). I want to thank you for inviting me here today to discuss the SBA's disaster assistance program; the program that Administrator Lader refers to as "The SBA Nobody Knows." Although this is a little known function of the Agency, it is one of our major efforts and plays a key role in all 50 states and 6 territories in helping victims of natural disasters recover from the devastation and put the pieces of their lives back together again.

Background

SBA does not provide immediate, emergency relief. When a disaster outstrips the ability of the state and local governments to provide immediate recovery assistance, temporary housing, medical assistance, food, and other services are provided by different branches of the Federal government and voluntary organizations, such as the American Red Cross, under the very capable coordination of the Federal Emergency Management Agency (FEMA). SBA's role is the long term recovery effort.

SBA's disaster loans are the primary form of Federal assistance for nonfarm, private sector disaster losses. The Federal design for disaster recovery for individuals and businesses is first to have them rely on private insurance. Second, SBA can provide long term, low interest loans to cover those losses not compensated for by insurance. Finally, individuals are given assistance through a combined Federal/state grant program if declined for SBA disaster loans.

The disaster loan program is the only form of SBA assistance not limited to small businesses: SBA disaster loans help homeowners, renters, businesses of all sizes, and nonprofit organizations. SBA's disaster loans are often the lifeline in disaster-ravaged communities, helping to spur employment and stabilize the tax base.

By providing disaster assistance in the form of loans, which are repaid to the U.S. Treasury, the SBA's disaster loan program helps reduce Federal disaster costs compared to other forms of assistance, such as grants. When disaster victims need to borrow to repair damages not covered by insurance, SBA loans are tailored to each borrower's ability to repay. Moreover, providing disaster assistance in the form of loans rather than grants avoids creating an incentive for property owners to underinsure against risk. As a condition of collateralization, disaster loan agreements require borrowers to maintain appropriate hazard and flood insurance coverage, thereby reducing the need for future disaster assistance.

How the Disaster Loan Program Works

The disaster loan program is the SBA's largest direct loan program and is available to all entities except governmental units and agricultural enterprises. (Agricultural producers may seek disaster assistance from the U.S. Department of Agriculture, which has programs and the expertise tailored to meet the specific needs of agricultural enterprises.)

The Small Business Act authorizes SBA to make two types of disaster loans:

Physical disaster loans are a primary source of funding for permanent rebuilding and replacement of underinsured disaster-damaged, privately-owned real or personal property. These loans are available to homeowners, renters, nonfarm businesses of all sizes and nonprofit organizations.

Economic injury disaster loans help provide necessary working capital to businesses until they can resume normal operations after a physical disaster event. The law restricts economic injury disaster loans to small businesses that do not have credit elsewhere available.

SBA disaster assistance is not a giveaway: the loans must be repaid. The Agency will only approve loans to applicants having a reasonable ability to repay the loan and other obligations from earnings. Additionally, a number of safeguards are built into the program to avoid fraud. Prior to making a loan, the SBA verifies the applicant's income information from IRS filings; SBA employees independently verify disaster damages and repair costs; and the SBA collects social security numbers and examines credit reports for all applicants. As a processing safeguard, no one SBA employee can approve a disaster loan (the "rule of two" requires that each loan must be approved by a processing loan officer and a supervisory loan officer). In addition the Agency takes whatever collateral is available for a loan (preferably real estate), and loan proceeds are disbursed serially as the funds are used and needed.

The law gives the SBA several powerful tools to make disaster loans affordable including low interest rates, long terms, and refinancing of prior debts in some cases. Currently, interest rates for disaster loans are set by statutory formulas with caps of 4 percent for borrowers without credit elsewhere available, and 8 percent for borrowers with credit elsewhere available. The determination of credit elsewhere available (the ability of the victim to borrow or use their own resources to overcome the disaster without undue hardship) is made by the SBA in each case. Generally, over 90 percent of the SBA's disaster loans are to borrowers without credit elsewhere available.

Recent Disaster Assistance Activity

The demand for disaster loans is as unpredictable as the weather. In the past few years, the country has experienced an unusually high number of damaging natural disasters. Since the inception of the Agency in 1953, SBA has approved more than 1.289 million disaster loans for more than $22.8 billion. However, in just the past 5 years, from fiscal year 1990 to the present, the Agency has approved over 303,000 loans for more than $9 billion. These included loans made as a result of such major disasters as Hurricane Hugo in the Caribbean and the Carolinas, the Loma Prieta earthquake in California, Hurricane Andrew in Florida and Louisiana, the nine-state Midwest floods and the mega-disaster of the Northridge Earthquake. Northridge is by far the largest disaster we have ever handled and it resulted in over 123,000 loan approvals for over $3.96 billion. Our largest single year of activity was FY 1994, during which we made over 125,000 loans for more than $4.159 billion.

Thus far in fiscal year 1995, the Agency has approved over 32,424 loans for more than $945 million for loans generated by the Northridge earthquake, California flooding of January and March 1995, last year's Georgia and Houston floods, and the current flood activity in Louisiana and Mississippi.

The SBA loan program plays a major role in long term recovery, even in disasters such as the Oklahoma City bombing. There were many businesses and residences damaged in that explosion, not to mention destroyed cars. The President declared a major disaster on Wednesday, April 26. SBA was the first agency present in the FEMA service center, which opened Friday, April 28. The first SBA loan applications were received the same day and the first SBA loan checks were delivered to disaster victims on Wednesday, May 3. Although the filing period does not close until June 24, we have already approved 80 loans for $1.24 million.

Disaster Loan Program Staff

Because of the unforeseeable peaks and valleys in its activities, the SBA's disaster loan making function is in a separate unit within the Agency that is responsible only for making disaster loans. It is a centralized unit that operates out of 4 disaster area offices. One office each is located in Niagara Falls, NY; Atlanta, GA; Ft. Worth, TX; and Sacramento, CA.

It is interesting to note that this successful program is run with just 8 full-time permanent employees. The mainstay of the program is a group of employees known as the disaster cadre, who are permanent employees but are only guaranteed 6 months work each year. This group is made up of the core professionals, such as loan officers, loss verifiers, attorneys, and support administrative staff. They have the expertise to do the job in smaller disasters and to do the training and supervising when the disaster staff has to be expanded. This permits almost instant expansion and contraction of the staff with temporary employees, as needed. The authorized cadre ceiling is kept purposely low (300) so that cadre employees essentially work full time employment and stay with the program.

The disaster cadre is supplemented by temporary employees whose number varies, of course, with demand. In the 5-year period from 1990 that I mentioned above, our temporary staff has ranged from a low of 280 to a high of 3,300 at the height of Northridge. As of the end of April, there were 220 cadre employees and 1,459 temporary employees on board. Additionally, the Agency has placed strong emphasis on national uniformity, which is not only important to the quality of our disaster lending, but has enabled us to use our resources efficiently by moving employees and resources among offices to meet sudden changes in workload. This interchangeability has allowed a very fast response time while maintaining high quality.

SBA's Relationship with FEMA

In all major disasters declared by the President, FEMA is the lead agency, responsible together with the state for coordination of all Federal efforts for both response (immediate emergency needs) and recovery. As mentioned earlier, the SBA is the major player on the response side working in partnership with FEMA. The working relationship is excellent, due in major part to the efforts of the current FEMA Director, James Lee Witt. The SBA is a member of the Federal Disaster Response Team and cooperates at all stages of a disaster. For example, when a declaration is requested, there is usually a joint Federal/state preliminary damage assessment made to determine the severity and extent of the damage. SBA is always represented on those teams to estimate both business and residential damage.

When a disaster is declared, FEMA activates its teleregistration hotline, located in Denton, TX and Berryville, VA. The SBA has staff at each center to answer questions concerning the disaster loan program and to help advise registrants. At the disaster site, SBA will co-locate with FEMA at the Disaster Field Office (DFO) and at any on-site locations such as disaster assistance centers and disaster service centers. In fact, when FEMA decides not to have on-site locations, the SBA will open workshops in the disaster area and often FEMA will join if the demand warrants. Although the programs administered by FEMA and SBA are very different, a close working relationship is important to the effective delivery of all forms of disaster assistance.

Additionally, SBA's program is intertwined with the FEMA temporary housing and individual and family grant programs. A good working relationship is necessary to avoid confusing the disaster victim and duplicating benefits. Information is passed back and forth between the agencies so that SBA is aware of any minor repairs that FEMA has funded as part of the temporary housing program which, generally, is delivered prior to SBA assistance. Similarly, the SBA acts as a filter for the individual and family grant program; only those individuals who have been declined for an SBA loan are eligible for a grant. SBA keeps FEMA and the state fully informed and automatically refers declined applicants to the grant program.

Improving the Disaster Assistance Program

Given rising Federal costs resulting from the tremendous level of disasters experienced over the past six years, the Administration plans to work with the Congress in the coming months to reform the way the Federal government plans for and responds to disasters. Accordingly, the Agency is proposing to reduce the subsidy rate for disaster loans in 1996 from its current level of 31.54 percent down to 8.46 percent. This reduction would permit SBA to make $407 million in disaster loans with the requested subsidy authority of $34 million as opposed to $110 million in loans with the current subsidy rate.

In addition, the Agency has made many changes to simplify the program and make it more customer friendly. Specifically, we have:

- Simplified the home loan filing requirements: The SBA now requires certain information only after a loan is approved so that disaster victims are not required to do unnecessary paperwork.

- Simplified the filing process and the requirements for disaster business loans: As a result of the Agency's experience in the Midwest floods, the SBA has cut the disaster loan application by half.

- Increased the disaster home loan limits from $100,000 to $200,000 for real estate damage, and from $20,000 to $40,000 for personal property damage.

- Made landlords eligible for economic injury loans.

- Modified the major source of employment criteria to permit consideration of waiver of the $1.5 million business loan limit in more cases. (The law provides a maximum loan limit of $1.5 million for any business in any one disaster. It also permits the Administrator to waive that limit for a "major source of employment," as defined in our regulations. The modification made it easier for businesses to qualify as major sources of employment.)

We are grateful to the Internal Revenue Service for their invaluable assistance in helping us simplify the task of completing loan applications. Instead of our asking victims to locate copies of their tax returns to supply to SBA, victims are now authorizing the IRS to provide the information directly to us. The IRS has been extremely cooperative in providing rapid turnaround to our requests so we can expedite processing.

In addition, the Agency is continuing its approaches to make the program more customer friendly in line with the Administration's reinventing government effort. For the first time, after the bulk of the applications for Northridge had been processed and much of the approved loan funds disbursed, we held meetings with focus groups of victims who had received loans to determine how they viewed the process and what we could do to improve it. The reactions were both interesting and thought provoking. Some suggestions were impractical, and some problems were caused specifically by the fact that the size of this disaster was at first overwhelming; other suggestions, however, are being addressed. For example, the focus group meetings revealed that most applicants do not understand the SBA loan process and how it differs from other commercial loan procedures. Whereas, FEMA relies on teleregistration, which permits them to handle large numbers quickly and efficiently in providing immediate emergency response, the SBA prefers meeting victims one-on-one to explain our program and forms and to take the mystery out of the whole process. Where the Agency is able to do this, victims have understood and have been pleased with the service. Where the Agency has had to rely on the teleregistration contact, there is a greater possibility that our customers are confused. Currently, the SBA is working on informational material that will be mailed along with a simplified application package to explain the process and the steps involved to avoid future confusion.

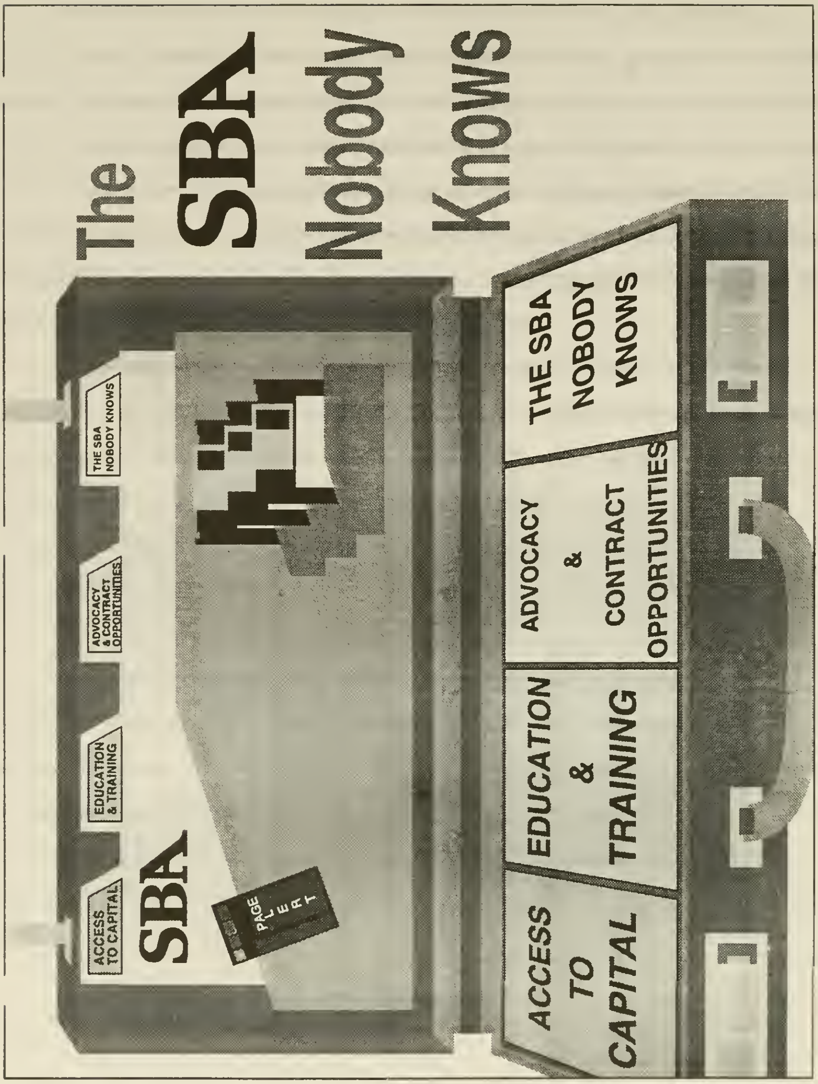
Many businesses spoke of the need for immediate cash funds availability, similar to FEMA's temporary housing assistance available for individuals. Unfortunately no such program exists for businesses. In response to this need, the SBA is reemphasizing the concept of "bridge lending" by commercial sources in the disaster area. The Agency has long urged local banks to offer immediate, favorable loans to business disaster victims, particularly their own customers. These loans can be taken out with the proceeds of a subsequent SBA disaster loan, if one is approved. The level of cooperation from local lenders has varied from disaster to disaster and even within disasters.

As a result of the focus groups as well as the efforts of reinventing government, we are exploring some exciting possibilities. Specifically, is it possible to have just one verification of the damage to a disaster victim rather than one by FEMA for temporary housing, one by SBA for disaster loan purposes, and perhaps others? We think so and we are working with FEMA to make it a reality.

The SBA is also looking into the possibility of having one standardized application from a disaster victim that could be presented to all agencies. This presents more challenges, both legal and practical. But the Agency is actively trying to identify the problems and see how they can be resolved. The goal is to make the process as customer friendly as possible without giving up any of the necessary safeguards that are expected when taxpayer funds are being utilized.

In summary, we are proud of the work done by "The SBA that Nobody Knows." We believe our efforts over the very active past few years have demonstrated our ability to deliver our services in the face of the many and diverse needs of our customers. The Agency has shown its ability to adapt to many unanticipated situations, and we have demonstrated the flexibility needed to keep this program responsive to changing circumstances. But we are not satisfied that our efforts can't be further improved and we will continue to work to enhance the delivery of this important program.

Thank you, Mr. Chairman. That concludes my prepared remarks. I will be happy to answer any questions you may have.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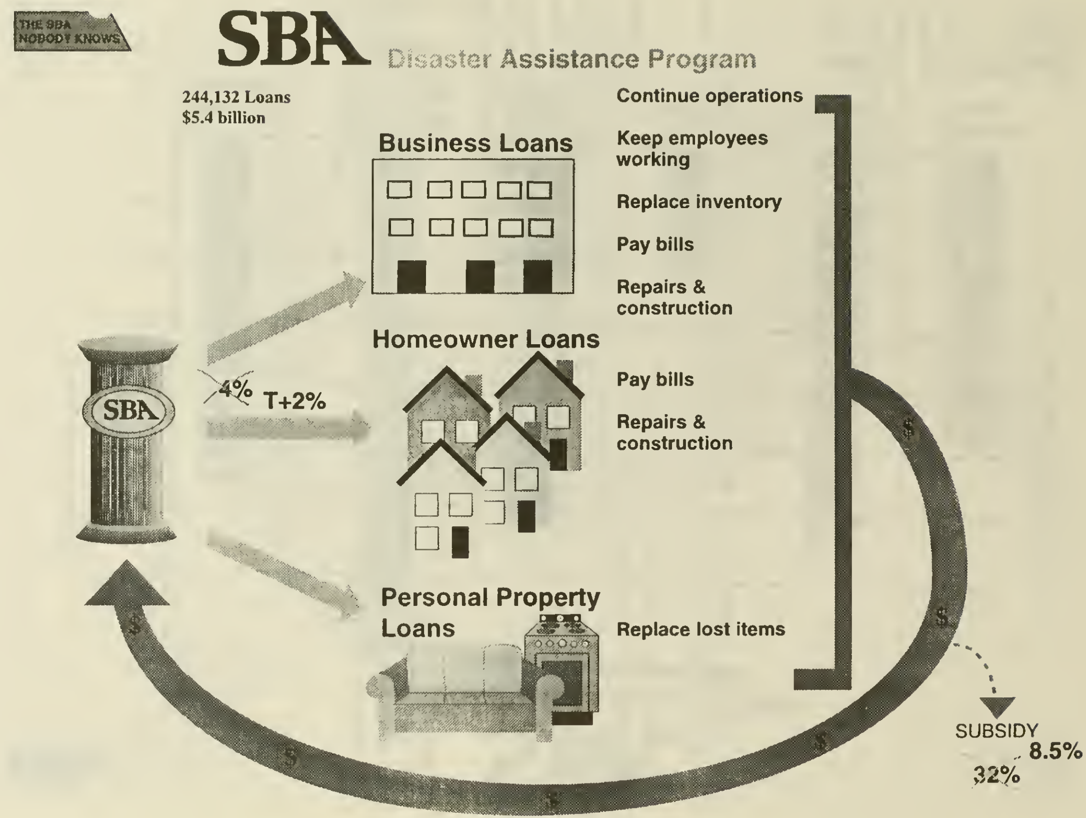
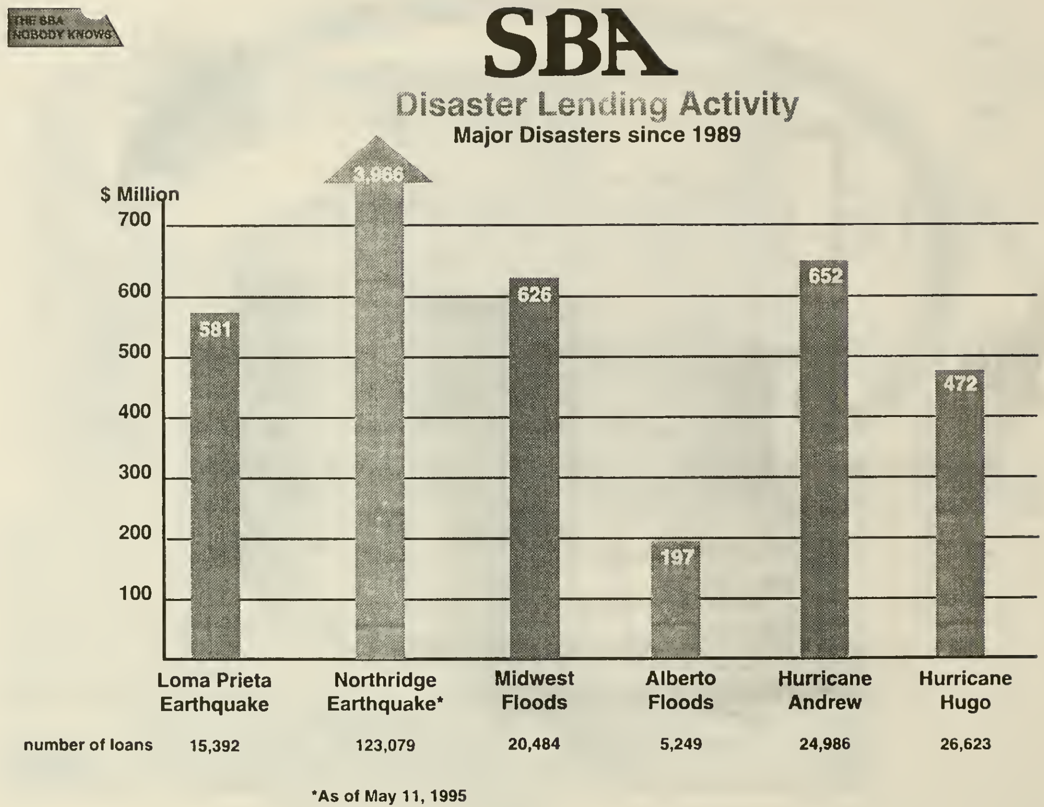

THE SBA NOBODY KNOWS
SBA Disaster Assistance Program
244,132 Loans
$5.4 billion
Business Loans
Continue operations
Keep employees working
Replace inventory
Pay bills
Repairs & construction
Homeowner Loans
Pay bills
Repairs & construction
Personal Property Loans
Replace lost items
4%
T+2%
SBA
SUBSIDY
8.5%
32%


THE SBA NOBODY KNOWS
SBA
Disaster Lending Activity
Major Disasters since 1989
$ Million
700
600
500
400
300
200
100
581
3,966
626
197
652
472
Loma Prieta Earthquake
Northridge Earthquake*
Midwest Floods
Alberto Floods
Hurricane Andrew
Hurricane Hugo
number of loans
15,392
123,079
20,484
5,249
24,986
26,623
*As of May 11, 1995

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Honorable Peter Torkildsen
Chairman
Subcommittee on Government Programs
Committee on Small Business
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Attached are the answers to two questions which Mr. Hammersley indicated would be supplied for the record at the recent hearing on the Disaster Assistance Program.

I would also like to clarify some information Mr. Hammersley provided to you. During the hearing, a question was asked regarding the minimum criteria for the declaration of a disaster by the SBA Administrator. These criteria are in 13 CFR 123.22. The basic criteria for a physical disaster declaration is, "in any county or other smaller political subdivision of a State, at least 25 homes or 25 businesses, or a combination of at least 25 homes, businesses, or other eligible institutions have each sustained uninsured losses of forty (40) percent or more of their estimated fair replacement value or predisaster fair market value, whichever is lower."

As you recall, Mr. Hammersley was called upon to testify for me after I was injured the day prior to the hearing. At the time, Mr. Hammersley inadvertently stated these criteria were statutory. In fact, they are regulatory and were adopted in their current form in 1981. Any changes to these criteria would only require a change in the regulation, not legislation. We regret the error.

If you need any additional information, please let us know.

Sincerely,

Bernard Kulik
Associate Administrator
for Disaster Assistance

Attachment

QUESTION: What is the loss rate and the default rate on disaster loans with a breakdown over the last five years?

ANSWER: The loss rate is calculated by dividing the dollars of loans that have been charged off by the dollars of loans that have been disbursed. A loan is charged off by SBA when the servicing office believes that additional collection efforts would be futile, usually some years after the loan was made. The loss rate below is calculated based on all loans made since the inception of the program in 1953.

NOTE: While we believe that a significant portion of the recent improvement in the default rate and the loss rate is a result of continual improvement in the making and servicing of disaster loans, we feel it important to know when reviewing the charts below that we have recently added a significant number of loans to the portfolio as a result substantial disasters in the past few years including the Northridge earthquake of 1994. Many of these loans are just beginning to make repayments and would not have been on the books long enough to default or be charged off.

LOSS RATE FOR SBA DISASTER LOANS

As of Fiscal Year	Actual Loss Rate
FY 1994	8.68%
FY 1993	9.45%
FY 1992	9.97%
FY 1991	9.58%
FY 1990	9.56%

The word default literally means any deviation from the terms and conditions of the note. At SBA, default indicates loans where the borrower is not current on all payments owed on the loan and can include deferments granted by the Agency at the borrower's request. Considering the unplanned nature of disaster loans, it is not unusual for a loan to be in default at some time during its life. This does not mean that there will be losses. The default rate is a snap shot of how the portfolio is performing at a given moment in time. The following chart shows the default rate in terms of dollars and number of loans as determined at the end of each of the past five fiscal years.

DEFAULT RATE FOR SBA DISASTER LOANS

Fiscal Year	Default Rate $	Default Rate #
FY 1994	11.3%	8.0%
FY 1993	13.2%	10.3%
FY 1992	15.2%	11.0%
FY 1991	16.8%	12.3%
FY 1990	16.6%	11.0%

We believe that looking at loans that are seriously delinquent (more than 60 days past due or in liquidation) provides a better picture of the potential for program losses because they are more likely to end as a loss. The following chart shows the percentage of the portfolio that was seriously delinquent at the end of the past five fiscal years.

DELINQUENCY RATE FOR SBA DISASTER LOANS

Fiscal Year	Delinquent Rate $	Delinquent Rate #
FY 1994	7.3%	4.5%
FY 1993	8.7%	5.9%
FY 1992	10.0%	6.2%
FY 1991	10.8%	6.9%
FY 1990	11.4%	5.8%

QUESTION: What is turnaround time in processing an application from the respective state for a disaster declaration ?

ANSWER: SBA makes disasters assistance available in four different situations:

1. **Presidential Disaster Declaration.** A Presidential declaration of a "major disaster" which includes the provisions of individual assistance pursuant to the "Stafford" Act, automatically triggers SBA disaster assistance for physical and economic injury losses. The President's authority is contained in the "Stafford" Act.

2. **SBA Administrator's Disaster Declaration.** Instead of requesting a Presidential declaration, a Governor may request the Administrator of SBA to declare a disaster. This is usually the case where the physical damages are insufficient to warrant a Presidential declaration. SBA's minimum criteria for a physical disaster declaration are 25 homes and/or businesses in a county which have each suffered 40% or more uninsured damage. Upon receiving a Governor's request, SBA surveys the affected area to determine if the criteria are met. The Small Business Act limits a disaster to a sudden physical event such as hurricane, flood, tornado, earthquake, fire, volcanic eruption, riot or civil disorder, etc. An SBA declaration covers physical and economic injury losses.

3. **Governor's Certification of Economic Injury.** When a disaster event (as defined in the Small Business Act) has caused substantial economic injury to at least 5 small business concerns or small agricultural cooperatives, a Governor may certify that such businesses are in need of financial assistance not otherwise available on reasonable terms. Upon receipt of such certification, the SBA Administrator may declare an area eligible for Economic Injury Disaster Loans (EIDLs) only.

4. **Disaster Designation by the Secretary of Agriculture.** When the Secretary of Agriculture designates an agricultural disaster, farmers and other agricultural enterprises are eligible for disaster loan assistance from the Farmers Home Administration (FmHA). SBA's Economic Injury Disaster Loan assistance is also triggered to provide assistance to agri-dependent small business concerns and small agricultural cooperatives which have suffered substantial economic injury as the result of the agricultural losses designated by the Secretary.

Requests for Presidential declarations are made by the Governor to and processed by the Federal Emergency Management Agency (FEMA). Requests for an SBA declaration are made by the Governor to the appropriate SBA Regional Administrator. Upon receiving a Governor's request for a physical disaster declaration, SBA surveys the affected area to determine if SBA's minimum criteria for a physical disaster declaration are met. The survey report is prepared by the appropriate Disaster Area Office and submitted to the Office of Disaster Assistance in Washington.

Our goals are to start our survey on site within three days of the receipt of the Governor's letter, and have the decision document ready for the Administrator's action within three days after completion of the survey. Except in very rare cases, we make our goals. For most declaration requests, the decision document is signed by the Administrator within 24 hours. The overall time frame is generally less than 10 days.

SBA does not act on declaration requests on its own if a Presidential declaration has been requested. If the full Presidential declaration is forthcoming, it includes SBA's disaster assistance. If the Presidential declaration is declined, a request from the Governor for an SBA declaration will be considered in accordance with the time goals stated above.

TESTIMONY

Quirino Iannazzo

Administrative Program Manager

Massachusetts Emergency Management Agency

Testimony Before the Subcommittee on Government Programs

of the House Committee on Small Business

May 25, 1995

In support of the Small Business Administration

Thank you Mr. Chairman for the invitation to testify before this committee in support of the Small Business Administration (SBA). As Administrative Program Manager for the Massachusetts Emergency Management Agency (MEMA), I welcome the opportunity to address the subcommittee to offer recommendations and other data concerning the SBA and its loan programs.

Since 1991, the Massachusetts Emergency Management Agency has developed a strong working relationship with the Small Business Administration. Working as partners, the interaction has produced some very real results for the citizens of the Commonwealth of Massachusetts. They are results that, I believe, prove the effectiveness of your investment in The Small Business Administration.

Let me cite some examples of how effective, one SBA program, Physical Disaster Loans, is. In November, 1991, the "No-Name Hurricane" raked the Massachusetts shoreline with high winds and rough surf causing extensive damage to our fishing fleet. In total, more than 2,400 applications were received in its wake. Of those, more than 200 were from fishing boat owners and lobstermen whose craft and equipment, especially lobster pots, were damaged by the storm. The SBA was able to assist with the loans these fishermen needed to keep their livelihoods. Please note that these were not handouts or bailouts, they were **loans** made to the fishermen so they could remain economically viable. The result of this investment in the fishermen was that our fishing and lobster industry remained economically viable. They were able to remain contributors like so many other small businesspeople, who form the backbone of this great nation's economy. There's more to this, though. Like other small businesspeople, the fishing boats usually had several people aboard, the captain and crewmembers. Thanks to the SBA loan program all of these folks were able to remain responsible, contributing citizens, as well.

Loans resulting from major disasters are not the only assistance that SBA has provided to the Commonwealth. Through its Economic Injury Disaster Loans for Small Businesses program, SBA is able to help businesses when the situation is limited in scope, perhaps to a single building or facility housing many businesses. If five or more businesses experience 40 percent losses in business, then the program applies and owners can receive assistance in rebuilding. For Massachusetts, this program has meant that many businesses in Palmer and Peabody remained viable. It is a key link in our economic chain in that it helps business people and their employees to help themselves.

In seeking this funding, MEMA was proactive. As soon as the local disasters occurred, we sought to assist the owners in their rebuilding. MEMA built the bridge to SBA that helped local business owners receive aid. I believe that the bridge MEMA provided indicates the extent of our partnership with the SBA's Regional Office in Boston and the Disaster Area I Office in Niagara, N.Y. The SBA has developed a capable, professional staff in the Regional Office that is a real credit.

The field staff is also a credit to the SBA. On-scene, staff members listen patiently to each request and find the best possible solution. Sometimes, a loan is not the best option and SBA staff will refer victims to the Federal Emergency Management Agency (FEMA). FEMA has a series of assistance grants for those who do not qualify for SBA help. Or, the referral may be to one of the many voluntary organization represented by Volunteer Organizations Active in Disaster.

Since 1991, there have been more than 3,356 applications for loans under the Small Business Loan Programs. The applications followed 14 SBA Disaster Declarations from coastal storms to hurricanes and numerous fires.

Storms weren't the only problems that businesspeople faced. They also had to contend with local disasters such as fire. In each case, though, SBA was there to help out. Rather than leaving empty, burned out storefronts and businesses in the Western Massachusetts town of Palmer or in the coastal city of Peabody, or having fishermen and lobstermen sitting idle in port, the SBA loans ensured that the businesses impacted by storms and fires were able to rebuild. The Small Business Loan Programs have approved more than $50 million dollars in loans to the hardworking businesspeople of Massachusetts.

I would ask you to think about this for a moment. Without the $50 million dollars in loans -- and remember that loans are repayable -- the affected businesses would likely not have been able to rebuild and as a result their contributions to the state's economy would have been lost. Taking this a step further, if those businesses and equipment had not been rebuilt and replaced then it is quite likely that hundreds of citizens would have had to turn to the government for assistance. This would have increased costs in several federal programs, at a time when we could have ill afforded those increased costs. The resulting costs would have been far more than the investment that the Small Business Administration has made.

The loans, in effect, have been an investment in our state's present and future economy; an investment in business; an investment in Massachusetts. This loan program is a win-win for both the state and federal governments.

Small business owners are central to the economic foundation of any state. I remember talking with a professor in a business class more than a few years ago. I don't remember the exact details of the conversation, but I do remember the theme, which was that small businesses are the country's engine of growth. It was just that simple; businesses with 50 or fewer employees provide the backbone of our country's economy. These are exactly the types of business that the SBA Loan Programs help out; the **backbone** of our economy. This federal agency has, almost single-handedly, helped keep many small businesses viable.

The SBA's Loan Programs are powerful economic tools that use low-cost loans to provide the funds that business need to rebuild and remain productive, employing the thousands of hard-working people who are the bedrock of our community. These are the people who are often ignored in the media but who go about their private lives day after day, obeying laws, keeping their families together, and who try their best to instill the values of hard-work and morality into their children. The funds that the SBA loan program has provided to not only employers, and, through them, to their employees has meant that each and every one of them can hold their heads up, knowing the work that they value can continue. This is the type of investment in our country that the Founding Fathers valued. It has a lasting value, one that cannot diminish with time.

The SBA's program should be considered an investment because each business person who receives a loan pays it back with interest. The program profits because not only does it bring in the amount of the original loan, but it also brings in interest, as well. Simply put, the SBA's program is one that works -- **AT A PROFIT** to the nation. It has worked for the Commonwealth's business community and it has worked for the nation, as well, by keeping businesses operating, employees working, and providing an economic engine for growth.

As with every program, there are some areas that could use some improvement. Specifically, I would like to see more flexibility in the thresholds SBA uses to determine when the loan program begins. As it stands now, the Disaster Loan Program begins when it has been determined that 25 businesses have sustained damage that will cause a 40 percent loss of income. It seems to us that a 20-business number would allow greater flexibility in the program.

Another area where we would like to see improvement is the turnaround time from Washington. Normally, the Regional Field Office in Boston to which our applications are sent will act in a speedy manner. Also, within a day or less of a disaster declaration, field personnel from Disaster Area I Field Office in Niagara are on scene and "open for business." They also handle our requests and applications just as speedily. The slowdown occurs in Washington where things can markedly slow down. A matter that should take just days can take weeks or longer to move from Washington to Boston to MEMA, even though it was expedited at the start. So, we would ask that some guidelines be instituted as to an acceptable timeframe for application review so that those who suffer losses can become productive as quickly as possible.

The Small Business Administration-MEMA partnership is one that works. It works for business; it works for people, and it works for the state and nation. SBA's Disaster Loan Program helps people and business help themselves. It is not a bailout program; it's a profit-maker in more ways than one. We fully support the SBA program and would ask the honorable members of this subcommittee to continue their support.

Thank you again, Mr. Chairman, for the opportunity to testify today in support of the Small Business Administration. MEMA urges continuing support of this important program. I would now be pleased to answer any questions.

Testimony of

Karen S. Lee
Deputy Inspector General

U.S. Small Business Administration

Before

The Subcommittee on Government Programs
of the Committee on Small Business
United States House of Representatives

May 25, 1995

Good afternoon Mister Chairman and Members of the Subcommittee. Thank you for inviting us to appear before you this afternoon to discuss the Disaster Assistance program of the Small Business Administration (SBA). I am Karen S. Lee, the Deputy Inspector General. The Inspector General is on personal leave and asked me to represent the Office of Inspector General (OIG) before the Subcommittee. First, I would like to introduce my colleagues who accompany me today: Steve Marica, Assistant Inspector General for Investigations; Peter McClintock, Assistant Inspector General for Auditing; Tim Cross, Assistant Inspector General for Inspection and Evaluation; and Phyllis Fong, Assistant Inspector General for Management and Legal Counsel.

In FY 1994 the OIG received supplemental funding of $2.5 million, to remain available until expended, and $500,000 from the President's "Unanticipated Needs Account." These funds were to be specifically targeted at disaster fraud. The OIG prepared a management plan for the use of these funds, a copy of which is attached to the formal statement (Office of Inspector General Disaster Plan) which, with your permission, I would like to submit for the record. I will cover various aspects of this plan as I summarize what the OIG is doing in our investigative, audit, and inspection activities to detect and deter fraud in the Disaster Assistance program and to assist the Agency in improving its program management in times of national disasters.

INVESTIGATIONS

Beginning with Hurricane Hugo in 1989, Disaster Assistance program fraud referrals, and the concomitant demands on investigative resources, have been steadily rising. From 1986 through 1989, the share of investigative resources allocated annually to the Disaster Assistance program was approximately five percent; however, in the past five years, the percentage of resources used in response to Disaster fraud referrals has risen to the current level of 22 percent. This significant increase in fraud referrals is the result of unprecedented loan activity stemming from disasters such as Hurricanes Hugo, Iniki, and Andrew; civil disturbances, mudslides, and wildfires in Southern California; floods in the Midwest, Southern Georgia, and Texas; and the earthquakes in Loma Prieta and Northridge, among many other, less publicized, disasters. Figure 1 below depicts the number of disaster loans made in each fiscal year from 1990 through 1994.

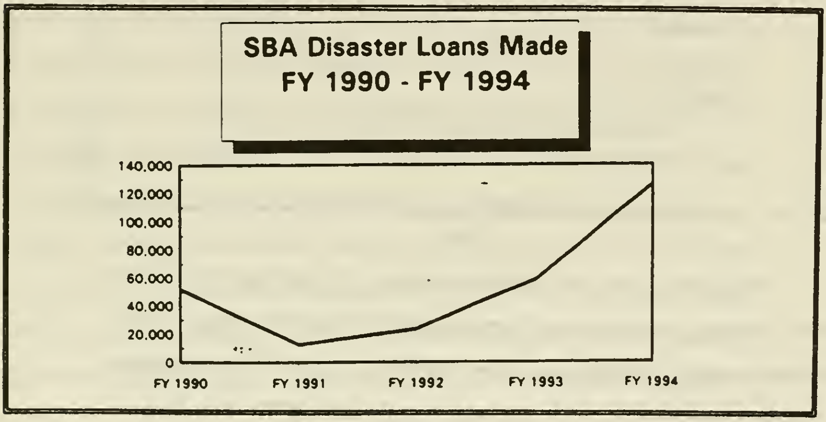


Figure 1

Since 1990, the OIG's Investigations Division has initiated 148 criminal investigations involving 533 subjects and approximately $64 million in potential losses from disaster loans, which includes over $7.5 million to date in FY 1995. Figure 2 below identifies potential dollar losses from fraud in each fiscal year. As the result of our efforts to date, 76 individuals have been indicted and $5.3 million has been recovered through court-ordered restitution, fines, or savings. Our current inventory consists of 65 active cases, involving 414 subjects and $45 million in potential Government losses.

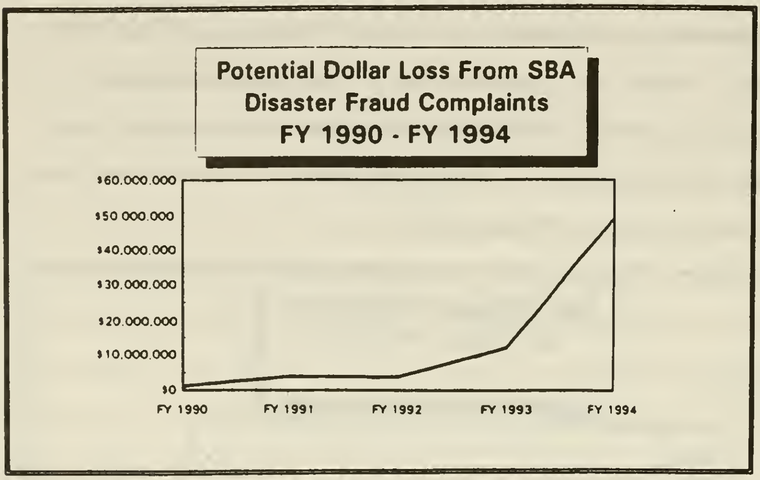


Figure 2

These statistics reflect the most significant increase in fraudulent activity in any of SBA's programs in the past decade. There are a number of factors that account for the dramatic increases in fraud referrals. These include the large number of loan applications received by the SBA during the past five years; the scope and magnitude of the major disasters, particularly the Northridge earthquake; the time constraints on loan approvals; the apparent increase in the number of unscrupulous "loan packagers"; and the use of false tax returns as a scheme to defraud the Government. Disaster Assistance employees, most of whom are temporary hires, are placed in extremely chaotic situations and are charged with obtaining loan information and determining repayment ability from individuals who may have little or no documentation or other necessary information as a consequence of the particular disaster. These program management problems are further compounded by the large volume of applications received and processed in the prescribed time periods of 7-20 days. These factors clearly increase the vulnerability of the loan approval process because the Agency is unable to do a more complete analysis of the loan applications. Consequently, we are finding more unscrupulous individuals are attempting to take advantage of the situation.

The OIG has identified two situations which have had a significant impact on the number of fraud cases stemming from disasters. The first situation involves the use of falsified copies of Federal income tax returns which are submitted as part of the loan application package. This scheme was initially discovered in Southern California in 1992 and has proven to be the largest single method used to defraud the Agency in the history of the Disaster Assistance program. Over 50 percent of our open investigations in this program contain allegations of false tax return submissions. The Inspector General brought this problem to the attention of the SBA Administrator in a Program Vulnerability Memorandum in June 1993. In October 1994 the Administrator implemented the Tax Return Verification Program requiring verification of tax return information submitted with loan applications in all of SBA's lending programs. The tax verification program has received outstanding cooperation from the Internal Revenue Service and has significantly reduced the number of referrals that include allegations of false tax returns in loan applications.

Another disturbing trend identified by investigators has been the marked increase in false applications being prepared by "loan packagers"; that is, individuals who provide assistance to loan applicants for a fee. Unscrupulous packagers are skilled at preparing fictitious financial statements, tax returns, and other false documentation that can result in improper loan approvals and disbursement of public funds. The primary problem for the Agency and the OIG is that these individuals frequently package many fraudulent applications, thereby substantially increasing the potential loss to the Government. One example of multiple false applications involves Faramarz and Fariborz Javidzad, two brothers who specialized in packaging disaster loans in Los Angeles. To date our investigation in this case has resulted in the indictment of both brothers and 17 of their clients for the submission of false loan applications to the SBA totaling more than $7 million. Faramarz Javidzad is awaiting trial; Fariborz Javidzad is currently a fugitive, believed to be in Iran; and all 17 of their clients have pled guilty. The investigation has identified approximately 130 additional applications that will have to be examined, representing claims for over $30 million in disaster funds. This investigation was opened following the receipt of an anonymous complaint. Through our coordination with officials of the Disaster Assistance Area 4 Office, we learned they were preparing a referral to the OIG concerning a pattern they had uncovered linking a number of similar loan files.

Dishonest loan packagers pose a particularly serious threat to the integrity of the SBA's lending programs. Currently, there are no Federal registration, certification, or licensing requirements; no minimum qualifications; no educational or experience standards;

and no ethical code of conduct applied to individuals who accept fees for assisting SBA applicants. The existing regulations pertaining to the disclosure of the packager's identity and fees paid by the loan applicant are largely ignored by the packager. We have seen some situations where the fees charged for preparing a loan application were as high as 40 percent of the loan. Moreover, while the SBA has no master listing of individuals who actively package loans and cannot estimate the number of packagers presently operating, the Disaster Assistance program maintains listings in individual area offices. Given this situation, the public is vulnerable to abuses by loan packagers, ranging from excessive fees to outright fraud. The OIG has already been instrumental in prosecuting three individuals for defrauding SBA applicants by demanding fees for the preparation of a loan application and failing to submit the application to the SBA. These individuals were convicted under state fraud statutes because there is no Federal law prohibiting an individual from misrepresenting himself/herself as a packager or defrauding applicants through the SBA loan process. Without some formal means of registration or licensing, such abuses will surely continue because, currently, there are no available Federal sanctions to prevent individuals from purporting to be loan packagers for SBA. For example, one of the three individuals convicted under state law is currently packaging SBA loans in another state.

In FY 1994, in response to publicity surrounding the indictment of several loan packagers and applicants in both the Disaster Assistance and Business Loan programs, the SBA Administrator created a task force to present recommendations on regulating the packaging industry. To date, there have been no recommendations submitted by the task force; however, the Administrator has recently urged the task force to move forward on this initiative.

Other OIG efforts to reduce fraud in the Disaster Assistance program include the development of a specialized course designed to train Disaster Assistance employees on how to identify fraud indicators in loan applications. This course was developed by our Investigations Division in response to the significant increase in fraud referrals over the past five years and a recommendation made at the conclusion of a 1993 inspection of the Disaster Assistance program conducted by our Inspection and Evaluation Division. The course has received strong support from Disaster Assistance management and has been effective in assisting their personnel in recognizing potential fraud in the loan process. We feel that this training is working as demonstrated by the fact that 61 percent of the referrals resulting in case initiations are received from employees. Other initiatives include the development of a fraud poster that features the OIG Fraudline number for display at all Disaster Assistance sites and field offices; generation of mass media publicity on criminal indictments and prosecutions to promote deterrence; and use of the civil remedies available under the False Claims Act in those cases not accepted for criminal prosecution by the Department of Justice. Our fraud poster, coupled with the publicity generated from successful cases, has been exceptionally effective in identifying additional fraud in the program. Fraud referrals from private citizens are responsible for 17 percent of all the cases initiated in the Disaster Assistance program; this is the highest percentage of case referrals received from private citizens across all of SBA's programs.

The OIG has also received exceptional cooperation from both senior management and employees in the Disaster Assistance program. They are very involved in our efforts to detect and deter fraud. In Sacramento, for example, they have created a special section, consisting of a senior attorney and two assistants, who are responsible for evaluating and preparing case referrals to the OIG's Los Angeles office. In the past two years, this group has referred over 100 files to the OIG, resulting in the indictment of 25 individuals. Disaster Assistance program officials have also worked closely with the OIG's Office of Security Operations to ensure that appropriate background investigations are completed on all temporary Disaster Assistance employees, thereby maintaining a high level of internal integrity in the program. As a result, while there have been over 10,000 employees hired to work various disasters in the past five years, only three individuals have been convicted for criminal acts relating to their employment.

As outlined in the OIG Disaster Plan appended to this written testimony, the Investigations Division has hired five criminal investigators, using temporary appointment authority, to help existing staff handle the ever-increasing workload. Two of the temporary agents have been assigned to Atlanta where they are responsible for investigations in the southeastern and southwestern sections of the country. Three agents have been assigned to Los Angeles to focus on the disasters in California and other western states. As stated above, Disaster Assistance cases now command 22 percent of our investigative resources, and we expect this figure to increase over the next three years as some of the loans approved from 1989 through 1993 begin to default. Historically, fraud referrals increase when the loans reach the liquidation stage due to the identification of schemes including misuse of proceeds, conversion of collateral, and other post-application fraud. The SBA estimates over 11,000 cases will go into default in Southern California alone.

AUDITING

As part of its contribution to the OIG Disaster Plan, the Auditing Division placed two auditors in Los Angeles in June 1994. Initially, these resources were used in support of ongoing fraud investigations. A number of computer data bases were established to provide needed evidentiary information to support cases which were ultimately prosecuted by the U.S. Attorney's Office. In addition, at the request of the SBA Administrator, our auditors, with the cooperation of the Disaster Assistance program's loss verifiers, completed a study to determine the validity of applications submitted 10 months after the Northridge earthquake. The report concluded that these applications were based on actual damages and there were a number of legitimate reasons for the delay in submitting applications. In some cases, however, the delay in filing made it difficult to determine precisely if the damages were caused by the Northridge earthquake.

Under the OIG Disaster Plan, a total of seven auditors are dedicated to analysis of both known and potential problem areas in the Disaster Assistance program. Four auditors have been assigned to Los Angeles, two to Atlanta, and one to Headquarters. To assure effective accomplishment of all Disaster Assistance audit work, the supervision of these audits has been placed with the Auditing Division's Director of Field Operations.

Auditors in Los Angeles are focusing on loans in liquidation to determine whether there were preventable reasons why they defaulted. In Los Angeles, the liquidation workload has exploded from 77 loans in all of 1992 to over 1,000 for the first six months of FY 1995. As stated above, this workload is expected to grow tenfold. OIG audits will consider defective loan origination by SBA, improper use of funds by borrowers, possible fraudulent statements, and other systemic weaknesses. The expected results should include both case referrals to the OIG Investigations Division and recommendations to program managers for systemic improvements.

In Atlanta, an audit survey has just begun. The review will include documentation of policies and procedures and testing of transactions. This will serve as the basis for more detailed audits and further recommendations for improvements. Auditors will also conduct computer analyses of disaster data base information to identify unusual conditions for further study. The first analysis will be a computer matching routine to identify misstatements of income for California disaster loan borrowers.

INSPECTION AND EVALUATION

In December 1992, the OIG Inspection and Evaluation Division issued a report which, among other things, identified the extent, types, and characteristics of fraud in the Disaster Assistance program. The conclusions were based on an analysis of the 29 files of criminal investigations of disaster loans that were active in 1991. Although our 65 current active cases reflect a more systematic and organized attempt at defrauding the Federal Government than was present at the time of our study, we believe that the conclusions from the 1992 report are suggestive of the characteristics of current cases involving individual, non-organized fraud. Of the 29 files, 27 involved fraud committed by borrowers, 1 by a temporary loan officer, and 1 by an SBA contractor who was involved in liquidating loans. The most common types of fraud perpetrated on SBA were falsification of documents (25), misuse of loan proceeds (11), and nondisclosure of criminal records (7). The 27 investigations of borrower fraud covered 30 loans. Of these, 13 were business physical-damage loans, 12 were home loans, and 5 were business economic injury loans.

Based on further review of the 12 criminal investigation files that were closed in 1991, our office found that in one-third of them, loan officers or loss verifiers could have detected the fraud before the loans were made by recognizing certain "red flags." At the time of our study, training for loan officers and loss verifiers did not include instruction in fraud prevention. We recommended, therefore, that the Office of Disaster Assistance provide formal training in fraud prevention to all loan officers and loss verifiers. As noted above, our Investigations Division has developed a training course in Fraud Prevention with successful results.

At the time of the OIG study, SBA lacked the electronic capability of detecting disaster loan applicants who had defaulted on prior SBA loans and were, therefore, ineligible for disaster loan assistance. Furthermore, Agency program offices collected and recorded borrower data incompletely, e.g., by business name only without including the name(s) of the principal(s), resulting in partial and often inconclusive manual checks of loan applicants' SBA credit histories.

In December 1993, the Agency upgraded its computer capability to allow loan officers to query SBA's loan accounting database of previous loan recipients and related parties using business name, principal or guarantor name, social security number, or employer identification number. In addition, searches may be qualified by state, region, SBA servicing office, taxpayer identification number, or zip code. Yet, because the various lending programs across SBA are not required to record uniform information on loan borrowers at the time loans are originated, the system can not reliably detect previous borrower defaults. It is our understanding, however, that the Office of Financial Assistance plans to require its lending programs to enter uniform information on loan borrowers and related principals of the borrowing entity at the time SBA purchases their loans due to default. We believe that the Office of Financial Assistance should expedite its plans to enable the Agency to prevent ineligible loan assistance more effectively.

The OIG inspection also looked at disaster loan delinquency rates[1] across the three disaster loan programs. From October 1, 1987, through December 31, 1991, overall, business economic injury loans had the highest delinquency rate at 10 percent, business physical-damage loans had the next highest at 7.9 percent, and home loans had the lowest, at 6.5 percent.

In addition, we examined whether loan making procedures for business economic injury disaster loans adequately protect the Government's interest. A detailed examination of the underwriting of a limited number of these loans being serviced in one SBA district office illustrated potential program vulnerabilities. These included loans made to borrowers who, in our opinion, were unable to repay and loans made for higher amounts than appropriate. Most of these problems could have been alleviated with more thorough and discerning reviews of the loan underwriting by supervisory loan officers.

Finally, we looked at the frequency with which home loan borrower claims were unreasonable and/or excessive. I am pleased to report that we found that loss verifiers were doing reasonably well in ensuring that borrowers' claims fell within personal property loss verification guidelines. Our analysis of a statistical sample of home loans revealed that just

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[1] We defined delinquency as 60 days past due or in liquidation. We chose to measure program performance by delinquency rates, rather than loss rates (as SBA uses), because we believe delinquency rates--which represent much more current performance--are a more valid measure of recent program performance than loss rates, which cannot be accurately computed until at least four or five years after the loans were made.

4.5 percent of SBA's delinquent home loan borrowers[2] received loans for personal property loss claims that exceeded the maximum allowed by the guidelines.

As outlined in the OIG Disaster Plan, our Inspection and Evaluation Division plans to assess SBA's readiness to handle the exceptionally heavy volume of loan defaults and liquidations anticipated during the 1997-2000 timeframe as a result of the Northridge earthquake, the Los Angeles civil disturbances of 1993, and the California fires and floods.

Mister Chairman, this concludes my formal testimony. I would be happy to answer any questions the Subcommittee Members may have.

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[2] We sampled 213 of the 3,209 loans approved after September 30, 1987, and delinquent as of December 31, 1991.

U.S. Small Business Administration
Washington, D.C. 20416

OFFICE OF
INSPECTOR GENERAL

Date: December 30, 1994

To: Philip Lader
Administrator

From: James F. Hoobler
Inspector General

Subject: OIG Disaster Plan

In April 1994, OMB made $500,000 available to the OIG from the President's "Unanticipated Needs Account" in Funds Appropriated to the President by Public Law 103-211, the Emergency Supplemental Appropriations Act of 1994. Congress subsequently enacted Public Law 103-317, a supplemental appropriation that provided, among other things, additional funds for the Small Business Administration's (SBA) disaster loan program. In September, at the request of then SBA Administrator Erskine Bowles, OMB apportioned $2.5 million of these funds to the Office of Inspector General (OIG) for audits and reviews of disaster loans and the disaster loan program. This Congressional action has resulted in a total of $3 million in supplemental funds becoming available to the OIG for disaster activities.

To provide for the optimal use of these resources, we have prepared a formal management plan setting forth OIG audit, inspection, investigation, and management and legal counsel initiatives. This blueprint incorporates and builds upon the provisions of the original plan (for the use of the $500,000) that I prepared in July 1994. Briefly, our audit objectives are to: make recommendations for improving procedures and management controls against fraud, identify potentially fraudulent applications and loans, and provide technical assistance to SBA's disaster loan automation project. Our inspection objectives are to: estimate the volume of likely disaster loan defaults and liquidations and make recommendations to assist SBA in managing this workload. Our investigative objectives are to: provide deterrence by detecting and prosecuting fraud, recognize trends (or patterns) and identify organized instances of fraud, provide fraud awareness training to disaster employees, report any weaknesses found in the disaster assistance delivery system to appropriate program managers, and improve screening processes for disaster loan applications. Our management and legal counsel objectives are to: pursue civil and administrative actions involving false statements or claims for disaster loans, and provide management and support services for all OIG disaster initiatives. A more detailed plan is enclosed for your information.

I trust that this information will be useful to you and truly appreciate your continuing support of our efforts. I will be transmitting copies of this plan to OMB and our Congressional oversight committees.

Attachment

SBA OFFICE OF INSPECTOR GENERAL
PLAN FOR UTILIZATION OF SUPPLEMENTAL APPROPRIATION
FOR DISASTER ASSISTANCE ACTIVITIES

Background

On August 26, 1994, Congress enacted Public Law 103-317, a supplemental appropriation that provided, among other things, an additional $470 million for the Small Business Administration's (SBA) disaster loan program. These funds were made available in recognition of the extensive need for additional funds to respond to the Northridge earthquake; the floods caused by Tropical Storm Alberto in Georgia, Alabama, and Florida; and other disasters (including the wild fires in the west), as well as associated administrative expenses. This measure also included language specifically authorizing the transfer of up to $2.5 million in funds to the Office of Inspector General (OIG) for audits and reviews of disaster loans and the disaster loan program. On September 1, 1994, at the request of the SBA Administrator, the Office of Management and Budget apportioned $2.5 million to the OIG for disaster activities. These funds are available until expended.

Earlier, on April 30, 1994, OMB approved an allocation of $500,000 to the SBA OIG from the President's "Unanticipated Needs Account" in Funds Appropriated to the President by Public Law 103-211. These funds were provided to the OIG to support fraud detection and deterrence activities in Los Angeles in the wake of the Northridge earthquake and to minimize opportunities for illegal activities and abuse in SBA's disaster loan program.

In summary, a total of $3 million in supplemental funds became available to the OIG in FY 1994 for disaster activities. To provide for their optimal use, we prepared a formal management plan in July 1994 setting forth OIG audit and investigative objectives for the $500,000 allocation (copy attached). With the additional appropriation of $2.5 million, we have developed a new plan that incorporates the provisions of the original plan and includes new or expanded audit, investigative, inspection, and management and legal counsel initiatives.

Disaster Loan Program

The need for increased OIG attention to the disaster loan program arises with a series of five major disasters in California and the southeastern United States, culminating with the Northridge earthquake of 1994. Before Northridge, SBA had made 74,174 disaster loans totaling $1.9 billion through March 1993 for four major disasters:

Year	Disaster	Loans	Amount
1989	Loma Prieta earthquake	15,472	$ 583,658,000
1989	Hurricane Hugo		
	North Carolina	481	6,495,100
	Puerto Rico	12,208	118,146,500
	South Carolina	8,717	199,794,500
	Virgin Islands	5,762	166,749,400
	Total	27,168	$ 491,185,500
1992	Los Angeles civil disorders	5,596	334,268,800
1992	Hurricane Andrew		
	Florida	23,330	652,895,200
	Louisiana	2,608	39,510,300
	Total	25,938	$ 692,405,500

In the first seven months following the Northridge earthquake, disaster loan applications have been filed at record levels. Based on prior ratios of acceptance and approval of loan applications, this disaster is expected to generate 100,000 loans totaling more than $4 billion, making it SBA's largest single disaster assistance effort several times over. SBA's response to the Northridge earthquake alone will exceed SBA's total disaster loan making activity for the prior three years.

The Northridge disaster has strained SBA's delivery system to the limit. The control environment for the disaster loan program has built-in vulnerabilities due to time pressures and the temporary nature of the organizational configuration. It is necessary to make disaster loans quickly, and public criticism is quick to arise when SBA's response times are perceived as being too slow. Whereas SBA managers see 30 days as an optimal loan processing period, public pressure has resulted in the current 7-day goal. Consequently, high level management changes were made in California when backlogs pushed the average response time above 50 days. Production standards continue to be emphasized and posted prominently; they are also used to conduct weekly performance reviews of all disaster employees.

SBA maintains a skeleton staff of trained disaster assistance professionals; this staff serves as the core for an ad hoc delivery system which is dependent upon temporary employees for each major disaster. In Disaster Area 4 (the 13 western states and the Pacific Islands), there were 350 employees on-board before the Northridge earthquake. In May 1994, there were 3,000 employees in California alone.

Loans made during this surge of disasters were made with a delivery system that is long overdue for modernization. An SBA task force that included a representative of the OIG Auditing Division studied the current manual processing procedures in the summer of 1994. The Associate Administrator for Disaster Assistance also initiated the Disaster Loan Activity Modernization Project (DLAMP) to assess total automation of the loan process. DLAMP consists of 10 tasks to be completed before April 1995. The tasks include technological review of automating disaster loan making, a requirements study, a cost-benefit evaluation, and an implementation plan. A decision paper is to be given to the Administrator by April 28, 1995.

Current OIG Disaster Initiatives

With the additional resources provided by Congress, the OIG will undertake several audit, investigative, inspection, and support initiatives to address the growing disaster loan portfolio and accompanying financial risk to the Government.

Audit Initiatives

Our auditing objectives will be:

- Make recommendations for improvements in procedures and management controls to combat fraud.
- Identify potential fraudulent applications and loans and refer them to the OIG's Investigations Division.
- Provide technical assistance to the ODA automation project to assure the inclusion of proper management and fiscal controls and to provide an adequate audit trail.

The Auditing Division placed two auditors in Los Angeles in June 1994 after OMB funding became available for OIG disaster activities. With the supplemental funding subsequently provided by Congress, five more auditors will be added to the staff (two in Los Angeles, two in Atlanta, and one at the Auditing Division's headquarters in Washington, DC.). The auditor assigned to headquarters will have ADP auditing expertise, be primarily responsible for technical support to DLAMP, and be capable of retrieving and analyzing information in SBA's computerized databases to support the line auditors. This additional audit staff will permit more complete implementation of the disaster auditing plan developed in June and afford technical assistance to ODA management in developing new systems.

Given the scale of the Northridge earthquake, seven auditors will still be insufficient to provide comprehensive audit coverage of a program this large. The OIG will therefore leverage its audit resources by reviewing system controls and identifying vulnerabilities that should be the focus of further OIG audit attention. This review will include:

- Review of management controls. This review will include documentation of policies and procedures and testing of transactions to determine actual practices and identify weaknesses.

- Review of OIG Investigations Division cases. This review will cover 20 cases to provide assistance in building evidence and to identify systemic problems for further study.

- Review of the characteristics of defaults. Defaulted disaster assistance loans are transferred from loan servicing offices to SBA District Offices for liquidation. Because of the flurry of major disasters in recent years, workload in the Liquidation Branch in the Los Angeles District Office is currently four times greater than normal levels and is expected to increase. We will review current and past defaults for trends that indicate systemic weaknesses and fraudulent applications, as well as identify individual cases of fraud for subsequent referral to the OIG's Investigations Division.

- Conduct computer analyses to identify the extent of out-of-range conditions and aberrant values for further review. We will explore the feasibility of computer matching routines to identify misstatement of incomes. (About two-thirds of disaster loan rejections are based on lack of repayment ability, so applicants have an incentive to overstate their income; there is also an incentive to understate income to qualify for FEMA grants.)

After completion of these reviews, the Auditing Division will look at selected topics for further work. Possible topics include:

- False statements on income;

- Adequacy of loss verification procedures to prevent overstatement of applicant losses;

- Use of proceeds to determine whether funds were used to restore property to its condition before the disaster.

(According to the Small Business Act, the penalty for misusing disaster funds is immediate repayment of 1.5 times the original amount of the loan);

- Adequacy of procedures for extending payments. Some Northridge Earthquake victims held SBA loans from previous disasters; an extension of payments on the prior loans is being offered, increasing the Government's risk; and

- Adequacy of procedures to preclude borrowers from disappearing.

Performance measures for disaster auditing will include the number of referrals to the Investigations Division, the amount of potential savings, the number and quality of recommendations for improvement, and the number of OIG cases pursued or referred to other law enforcement agencies where audit assistance was critical to the formulation of the case.

Inspection Initiatives

Our inspection objectives will be:

- Develop an estimate of the volume of likely disaster loan defaults and liquidations.

- Assess SBA's ability to manage this workload and make recommendations to assist Agency program managers.

The Inspection and Evaluation Division will develop and oversee a comprehensive study of SBA's readiness to handle the exceptionally heavy volume of loan defaults and liquidations anticipated during the 1997-2000 timeframe as a result of the Northridge earthquake and Los Angeles civil disturbances of 1993. Under a contract managed by the Inspection and Evaluation Division, independent consultants with expertise in management analysis and experience in disaster planning and/or related fields will prepare estimates of the magnitude of the problem and assess SBA's ability to handle it. The study will be completed by the end of FY 1996, in time to be of assistance to SBA managers responsible for planning for the expected surge in defaults and liquidation tasks.

Performance measures will include the thoroughness of data collection, the quality of data, the timeliness of delivery, and the suitability of recommendations for improved management of loan defaults and liquidations.

Investigation Initiatives

Our investigative objectives will be:

- Provide deterrence through the detection and prosecution of fraud against the SBA.
- Share knowledge with Auditing Division to recognize trends or patterns and to identify organized instances of fraud.
- Provide fraud awareness training to disaster employees.
- Report systemic weaknesses within the disaster program by preparing Program Vulnerability Memoranda (PVM) from the Inspector General to the Associate Administrator for Disaster Assistance.
- Improve screening processes for disaster loan applications through technological improvements.

The Investigations Division currently has 62 open investigations involving fraud in the disaster program and is opening approximately 4 cases per week as we continue to receive referrals from disasters reaching back to Hurricane Andrew and the civil disturbances in Los Angeles. This is the largest inventory of disaster cases in the history of the OIG and represents over $11.6 million in Government funds at risk. Based on current case activity, we anticipate that the cases in the disaster program will require a substantial amount of investigative resources as referrals develop from the Northridge earthquake; the recent floods in Georgia; and less publicized disasters in South Carolina, Wisconsin, Ohio, and other states.

The effect of this workload is demonstrated by the rapidly increasing percentage of investigative time being allocated to the disaster program. At the beginning of FY 1994, we had projected that six percent of available resources would be spent on disaster investigations. At the end of the fiscal year, however, we were using about 20 percent of our resources in this program. This dramatic increase in our time is even more remarkable considering our efforts to leverage the resources of other agencies such as the FBI, Secret Service, Postal Service, and FEMA to assist in conducting these investigations.

To meet the increased disaster caseload, we hired three investigators in FY 1994, using the supplemental funds made available for this purpose. We plan to hire two more investigators in FY 1995, bringing our total complement to five special agents assigned exclusively to disaster investigations (three in Los Angeles, two in Atlanta). Even with this additional staff, the volume of cases will continue to require a substantial amount of time from other agents, thus reducing our ability to pursue cases in our larger programs, i.e., Section 7(a) business loans, Section 8(a) minority enterprise development, and Small Business Investment Companies. The offices most directly affected by these demands will be Atlanta and Los Angeles; these OIG offices have the highest inventories of regular cases as well as the majority of the disaster referrals. As a result, we estimate that we will devote the equivalent of one full investigative staff year (in addition to the five agents assigned exclusively to disaster cases) to disaster investigations. We anticipate that this level of effort will continue for the life of the disaster project; accordingly, we are funding the salary of one investigator, at our average grade level, from the disaster allocation.

We also feel it is imperative to address the fraud issue at the beginning of the loan process through more effective screening of applications to identify potentially false statements. We are exploring the feasibility of using existing technology to provide effective and timely checks on criminal histories and Social Security numbers.

In carrying out our objectives, the Investigations Division will:

- Meet with OIG auditors on a biweekly basis to discuss ongoing investigations and audits and share ideas.

- Focus investigative resources on those cases with the highest potential for prosecution and maximum dollar recovery.

- Maintain close working relationships with local SBA disaster officials and keep each other apprised of investigations, including trends, patterns, or systemic weaknesses identified.

- Coordinate with U.S. Attorneys' offices to ensure that resources are not consumed on cases with little prosecutive or recovery potential and that appropriate publicity is received from prosecution cases.

- Determine, through contact with the Civil Division of U.S. Attorneys' offices, the criteria for cases meriting civil action and be alert to referrals meeting those standards.

- Acquire and implement an automated system to conduct FBI name and fingerprint checks on disaster loan applicants.

Under our present manual system of conducting these criminal history checks, over 90 percent of applicants for disaster loans are not checked for criminal histories due to the inordinate amount of time it takes to process the paperwork. Because of the Agency mandate to process loans in a 7-14 day period, the current system became an irrelevant process as funds were disbursed before the results of the background check were received.

The FBI assures us that, using the available technology, both the turnaround time and costs of the criminal history checks will be reduced significantly. This will allow us to conduct more checks in a timely fashion and further reduce the vulnerability to fraud. We estimate the cost of the equipment, software, installation, and training will be $10,000; the system should be operational by January 15, 1995.

Performance measures for investigations will be the number of indictments and convictions, civil recoveries, administrative declinations of loans, court-ordered restitutions, and disaster assistance program weaknesses reported through the filing of PVMs.

Management and Legal Counsel Initiatives

Our management and legal counsel objectives will be:

- Pursue civil and administrative actions involving false statements or claims for disaster assistance.

- Provide expert management planning and support services for all OIG disaster initiatives.

One attorney will be hired under the special allocation to work closely with the Investigations Division in identifying and coordinating the prosecution of non-criminal actions involving fraud in the disaster assistance program. All management support activities will be handled by existing OIG staff. In carrying out our objectives, the Management and Legal Counsel Division will:

- Provide planning, budget, procurement, staffing and recruitment, and ADP services in hiring and supporting new OIG staff under the disaster initiatives outlined in this plan;

- Review Investigations Division case inventories for potential candidates for civil and administrative action;

- Coordinate civil and administrative actions with U. S. Attorneys and SBA program officials as appropriate; and
- Develop a brief bank of model pleadings and precedent cases for disaster assistance cases.

The Investigations Division has a large number of disaster assistance cases (75-100 active and closed cases) in its inventory. Many of these cases have been or will be declined for criminal prosecution because there has been no loss to the Government or the amounts involved are too low to meet prosecutorial thresholds. Successful civil or administrative actions could, however, be initiated against individuals who made false statements in their loan applications; such actions would be brought under the administrative penalty provision of SBA's disaster loan program, the Program Fraud Civil Remedies Act, or the False Claims Act. In such instances, the false claim or statement is sufficient to establish liability; no loss to the Government need be shown.

The attorney hired under this appropriation would be responsible for developing a model program to initiate civil and administrative litigation in appropriate disaster cases around the country. This will be a new initiative for both the SBA and the OIG, which have previously lacked the staff resources to systematically pursue these remedies against disaster loan applicants.

Executive program direction and management support for all OIG disaster initiatives would continue to be provided by current staff. With the extraordinary growth of the disaster assistance program, OIG managerial staff has devoted a significant amount of time to planning, managing, and directing these initiatives. Substantial staff time and resources have also been devoted to recruitment, budget planning and execution, procurement, and facilities management activities in support of OIG disaster activities. We anticipate that a similar level of executive management support will continue for the life of the disaster project; accordingly, we are funding six percent of the salaries of these employees from the disaster allocation.

Performance measures will include the timeliness and effectiveness of management support services, the number of successful civil and administrative actions prosecuted, and dollar recoveries.

Funding and Resources

We anticipate that, with prudent management, the $3 million in funding provided to the OIG by the two supplemental disaster appropriations will enable us to fund the initiatives described above through the first quarter of FY 1998. In summary, these resources will fund the following:

- Seven auditors (two hired in FY 1994),
- Five investigators (three hired in FY 1994),
- One attorney,
- Other direct investigative staff time devoted to disaster cases,
- Consulting contract to assess disaster loan defaults and liquidations,
- Equipment and software to automate the name and fingerprint checks of disaster loan applicants, and
- Executive direction and management support for OIG disaster initiatives.

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