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Congress of the United States

U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515–6315

To: Members, Committee on Small Business
From: Committee Staff
Date: July 3, 2015
Re: Full Committee Hearing: "*The Calm Before the Storm: Oversight of SBA's Disaster Loan Program*"

On Wednesday, July 8, 2015, at 11:00 am in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet for the purpose of providing oversight of the Small Business Administration's (SBA's) Disaster Loan Program. The hearing will examine challenges faced by the SBA in response to Hurricane "Superstorm" Sandy, including a discussion of a September 2014 report by the Government Accountability Office (GAO), as well as a discussion of the SBA's implementation of the Small Business Disaster Response and Loan Improvements Act of 2008.

I. Introduction

According to the National Oceanic and Atmospheric Administration (NOAA), within the past ten years the United States has experienced two of its costliest storms. In August 2005, Hurricane Katrina caused an estimated cost of $125 billion (or $151 billion if adjusted for the 2015 consumer price index) in damages. More recently, in October 2012 Hurricane "Superstorm" Sandy led to damages estimated at $65 billion ($67 billion if adjusted).[1] In the aftermath of a disaster, the federal government has several financial assistance programs to help homeowners, renters, and businesses of all sizes recover and rebuild. Immediate disaster assistance is led by state governments along with assistance from the Federal Emergency Management Agency (FEMA). Longer term recovery is spearheaded by the SBA, which offers subsidized loans with terms of up to 30 years to borrowers who have incurred uninsured physical losses as a result of a disaster. These loans help disaster victims pay for the cost of replacing, rebuilding, or repairing property damaged by disasters.

According to reports by the GAO, it appears that the SBA mismanaged the disaster loan program after Katrina, and again during Sandy recovery efforts.[2] Following Katrina, the SBA

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[1] https://www.ncdc.noaa.gov/billions/events.pdf. Please note this is a modest estimate as the Economics and Statistics Administration estimated in New York and New Jersey alone it would cost nearly $80 billion to rebuild the infrastructure, homes, and businesses. ECONOMICS AND STATISTICS ADMINISTRATION, UNITED STATES DEP'T OF COMMERCE, ECONOMIC IMPACT OF HURRICANE SANDY 4,7 (2013).

[2] Please note that this memorandum will not discuss the GAO report on Hurricane Katrina in depth. For a more comprehensive discussion of that report please see the Committee's hearing memorandum on *Disaster Assistance: Is SBA Meeting the Recovery Needs of Disaster Victims? Before the H. Comm. on Small Business*, 112th Cong. (Nov. 30, 2011), *available at* http://smbiz.house.gov/uploadedfiles/11-30_hearing_memo.pdf.

implemented a variety of measures aimed at improving its disaster response. Subsequent to those internal changes, Congress also intervened and made significant changes to the SBA's process for planning and responding to disasters in the Small Business Disaster Response and Loan Improvements Act of 2008 (SBDRLIA).[3] The SBA has not implemented some of the changes made by Congress in 2008 and GAO findings suggest that these program changes would have led to greater efficiencies in the response to Superstorm Sandy.

II. SBA Disaster Loan Programs

The SBA provides the primary financial resource for homeowners, small businesses, and small not-for-profit organizations[4] attempting to recover from a disaster. The vast majority of disaster loans are physical disaster loans (loans to replace buildings destroyed as a result of a disaster) provided to homeowners for losses not otherwise covered by either private insurance or that purchased pursuant to the National Flood Insurance Program. Small businesses also are eligible for physical disaster loans. In addition, small businesses (whether their place of business was destroyed or not) also are eligible for economic injury disaster loans (loans to cover the costs while the business and area recover).[5] A small business is limited to a maximum loan amount of $2.0 million for a combination of physical and economic injury disaster loans.[6]

Loans made under the disaster loan authority are made directly by the SBA[7] to borrowers so in this regard it is different than other SBA capital access programs. This means that application review, processing, closing, and servicing are all performed by the SBA.[8] To be eligible for this type of SBA loan, the victim suffering damage must first submit an application to FEMA to determine whether they are eligible for grant assistance. If the victim is not eligible for assistance from FEMA, their application is automatically referred to the SBA.

For the SBA to offer disaster assistance, a disaster declaration must be issued. A disaster declaration is an official notice recognizing that a specific geographical area has been damaged.[9] The importance of a declaration is that it sets forth the type of assistance available, the interest

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[3] The Act was incorporated into part of Title XII of the Farm, Conservation and Energy Act, Pub. L. No. 110-246, 122 Stat. 1651. Specifically, the Small Business Disaster Response and Loan Improvements Act of 2008 can be found in §§ 12051-12086, 122 Stat. at 2168-2185.

[4] Small not-for-profit organizations were added by § 12061 of the SBDRLIA, 122 Stat. at 2168.

[5] Businesses can obtain so-called "business interruption" insurance. To the extent that a business has such insurance, the amount of an economic injury disaster loan would be reduced by the coverage afforded under the business interruption insurance policy.

[6] Until June 18, 2008, the amount of disaster assistance awarded to small businesses was limited to a total of $1.5 million. Section 12078 of the 2008 Farm Bill increased the overall disaster loan amount to $2.0 million. That same section of the Farm Bill authorized the SBA to waive the $2.0 million cap if circumstances determined such a waiver was necessary to help resuscitate the area affected by the disaster.

[7] There are exceptions to the SBA making direct loans. In case of disasters on the scope of Hurricane Katrina, private banks may be authorized to make disaster loans at below commercial rates with the difference being paid by the federal government to the private lenders. 15 U.S.C. § 636(c). As will be discussed in further detailed later in this memorandum, the SBA has not drafted implementing regulations for two of these programs, has not used the authority for three programs, and did not use the authority despite the overwhelming number of disaster loan applications received by the agency in the days following landfall of Hurricane Sandy. Nor did the SBA call on assistance from private enterprises to help the agency process the loans after Hurricane Sandy.

[8] 13 C.F.R. § 123.16.

[9] *Id.* at § 123.2.

rate, and the eligible recipients. Only victims located in the designated geographical area are eligible for assistance.[10] Unless otherwise noted, this memorandum will be addressing assistance available after a Presidential Disaster Declaration made pursuant to the Stafford Act authorizing federal assistance including individual assistance.

After a major disaster, the governor of the affected state is responsible for requesting that the President of the United States issue a disaster declaration.[11] By requesting a presidential disaster declaration, the governor is affirming that assistance is beyond the capability of the state to adequately respond and that federal intervention is required.[12]

Notably, not all individuals located in a declared disaster area are eligible for an SBA disaster loan. Congress prohibits the SBA from lending to people not legally in the country, people who have not filed tax returns (or owe the federal government back taxes), or are not current on child support payments. Since the assistance provided by the SBA is a loan, SBA is required to reject any loan applicant who, in the agency's determination, is unlikely to have the resources to repay the loan; otherwise it would turn a loan program into a government grant program. There are three types of disaster loans offered by the SBA – Physical Disaster Home Loans, Physical Disaster Business Loans, and Economic Injury Disaster Loans (EIDL).

A. Physical Disaster Home Loans

Homeowners who suffer damage in a geographic area designated by the disaster declaration are eligible for loans of up to $200,000 to restore or replace their primary residence to the condition before the disaster occurred.[13] Loan proceeds may not be used to make improvements to property except to the extent those modifications to the original structure are designed to mitigate damage from future disasters. Borrowers must demonstrate to SBA that they are creditworthy, have sufficient character, and have the ability to repay the loan.[14] Borrowers are also required to pledge collateral for loans over $14,000.[15] The interest rate on the loan is based on whether the borrower has credit available elsewhere. If a borrower has no credit available elsewhere, the interest rate is capped at a maximum of four percent and if the borrower does have credit available elsewhere, the interest rate is capped at eight percent.[16]

B. Physical Disaster Business Loans

Business owners suffering damage in a declared disaster area also may apply for assistance from the SBA of up to $2 million.[17] Business assistance is not limited to small businesses; businesses of all sizes are eligible for SBA disaster loans.[18] Like the home loan, the

[10] *Id.* at § 123.4.
[11] 42 U.S.C. § 5170.
[12] *Id.*
[13] *Id.* at § 123.7.
[14] *Id.* at § 123.6.
[15] *Id.* at § 123.11.
[16] *Id.* at § 123.104.
[17] *Id.* at § 123.202.
[18] *Id.* at § 123.200. However, given the maximum assistance available from the SBA, it is unlikely that large businesses will find the physical disaster loans will be of significant aid in their recovery from a natural disaster.

business loan interest rate is determined based on whether the borrower has credit available elsewhere. If a borrower has no credit available elsewhere, the interest rate is capped at a maximum of four percent and if the borrower does have credit available elsewhere, the interest rate is capped at eight percent.[19]

C. Economic Injury Disaster Loans (EIDL)

Businesses located in a declared disaster area which suffer an economic loss as a result of the disaster are eligible for SBA assistance irrespective of whether they suffered any physical damage to their business. Unlike Physical Disaster Business Loans, EIDLs only are available to small businesses.[20] Further, the interest rate for EIDLs is capped at four percent.[21]

III. Small Business Disaster Response and Loan Improvements Act of 2008

SBA's response following Hurricane Katrina led to Congress passing a host of reform measures in the SBDRLIA. These provisions were designed to improve disaster planning, public outreach, and capacity so that the SBA is better able to respond to future disasters. Today, over 7 years later, the SBA has still failed to implement some of those provisions. Specifically, the SBA has not fully implemented sections 12083, 12084, and 12085.

Section 12083 requires the SBA to establish and implement a Private Disaster Assistance Program. Under this section, the SBA may guarantee timely payment of principal and interest on private disaster loans issued to eligible small businesses and homeowners within an eligible disaster area.[22]

Section 12084 created the Immediate Disaster Assistance Program (IDAP) for small businesses. This program enables small businesses to receive loans under $25,000 from private banks with 85 percent of the loan guaranteed by the SBA. Businesses must otherwise be eligible to receive a disaster loan from the SBA and if the business ultimately receives a disaster loan from the SBA, it must use the proceeds to immediately pay back the immediate assistance loan.[23] The idea of the program was to let eligible small businesses get some assistance from private banks that would be able to process loans more quickly than the SBA.[24] While the SBA has issued regulations on this program, it is has not been used in response to a disaster.[25]

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[19] *Id.* at § 123.203(a).
[20] *Id.* at § 123.300(b). Specifically only businesses that do not exceed the threshold size standards set forth in the agency regulations at 13 C.F.R. § 121.201
[21] *Id.* at § 123.302.
[22] SBDRLIA, 122 Stat. at 2180- 2182, codified at 15 U.S.C. § 636(c).
[23] *Id.* , 122 Stat. at 2182-2183, codified at 15 U.S.C. § 657n
[24] It is important to recognize that the overwhelming number of loans made by the SBA after a disaster are physical injury loans made to homeowners whose property was destroyed – not to business owners. For example, after Hurricane Sandy there were approximately 73,000 applications from homeowners but only about 15,500 from business owners. The SBA processes loans on first-in first-out basis so a business owner could be behind a long queue of equally deserving homeowners.
[25] 13 C.F.R. §§ 123.700-706 and was not used in response to Hurricane Sandy.

Finally, section 12085 required the SBA to establish an Expedited Disaster Assistance Business Loan Program. Under this section, the SBA may guarantee timely payment of principal and interest for loans up to $150,000 on a short term basis of under 180 days.[26] The goal here was to provide faster access to disaster loans so that small firms could start rebuilding more quickly. As will be discussed in more detail below, the SBA has failed to implement any of these programs. Nor did the SBA declare Hurricane Sandy a catastrophic event that would have enabled the agency to retain private contractors to help process loan applications as authorized by § 12066 of SBDRLIA. The failure to implement these Congressionally-mandated initiatives may have played a significant role in reducing the SBA's effectiveness in responding to Hurricane Sandy.

IV. SBA's Disaster Preparedness Following Hurricane Sandy

The President created a Hurricane Sandy Task Force to coordinate and oversee the rebuilding efforts in the affected communities.[27] The Task Force also had responsibility to provide recommendations on ways to improve the federal response to major disasters. As a result of the Task Force's findings,[28] the SBA updated its disaster preparedness and recovery plan (DPRP).[29] The DPRP "outline[s] how SBA conducts operations in support of the national preparedness frameworks required by [the Presidential Policy Directive 8 (PPD-8)] and the National Preparedness Goal."[30] Specifically, as a result of the Task Force's findings, the SBA created a Disaster Preparedness and Operations Team (DPOT) to lead long-term recovery efforts within the SBA and coordinate with resource partners.[31]

Additionally, the SBA's Inspector General (IG) has issued two audit reports reviewing SBA's disaster loan process following Hurricane Sandy. The first report issued in August 2014 evaluated the effectiveness and timeliness of loan closing and disbursements for disaster loans issued after Hurricane Sandy.[32] The IG provided recommendations to SBA managers for improving the efficiency of disaster loan processing but found that the SBA complied with its own standards loan approval and disbursement.[33] However, the IG's most recent audit, issued in February 2015, reviewing SBA's compliance with businesses repayment ability was more critical.[34] In this report, the IG found that the SBA's methodology for determining who had

[26] Pub. L. No. 110-246, 122 Stat. at 2183-2184.
[27] Exec. Order No. 13,632, 3 C.F.R. 328 (2013).
[28] HURRICANE SANDY REBUILDING TASK FORCE, HURRICANE SANDY REBUILDING STRATEGY: STRONGER COMMUNITIES, A RESILIENT REGION 100 (Aug. 2013), *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=hsrebuildingstrategy.pdf.
[29] SBA, DISASTER PREPAREDNESS AND RECOVERY PLAN 1 (March 2014) (hereinafter DPRP), *available at* https://www.sba.gov/sites/default/files/articles/FINAL%202014%20SBA%20Disaster%20Preparedness%20Plan.pdf.
[30] *Id.* at 3.
[31] *Id.* at i.
[32] OFFICE OF INSPECTOR GENERAL, SBA, EFFECTIVENESS AND TIMELINESS OF HURRICANE SANDY DISASTER LOAN CLOSING AND DISBURSEMENT PROCESSES 1 (Aug. 2014), *available at* https://www.sba.gov/sites/default/files/oig/Audit%20Report%2014-16%20-%20Effectiveness%20and%20Timeliness%20of%20the%20Hurricane%20Sandy%20Disaster%20Loan%20Closing%20and%20Disbursement%20Processes.pdf.
[33] *Id.* at Executive Summary.
[34] OFFICE OF INSPECTOR GENERAL, SBA, SBA'S EVALUATION OF PRINCIPAL'S REPAYMENT ABILITY FOR HURRICANE SANDY BUSINESS LOANS – EXECUTIVE SUMMARY (Feb. 2015), *available at* https://www.sba.gov/sites/default/files/oig/Use_of_Principals_Income_-_Final_Report.pdf.

repayment ability was inconsistent.[35] Given this, the IG projected that the SBA did not have reasonable assurance of repayment ability for approximately $17.9 million disaster business loans.[36] The IG recommended that the SBA update its standard operating procedures (SOPs) to include guidance on analyzing repayment of business loans and ensure loan officers were using a consistent methodology[37] so all similarly situated businesses would be treated the same as required by the Administrative Procedure Act. On July 1, 2015, the SBA updated its SOPs for disaster loans; however, the Committee is not certain these updates meet the IG's recommendations.[38]

V. GAO Report on Superstorm Sandy

The Ranking Member of the Committee requested a comprehensive GAO examination of the SBA's response to Hurricane Sandy for small businesses. GAO issued its report in September 2014.[39] The GAO report examined: (1) SBA's timeliness in providing disaster assistance; (2) loan approval and withdrawal rates; and (3) SBA's implementation of loan programs required by SBDRLIA.[40]

A. Loan Processing Times

GAO found that the "SBA did not meet its timeliness goal of processing business loan applications from receipt to loan decisions within 21 days."[41] On average, it took the SBA 45 days for physical business loan applications and 38 days for EIDL applications to receive a loan decision.[42] If approved, it took the SBA an additional 66 days for physical disaster business loans and 43 days for EIDLs to close.[43] The SBA did not meet its goal because its projections did not accurately anticipate the volume of early applications which led to inadequate staffing.[44] Further, the SBA's projections did not reflect increased usage of the SBA's redesigned electronic disaster loan application system (an accomplishment hailed by then Administrator Karen Mills). This left the SBA unprepared to handle the surge of electronic applications.[45] The resulting backlog peaked in March 2013 when processing time averaged 60 days.[46]

According to the 2014 DPRP, before a declaration has been issued, the Associate Administrator for Disaster Assistance (AA/ODA) will assess the need for a surge and recommend one if a disaster is expected to generate over 100,000 applications – with the

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[35] *Id.* at 3.
[36] *Id.* 3-4. After 4 years and numerous recommendations including from the Sandy Task Force and the IG, the SBA updated its SOP on July 1, 2015.
[37] *Id.* at executive summary and 4-5.
[38] SOP 50-30-8, *available at* https://www.sba.gov/sites/default/files/sops/SOP_50_30_8_Final.pdf.
[39] GOVERNMENT ACCOUNTABILITY OFFICE (GAO), SMALL BUSINESS ADMINISTRATION: ADDITIONAL STEPS NEEDED TO HELP ENSURE MORE TIMELY DISASTER ASSISTANCE 1 (Sept. 2014) (GAO-14-760) (hereinafter Sandy GAO Report), *available at* http://www.gao.gov/assets/670/666213.pdf.
[40] *Id.* at 2.
[41] *Id.* at 15.
[42] *Id.* at 16.
[43] *Id.* at 18.
[44] *Id.* at 15.
[45] *Id.* at 19.
[46] *Id.* at 17.

Administrator making the final decision.[47] Surge policies and capabilities deserve constant vigilance because inadequate predictions continually inhibit SBA application response times. According to the GAO report, there is still room for improvement as the SBA appeared to miscalculate how and when the surge would occur in this instance.[48] Based on this finding, GAO recommended that the SBA update its disaster planning documents, particularly as it relates to early application submissions.[49]

B. Withdrawal and Loan Cancellation Rates

GAO found that "application withdrawal rates and loan cancellation rates were both higher for Hurricane Sandy than for the five previous disasters [GAO] examined."[50] For physical disaster loan applications, the approval rate was 45 percent whereas for EIDLs it was 28 percent; these rates were lower than those for Hurricane Katrina.[51] However, the withdrawal rate by either the SBA or the applicant was 32 percent. This was higher than previous disasters GAO examined with the SBA withdrawing 60 percent of those.[52] However, the 38 percent cancellation rate was primarily due to borrower's cancellation rather than the SBA.[53] GAO found that the factors leading to higher withdrawal and cancellations rates varied; but primarily included the availability of alternative sources such as insurance coverage and grants.[54]

C. Failure to Implement SBDRLIA

GAO examined the SBA's implementation (or lack thereof) of loan programs required by SBDRLIA. Initially, the SBA intended to implement IDAP first because smaller amounts of funds were at risk. Although regulations have been promulgated, IDAP's test on a pilot basis (even though the program was not created as a temporary initiative) is now almost five years past due. [55] The SBA has not yet issued regulations for the other two programs or taken any steps to begin implementing those. Given this, GAO focused on IDAP and GAO found that several businesses could have found IDAP program useful as a way to receive a short-term infusion of capital while rebuilding their business after Sandy.[56] The SBA informed GAO that its outreach with lenders indicated a lack of interest in the IDAP program; however, the SBA has not

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[47] DPRP, *supra* note 33, at 23.
[48] Sandy GAO Report, *supra* note 38, at 44.
[49] *Id.*
[50] *Id.* at 30. According to the SBA's SOP withdrawal of an application can occur at an applicant's request or by the SBA. The SBA must withdraw if they are unable to process a decision due to an incomplete or lack of a response to a 7-day loan processing letter, no-record of response from the IRS regarding a tax transcript request, or inability to verify losses. If it occurs by the SBA the agency must send a withdrawal letter which references what information is needed and the reacceptance deadline. SOP 50-30-8, at 146, *available at* https://www.sba.gov/sites/default/files/sops/SOP_50_30_8_Final.pdf. Cancellation may also occur at either the request of the borrower or by the SBA. The SBA has 7 reasons for which it may cancel and if cancelled by the SBA, they must notify the borrower by a mailed letter at least 14 days prior to the pending cancellation. This letter must specifically inform the borrower of the steps that can be taken to prevent cancellation as well as the result (cancellation of loan) if these steps are not taken. *Id.* at 156-157.
[51] Sandy GAO Report, *supra* note 31.
[52] *Id.* at 34-35.
[53] *Id.* at 36-37.
[54] *Id.* at 38.
[55] *Id.* at 39-40.
[56] *Id.* at 39.

documented its outreach or feedback.[57] As a result, the GAO recommends that the SBA conduct outreach which is properly documented and report to Congress the challenges with implementing this program.[58]

VI. Conclusion

Since the issuance of these various reports and the SBA's own lessons learned the SBA claims that it has begun implementing changes. For example, objective one of GAO's report recommended updating planning documents which SBA claims it has complied with.[59] Since Hurricane Sandy, the SBA has made over 58,000 disaster loans with an average loan processing time of 7.5 days.[60] In the aftermath of a disaster, it is imperative the SBA's Disaster Loan program operate as efficiently and effectively as possible. However, based on the GAO report following the most recent large scale disaster (Hurricane Sandy), it appears that the SBA may not be meeting the expectations required by Congress. Therefore, it is necessary for the Committee to evaluate the SBA Disaster Loan program to see where gaps may be and how to remedy them.

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[57] *Id.* at 41-42.

[58] *Id.* at 43.

[59] SBA, DISASTER PLAYBOOK 3-4 (June 2014). This playbook is dated June 9, 2014, which is prior to GAO's issuance of the Sept. 2014 report; however, the SBA states that changes on pages 3 and 4 of the playbook reflect the recommendations of GAO and it was updated on April 3, 2015. E-mail from Dan Krupnick, Office of Congressional and Legislative Affairs, Small Business Administration, to Corey Cooke, Counsel, House Committee on Small Business (June 25, 2015, 09:17 A.M. EST) (on file with the Small Business Committee).

[60] E-mail from Dan Krupnick, Office of Congressional and Legislative Affairs, Small Business Administration, to Corey Cooke, Counsel, House Committee on Small Business (June 25, 2015, 09:17 A.M. EST) (on file with the Small Business Committee).