

Preparing for Catastrophe:



Management Review of the Small Business Administration Disaster Loan Program

June 2007

NATIONAL ACADEMY OF
PUBLIC ADMINISTRATION®



A Report by a Panel of the

**NATIONAL ACADEMY OF
PUBLIC ADMINISTRATION**

For the U.S. Congress and the U.S. Small Business Administration

June 2007

PREPARING FOR CATASTROPHE:

Management Review of the Small Business Administration Disaster Loan Program

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The views expressed in this report are those of the Panel. They do not necessarily reflect the views of the Academy as an institution.

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FOREWORD

Before the 2005 Gulf Coast hurricanes, the Small Business Administration enjoyed a consistently positive reputation for providing efficient and effective long-term recovery assistance to disaster victims. After these storms, the agency found its actions and judgments challenged by the press, Congress and most importantly, by the people it was supposed to help.

As the federal government's primary lender to non-agricultural victims of disasters, SBA provides low interest loans and working capital to homeowners, renters, businesses and non-profit organizations under its Disaster Loan Program.

Following the Gulf Coast hurricanes, a congressional committee asked the Academy to conduct a management review of SBA's disaster recovery efforts. Working with SBA, the Academy Panel overseeing this study reviewed the program's experience over the last decade, with a focus on the agency's work after the recent hurricanes.

Overall, the Panel found that SBA provided disaster loans to affected homeowners and businesses on a timely and effective basis in "normal" disasters. When the massive 2005 Gulf Coast hurricanes hit, however, the agency's capacity was overwhelmed and performance suffered.

The Panel has recommended changes in business processes and the structure of the loans being offered in order to improve SBA's response to catastrophic disasters. Many of the recommendations would improve SBA's performance in responding to typical disasters, as well as catastrophic events.

The Academy was pleased to assist the Congress and SBA by conducting this study. Throughout the study, SBA's executives, employees and stakeholders generously contributed their time and expertise in support of the project's important goals.

We wish to thank the members of the Project Panel for their excellent work and keen insights, and acknowledge the effective contributions of the capable project team.



Jennifer L. Dorn

President and Chief Executive Officer

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ACRONYMS

Academy	National Academy of Public Administration
ALCS	Automated Loan Control System
AU	Automated Underwriting
CBRS	Coastal Barrier Resources System
COTS	Commercial-Off-the-Shelf
CSR	Customer Service Representative
DAO	Disaster Area Office
DCMS	Disaster Credit Management System
DOD	Department of Defense
DRC	Disaster Recovery Center
EIDL	Economic Injury Disaster Loan
FDM	Fixed Debt Method
FEMA	Federal Emergency Management Agency
FIT	Field Inspection Team
FMV	Fair Market Value
FOC	Field Operations Center
FY	Fiscal Year
GAI	Gross Annual Income
GAO	Government Accountability Office
GCBD	Office of Government Contracting and Business Development
GIS	Geographic Information System
GO Loan	Gulf Opportunity Loan
HUBZone	Historically Underutilized Business Zone
IA	Individual Assistance
IG	Inspector General
IHP	Individuals and Households Program
IRS	Internal Revenue Service
IT	Information Technology
IV&V	Independent Verification and Validation
JIO	Joint Information Office
LAA	Loan Authorization Agreement
LCD	Loan Closing Document
LO	Loan Officer
MFD	Monthly Fixed Debt
NCE	No Credit Elsewhere
NHSA	Neighborhood Housing Services of America
NWA	NeighborWorks America
OCA	Office of Capital Access
ODA	Office of Disaster Assistance
OIG	Office of Inspector General
OLO	Office of Lender Oversight
OMB	Office of Management and Budget
OSBP	Office of Small Business Programs

PDC	Processing and Disbursement Center
PIO	Public Information Officer
PLP	Preferred Lender Program
PPD	Preprocessing Decline
RFC	Reconstruction Finance Corporation
SBA	Small Business Administration
SBDC	Small Business Development Center
SCORE	Service Corps of Retired Executives
SFHA	Special Flood Hazard Area
SLO	Supervisory Loan Officer
TAD	Tax Assessor Database
USGS	U.S. Geological Survey
WBC	Women's Business Center

EXECUTIVE SUMMARY

Hurricane Katrina and the hurricanes that followed in the summer of 2005 not only laid waste to New Orleans and much of the Gulf Coast but also revealed how completely unprepared government agencies at all levels were to deal with a catastrophe of this magnitude. This costliest disaster in U.S. history triggered an outpouring of criticism of virtually all agencies involved in the response and recovery efforts that followed the devastation. As the Federal government's primary lender to non-agricultural victims of disasters, the Small Business Administration's (SBA) Disaster Assistance Program came under strong criticism for what was perceived to be a slow and confusing response to the Gulf Coast Storms.

By providing low interest loans and working capital to homeowners, renters, businesses and nonprofit organizations that have been devastated by disaster, the Disaster Loan Program makes recovery possible and is a critical source of economic stimulus in disaster-ravaged communities. A little known but key aspect of the program is that over 80 percent of disaster loans are made to individual homeowners as opposed to small businesses. SBA's Office of Disaster Assistance (ODA) is the agency element that responds to disasters and administers the Disaster Assistance Program.

Before Katrina, SBA had a positive reputation for being able to provide efficient and effective long-term relief to disaster victims. After Katrina, which in terms of size and impact dwarfed any of the previous disasters SBA had responded to in its 54 year history, the agency found its actions and judgments challenged in the press, in Congress and most importantly, from the people they were supposed to help—the victims of the Gulf Coast storms.

A congressional committee¹ asked the National Academy of Public Administration (Academy) to conduct a management review of SBA's Disaster Assistance Program. Working with SBA, the Academy Panel overseeing the study considered the Program's experiences over the last decade and concentrated the focus of this study on the agency's efforts and actions following the 2005 Gulf Coast hurricanes.

The Panel found that the Disaster Assistance Program has shown that it can provide loans to affected homeowners and businesses on a timely and effective basis in 'normal' disasters. When Katrina hit, however, the agency's capacity was overwhelmed, and performance suffered. The Panel determined that it would focus on identifying ways of improving SBA's response to a catastrophic disaster. The Panel's recommendations are geared to this objective though implementation of many of these recommendations will also improve SBA's performance in all disasters.

The recommendations outlined in this report apply to two broad aspects of the Disaster Assistance Program: improving current business processes and changing the fundamental structure of the type of loans offered.

¹ The Committee on Appropriations, Subcommittee on Science, State, Justice, Commerce and Related Agencies made the initial request. Oversight for SBA appropriations now comes under the Committee on Appropriations, Subcommittee on Financial Services and General Government.

CHANGING CURRENT BUSINESS PROCESSES

1. The Panel supports the SBA Administrator's steps to utilize more of a "One-SBA" approach to disaster assistance and therefore recommends that:

District, regional and branch offices be included in SBA's disaster planning, and local office Managers and Public Information Officers be used to assist ODA in providing outreach following catastrophic disasters.

SBA include Small Business Development Centers in its disaster planning, and utilize the services of SBDC representatives to assist business owners through the disaster loan application process following catastrophic disasters.

2. SBA district, regional and branch offices' community knowledge and presence could be better utilized to form and maintain a network of local organizations and large employers to provide information about the Disaster Assistance Program. The Panel recommends that:

In cooperation with ODA, SBA district, regional and branch offices form, maintain, and annually coordinate with a network of organizations in their regions to be available to provide disaster loan information to their constituents.

3. In order to provide outreach for the Disaster Assistance Program to a wider range of Americans following a disaster, the Panel recommends that:

SBA translate disaster loan fact sheets and applications into multiple languages, and have them available for Customer Service Representatives and Public Information Officers to download and disseminate as needed to serve residents of disaster areas.

4. Access to information about the disaster loan process before submitting an application helps clients and can reduce communication breakdowns. The Panel recommends that:

SBA prepare a one-page explanation of the disaster loan process, from application submittal to final disbursement, to be disseminated to potential disaster loan applicants as part of the outreach process.

5. The Reserve Corps is an important element of SBA's disaster response capabilities but the agency has often had difficulty maintaining an adequately sized force. For SBA to properly respond to a catastrophic disaster, it should provide incentives to keep the Reserve Corps fully staffed and trained to serve during periods of inactivity. With this in mind, the Panel recommends that:

SBA take steps to secure funding, statutory changes or other authorities to provide incentives for maintaining the disaster Reserve Corps.

6. Making financial underwriting decisions before the loss verification stage in the disaster loan process would significantly reduce unnecessary inspections and diminish the likelihood of future loss verification backlogs following catastrophic disasters. The Panel recommends that:

SBA make preliminary financial underwriting decisions before proceeding with the loss verification stage of the disaster loan process whenever possible.

7. Currently, in cases where there is an absence of property to inspect following total destruction from a disaster, Loss Verifiers still conduct on-site loss verification inspections. The Panel recommends that:

In cases where there may be an absence of property to inspect following total destruction from a disaster, SBA use available technology and FEMA loss verification reports whenever practical in place of on-site loss verification inspections.

8. The “credit elsewhere test,” to determine whether applicants have access to other sources of credit, which make them ineligible for deeply subsidized forms of SBA loans, consumes what SBA officials estimate to be 10 percent of Loan Officer time and resources. Since the test is amenable to automation, the Panel recommends that:

SBA revise the credit elsewhere test by basing it on borrower credit scores, net assets, and the applicant’s ability to afford loan payments at the market rate through a cash flow analysis.

Automate and incorporate the credit elsewhere test fully within the loan processing system.

9. To expedite decisions for loan applicants, reduce processing errors, and more fully automate underwriting decisions, SBA should establish a comprehensive electronic exchange of information with IRS that eliminates the manual steps built into the current process. SBA should also seek the statutory authority to include the tax filing release request on disaster loan applications. The Panel recommends that:

SBA and IRS set up a process to fully automate electronic exchange of applicant tax information for the purpose of expeditiously processing disaster victims loan applications.

SBA officially request statutory authority that would allow disaster loan applicants to authorize SBA to verify tax filing information with IRS by simply completing the disaster loan application form.

10. SBA would benefit from establishing an automated loan underwriting system to render a preliminary credit decision consistently within minutes and eliminate the time-consuming process of manually creating a credit profile for those applicants lacking a credit score. The Panel recommends that:

SBA begin the process of developing an automated underwriting system with the goal of making underwriting determinations on at least 80 percent of its disaster home loan applications.

11. Loan data are needed for the eventual development of an automated underwriting system based on the past performance of business and home disaster loans. The Panel recommends that:

SBA, with the assistance of a contracted automated underwriting modeling firm, should consistently and accurately collect loan-level data needed for the development of an automated underwriting system tailored to the post-disaster performance of home disaster loans, and eventually business disaster loans.

12. SBA's current "two-stage closing" of loans is costly in terms of administration and confusing to borrowers. The Panel recommends that:

SBA issue at one time the complete set of disaster loan closing documents, including documents on collateral and proof of insurance for secured loans.

13. Disaster Loan applicants who want to receive a smaller unsecured loan before they meet the requirements for a larger secured disaster loan should have this option. Thus, the Panel recommends that:

SBA provide disaster loan borrowers with the option to receive an unsecured disaster loan while they complete the loan closing process for a secured loan.

14. A more rigorous approach to servicing by SBA would help borrowers to keep their homes and businesses and preserve their access to credit. The Panel recommends that, similar to leading industry practice, SBA should:

Improve loan servicing by:

- **contacting disaster loan borrowers before they enter repayment status.**
- **automating the servicing workflow.**
- **targeting servicing interventions based on a borrower's risk profile.**
- **intervening with loss mitigation options at an appropriate time (i.e., before 90 days delinquency).**
- **collecting with the rigor of the commercial sector on defaulted loans.**

15. Monitoring risk indicators on a regular basis will enable SBA to better manage the risk it assumes on the Disaster Assistance Program. The Panel recommends:

Under guidance from the Congress and in consultation with OMB, SBA specify the general level of risk it will assume, monitor its risk on a quarterly basis, and manage risk by revising underwriting standards and servicing actions in response to observed trends.

CHANGING THE STRUCTURE OF THE LOAN PROGRAM

16. The Panel believes that the form of the disaster loan origination process should be changed to enlist the help of the private sector during catastrophic disasters and therefore recommends:

In an effort to expand staff capacity and serve disaster loan borrowers expeditiously following a catastrophic event, SBA should pilot a disaster assistance program utilizing banks and other financial institutions to process, close and disburse direct loans.

SBA should conduct the pilot on a regional basis to establish procedures and identify areas of operational weakness, potential fraud, and greatest risk before implementing any full-fledged program to augment the origination of direct disaster loans by SBA officials, as at present, during a presidentially declared catastrophic disaster.

CHAPTER I INTRODUCTION

BACKGROUND

The 2005 Gulf Coast hurricanes battered the U.S. Gulf Coast region and overwhelmed the ability of government disaster response and recovery agencies to timely meet the needs of disaster victims. The Small Business Administration's (SBA) Disaster Assistance Program, as the federal government's primary source of funds for restoring the homes and businesses of disaster victims, found itself inundated by the sheer volume of loan applications. Not only was it the largest disaster response in SBA's 54-year history, the volume of work from this single disaster represented almost one-fourth of the total disaster workload of the agency since it was created in 1953.

Table 1-1. SBA Assistance Following Four Largest Disasters

Event	Applicants	Dollar amount approved
Gulf Coast hurricanes (2005)	422,253	\$10.6 billion
Northridge, California Earthquake (1994)	250,402	\$4.0 billion
Florida hurricanes (2004)	181,751	\$1.8 billion
Hurricane Andrew (1992)	45,727	\$700 million

Source: SBA Office of Disaster Assistance

The disaster loan program provides low-interest loans and working capital to businesses and homeowners for their uncompensated disaster-related losses and is the only form of SBA assistance not limited to small businesses. Homeowners, not small businesses, receive the overwhelming majority (80 percent+) of loans. *Physical Disaster* loans provide for permanent rebuilding and replacement of uninsured, underinsured or uncompensated disaster-damaged privately-owned real or personal property. *Economic Injury* loans provide necessary working capital until normal operations resume and are restricted to small businesses only. SBA disaster loans bear lower interest rates and longer terms than conventional loans, and are a critical source of economic stimulus in disaster-ravaged communities.

SBA's disaster response to the Gulf Coast hurricanes was significantly slower than the agency's goals. Although loan processing goals were 18 days for businesses and 14 days for homes, it actually took SBA 71 days, on average, to make loan decisions. Loan disbursements (payments to applicants) were also slow, due to the large volume of approved loans, efficiency problems in the agency, and a variety of factors outside of the agency's control.

The agency received considerable criticism for its handling of disaster assistance following the Gulf Coast storms. Victims of the disasters, elected representatives, the U.S. Government Accountability Office (GAO), media observers, and witnesses at numerous public hearings have all voiced criticisms and complaints about SBA’s performance. As SBA Administrator Steven Preston noted: “Like every other level of government—local, state, and federal—SBA was initially overwhelmed by Hurricane Katrina. This demand surge left the agency struggling to meet the needs of thousands of disaster victims.”² These criticisms stung the staff of SBA, particularly staff members at the Office of Disaster Assistance (ODA) who were, as one observer noted, accustomed to being seen as the “good guys” who provide timely, long-term help to those devastated by disasters.

We didn’t know anything about SBA until they told us “please call, we can help.” The next time this happens we are never going to call. It was because they kept giving us false hopes and promises that we got stuck here.
Gulf Coast Hurricane Disaster Loan Applicant

Figure 1-1. Hurricane Katrina’s Aftermath



Source: Academy Staff Photo, January 2007

The Perfect Storm

The impact of the Gulf Coast storms on SBA’s disaster loan processing capabilities was compounded by several factors:

² Speech to the National Press Club. February 1, 2007.

- When Hurricane Katrina struck, SBA was in the midst of realigning its ODA organizational structure. ODA had previously operated with four area offices nationwide. Each office provided the full range of disaster response services for a particular geographic area such as customer service, loan processing, and administrative support. The four offices generally operated independently of one another. Under the realignment, SBA centralized its Disaster Assistance Program's customer service function in its Buffalo office and its loan processing function in its Fort Worth office. The area offices in Sacramento and Atlanta assumed responsibility for all disaster field operations, public information, and congressional relations functions.
- SBA was in the final stages of the Office of Management and Budget's (OMB) A-76 process³ for contracting out Loss Verification operations when the Gulf Coast storms occurred. This fundamental change to a critical step became an important contributor to backlogs in the loan approval process.
- The Disaster Credit Management System (DCMS), the computer system used to process loan applications, was in the midst of a phased rollout at the time of Katrina and did not have sufficient capacity to handle the unprecedented number of concurrent users, resulting in significant down time and slow response times.
- SBA was unprepared for a disaster of the magnitude caused by the 2005 Gulf Coast hurricanes.

THE ACADEMY STUDY

The Committee on Appropriations, Subcommittee on Science, State, Justice, Commerce and Related Agencies⁴ requested that the Academy work with SBA to conduct a management review of the agency's Disaster Assistance Program. The review was intended to analyze the structure, policies, and operating procedures of the program, and assess changes made to the program over the past several years, including the reasons those changes were made, and the impact of the changes on the cost, timeliness, and effectiveness of the program.

While the Academy Panel overseeing the study considered the program's performance over the last decade, the Panel concentrated on the agency's experience after, lessons learned from, and reactions to, the 2005 Gulf Coast hurricanes, including interaction with other programs with related or interlocking missions.

³ The A-76 circular sets forth the procedures for determining whether commercial activities should be performed under contract with commercial sources or in-house using government facilities and personnel.

⁴ Oversight for Small Business Administration appropriations now comes under the Committee on Appropriations, Subcommittee on Financial Services and General Government.

The Panel sought to answer the following questions:

- What changes have been made to the program over the past several years, and why have they been made?
- How do the volume and types of loan applications flowing from the 2005 hurricane season, i.e., a catastrophic disaster, compare to those experienced in prior years with other disasters?
- What difficulties, if any, did SBA experience in the receipt, processing, and evaluation of loan applications from the 2005 season? What caused any such difficulties?
 - What has been the approval rate for loan applications flowing from the 2005 hurricane season compared to experiences in prior years? What are the reasons for any differences in approval rates?
 - How do the cost and timeliness of processing these loan applications and servicing the loans compare with experiences in prior years?

The Panel also considered a wide range of issues related to program policies and procedures. The Panel sought to identify specific steps that could be taken to improve the operation of the program including:

- improvements to the support that other SBA offices provide to ODA to cope with catastrophic disasters, as well as steps to improve ongoing day-to-day assistance and support at other times
- improvements to the loan origination process, including analysis of the impact of federal Emergency Management Agency (FEMA) referral policies that affect SBA's ability to provide timely help to disaster loan applicants
- improvements designed to help avoid errors and provide accountability or recovery of improper payments as needed
- potential changes that have the greatest promise for improving underwriting consistency and accuracy, including automated underwriting and expanded application of scoring models
- proposals to increase the agency's "surge capacity" during catastrophic events

STUDY METHODOLOGY

An Academy Panel of four members—including three Fellows and a panel member with strong Disaster Assistance Program experience—guided this review. The Panel brought to the project a combination of disaster planning, management, policy, and research experience in the areas of financial and legal policy, management in the private and public sector and other federal lending

programs.

The Panel and staff used a multi-faceted approach for answering the questions listed above. The study began with an analysis of key policies, procedures, and processes that show how the ODA program is intended to work, its program goals and policy priorities. This background evaluation informed the later assessment of how the system works in practice, during actual disasters, and its limitations and constraints.

During site visits to the Gulf Coast and Florida, study team members visited Disaster Recovery Centers⁵ and interviewed government staff members who provide disaster assistance including managers and staff from ODA and FEMA and representatives from other federal, state and local agencies that work in the Centers. Site visits to the Gulf Coast focused on ODA's disaster response to those affected by the Gulf Coast hurricanes. In contrast, the study team visited central Florida following a series of tornadoes to observe ODA's disaster response following a non-catastrophic disaster. Other interviews included members of key private and nonprofit organizations that also provide disaster assistance.

Figure 1-2. Biloxi, MS, Disaster Recovery Center



Source: FEMA/Mark Wolfe

Interviews were held with ODA managers and staff both in headquarters and at ODA's Herndon, VA, Center, as well as senior leaders at SBA who have supervisory and/or policy authority over

⁵ A Disaster Recovery Center (DRC) is a readily accessible facility or mobile office where people may go for information about FEMA or other disaster assistance programs.

ODA, including SBA Administrator Steven Preston and Deputy Administrator Jovita Carranza. The Academy also interviewed ODA managers and staff working at the Fort Worth, TX, Processing and Disbursement Center (PDC), serving victims of the Gulf Coast hurricanes and other recent disasters. A list of all interviews and contacts is provided in Appendix A.

This study is also informed by the experiences of disaster loan applicants and recipients. With assistance from ODA, the study team conducted focus groups and individual interviews in New Orleans, LA and Biloxi, MS. These focus groups and interviews were designed to elicit client views about how well the Disaster Assistance Program functioned following Hurricanes Katrina and Rita. In total the study team spoke with 20 home loan applicants and borrowers and 20 business loan applicants and borrowers in March, 2007. A consensus on several themes emerged from the interviews; these are discussed in this report. Individual, illustrative comments from the panel sessions are included in text boxes throughout the report.

ORGANIZATION OF THIS REPORT

Chapter II provides a background on the history and current structure of the Disaster Assistance Program including current program issues, recent changes to the program, and loan processing performance over the last several years. Chapter III considers potential improvements to existing Disaster Assistance Program loan business processes from application intake through loan servicing. Chapter IV focuses on potential changes to the program's structure, including the use of loan guarantees and increased involvement in disaster loan-making by the private sector.

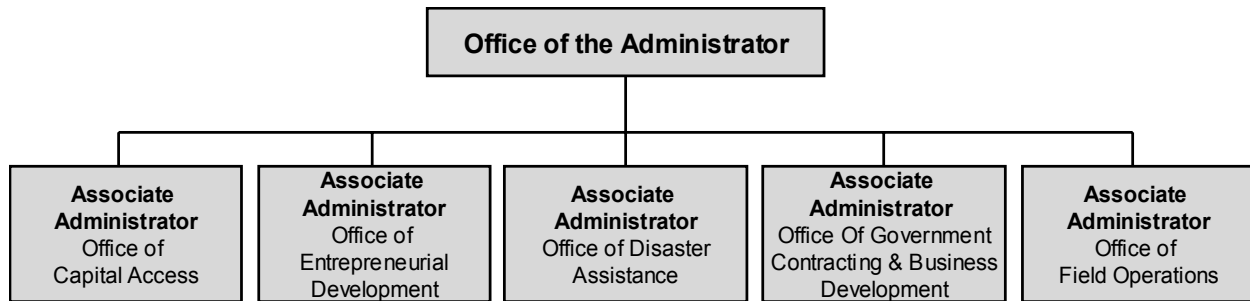
THE SMALL BUSINESS ADMINISTRATION (SBA)

In 1953, in his first term of office, President Dwight Eisenhower signed into law the Small Business Act which created the Small Business Administration. Successor to several agencies created during the Great Depression and World War II, SBA's function was to "aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns" and to ensure small businesses a "fair proportion" of government contracts and sales of surplus property.

SBA's stated purpose is to promote small business development and entrepreneurship through business financing, government contracting, and technical assistance programs. SBA also serves as a small business advocate, working with other federal agencies to reduce regulatory burdens on small businesses. Most SBA financial assistance is now provided in the form of guarantees for loans made by private and other institutions, while the agency's disaster program remains a direct loan program.

SBA's headquarters, located in Washington, DC, oversees the operations of 10 regional offices, 68 district offices, their corresponding branch offices, and resource partners in all 50 states, the District of Columbia, Puerto Rico, American Samoa, the U.S. Virgin Islands, and Guam.

Figure 1-3. SBA Organization Chart



The *Office of Capital Access* (OCA) assists small businesses in obtaining capital through SBA's 7(a), 504 and Micro Loan programs as well as the Small Business Investment Company program. The 7(a) General Business Loan Guaranty Program is the agency's largest program and provides loan guarantees to eligible small businesses that have been unsuccessful in obtaining private financing on reasonable terms through normal lending channels. The program operates through private-sector lenders that provide loans which are, in turn, guaranteed by SBA. OCA has the responsibility for servicing all SBA loans, including disaster loans.

The *Office of Entrepreneurial Development* (OED) provides business counseling and training through its partners' network composed of Small Business Development Centers (SBDC), Women Business Centers (WBC) and the Service Corps of Retired Executives (SCORE).

The *Office of Government Contracting and Business Development* (GCBD) provides assistance to small businesses in obtaining federal procurement opportunities. The 8(a) Business Development program helps small businesses to take advantage of procurement opportunities. In the wake of Katrina the GCBD office worked with federal agencies to create contract opportunities and for future needs, will continue to be the lead.

The *Office of Field Operations* represents SBA field offices at headquarters, providing policy guidance and oversight to regional administrators and district directors, overseeing field office program and policy implementation, and providing feedback to headquarters management regarding the performance of their programs.

The *Office of Disaster Assistance* (ODA) provides financial assistance to homeowners, renters, non-farm businesses of all sizes, and nonprofit organizations following a disaster, and is the primary subject of this study.

CHAPTER II THE DISASTER ASSISTANCE PROGRAM

INTRODUCTION AND BACKGROUND

SBA's disaster loan program is a critically important part of federal assistance to individuals and non-agricultural businesses following disasters. When a disaster is declared by the President or SBA Administrator, victims borrow to repair uninsured (or underinsured) damage. The low interest rates and long terms available from SBA may make recovery affordable and possible. SBA's disaster loans are a critical source of economic stimulus in disaster-ravaged communities, spurring job retention and creation, revitalizing business health, and stabilizing tax bases. Over 1.8 million loans totaling more than \$46 billion have been approved for homes, businesses, and non-profit institutions since the inception of the program.

SBA's provision of disaster loans officially began when Congress passed The Small Business Act in 1953. The law stated that it was the "policy of Congress that the Government should aid and assist victims of floods or other catastrophes." Subsequent legislation further amended the Act to expand the responsibilities of the SBA in the area of disaster loan assistance:

- 1955—Allowed SBA to provide economic injury disaster loans (EIDL) as the result of droughts.
- 1958—Established the interest rate at 3 percent for home and business loans.
- 1965—Extended the 30-year term to all SBA disaster loans.
- 1966—Added "riots or civil disorders" to the definition of disaster.
- 1969—Authorized SBA to refinance prior liens on properties that were destroyed or substantially damaged.
- 1970—Authorized "major source of employment" designation, provided limitations of assistance to uninsured damages, clarified refinancing eligibility, and changed interest rate calculation methodology.
- 1976—Expanded loan eligibility to include agricultural related small businesses.
- 1977—Expanded declaration criteria to allow a Governor to certify that due to a disaster event, small businesses within the impacted area suffered economic injury.
- 1979—Established the *credit elsewhere* test.⁶

⁶ The *credit elsewhere test* is described in detail in Chapter III.

- 1980—Limited eligibility to agricultural enterprises that were ineligible for assistance for the Farmers Home Administration on similar terms, and included a cap of \$500,000 for business loans.
- 1981—Rewrote the basic disaster authority and provided statutory rules for refinancing, limited physical disaster loans to 85 percent of the damage, limited business physical *credit elsewhere* loans to a maximum 3-year term, added setting interest rates by statutory formulas, added a *credit elsewhere* test for home loans, and placed a cap on interest rates of 8 percent for *no credit elsewhere* loans.
- 1984—Made small agricultural co-ops eligible for EIDL declarations, added the peso devaluation program, placed retroactive caps of 4 percent and 8 percent on *no credit elsewhere* and *credit elsewhere*, respectively, and increased the 85 percent limitation for business loans to 100 percent.
- 1986—Made agricultural enterprises no longer eligible for disaster loan assistance from SBA.
- 1988—Changed the definition of disasters to include “ocean conditions resulting in the closing of customary fishing waters,” made nurseries impacted by droughts eligible for EIDL assistance, and included contiguous counties in the “area affected by a disaster”. Also provided for the addition of up to 20 percent on disaster loans for mitigation measures, and barred SBA from requiring collateral for any physical disaster loan of \$10,000 or less.
- 1993—Increased the maximum disaster business loan to \$1.5 million.
- 1999—Created the Military Reservist Economic Injury Disaster Loan Program and a pre-disaster mitigation pilot program.
- 2006—Added drought eligibility for EIDL.

Before 1981, the Disaster Loan Program was delivered through local SBA district offices. This organizational structure was not consistently effective and often required individual district offices to curtail other agency programs and services they were responsible for delivering to the small business community.

In an effort to increase customer service and operate an effective and efficient program, the Office of Disaster Assistance (ODA) was created. Under this reorganization, ODA established four Disaster Area Offices, each having a specific territory in which to deliver the disaster loan program. Each Area Office had field operations, Public Information Officers (PIOs), damage inspectors, Loan Officers, legal staff and clerical support.

For many years, SBA has managed to expand and contract resources for the Disaster Assistance Program to meet its volatile workloads—driven by an unpredictable level of declared disasters—in a way that is generally recognized as serving victims of most disasters well. But Hurricanes Katrina, Rita and Wilma put SBA to a test that most would agree it failed, at least in the early stages. The sheer size of the catastrophe overwhelmed the agency—as it did so many other federal, state, and local agencies and nonprofit organizations. The storms also came in the midst of organizational change at SBA that, though ultimately intended to improve service, contributed to backlogs and confusion in the short run.

When I talked to the SBA representatives, I thought they were very professional. There was a long line of people and they got us right through.

Gulf Coast Hurricane Disaster Loan Applicant

Although these storms presented highly unusual challenges, they revealed aspects of the agency's operation that could be changed to significantly improve its response to catastrophes, and also improve efficiency and service under more normal circumstances. SBA was, in fact, able to make some mid-course corrections to help recover from the problems that occurred in the first months after the storms. SBA is now planning and implementing further changes designed to help it operate more efficiently and better respond should a disaster akin to the Gulf Coast hurricanes occur. The Panel believes these changes are on the right path, but may not be sufficiently far reaching, and that other changes could further improve service.

This chapter reviews the context in which the disaster loan program operates, describes SBA's policies and procedures, and discusses the strains placed on the agency and its clients by the Gulf Coast storms. It also describes changes the agency has already made, or plans to make, with regard to loan processing and its own disaster planning.

THE CONTEXT OF ODA'S WORK

Disasters happen often. Many have a local impact and do not receive the level of attention that Hurricane Katrina, the Northridge Earthquake, Hurricane Andrew, and other major disasters have received. A program serving the needs of disaster victims is, of necessity, different from SBA's other programs, which are intended to provide financial and other kinds of support to foster small, developing businesses.

The Nature of Disasters

Providing disaster assistance is a year-around job, but one that is, by its very nature, unpredictable and volatile. The size and form of disasters can vary; they can cover large, populated areas or be limited to relatively small geographic areas, or they can affect agriculture and businesses, but not large populations.

The number and size of declared disasters varies from year to year. Data supplied by SBA show that between 1997 and 2006, the number of Presidential disaster declarations ranged from 22 to 64. FY 2005 saw the lowest number of Presidential declarations in 10 years, but the biggest

single disaster in the program's history. SBA also responds to numerous smaller disasters. For example, as shown in Table 2-1, since 1997 SBA has responded to disasters declared by SBA, including those first certified by governors, as well as those declared by the Secretary of Agriculture. Between 1997 and 2006, the number of SBA/Governor declarations ranged from 30 to 60. The number of Agriculture declarations was much higher, ranging from 82 to 268.

Table 2-1. Disaster Declarations for FY 1997 to FY 2006⁷

Source	Presidential Declaration	SBA Declaration	Governor Certification	Secretary of Agriculture	Total
FY 1997	38	31	8	129	206
FY 1998	45	48	12	85	190
FY 1999	40	29	9	112	190
FY 2000	22	38	12	116	188
FY 2001	30	24	15	82	151
FY 2002	30	34	13	126	207
FY 2003	64	37	12	112	225
FY 2004	41	28	2	154	225
FY 2005	21	32	3	226	225
FY 2006	25	35	5	268	333
Total	356	336	94	1,410	

Some recently declared disasters include:⁸

- Georgia severe storms and tornadoes (March 2007)
- Florida tornadoes (February 2007)
- California freeze (January 2007)
- Colorado Castle West Apartment Complex Fire (January 2007)
- Missouri severe winter storms (November 2006)
- Massachusetts explosions and fires (November 2006)
- Maryland tropical storm Ernesto (September 2006)
- Delaware severe storms and flooding (June 2006)

Disaster Loans Are a Special Form of Assistance

The direct loans made through ODA's disaster loan program are unique. All of SBA's other

⁷ This table includes the most common types of disaster declarations. Others exist, including Secretary of Commerce Declarations. SBA also offers a Military Reservist Economic Injury Disaster Loan, intended to provide working capital assistance to small businesses that experience, or will experience, financial difficulties as a result of an essential employee being called up to active duty in his or her role as a Reservist. The program is small. Agency data as of March 2007 show that, since its inception in 2001, SBA has approved 271 loans, for an average of \$91,000 each. SBA approved 24 loans in FY 2006. Only a few disasters have been declared under this program; they are not included in the table. However, these loans are included in the data on loan activity in this report.

⁸ <http://sba.gov/services/disastereassistance/basics/recentdisaster/index/html> (accessed April 5, 2007).

programs provide loan guarantees for businesses; SBA does not directly fund the loans. The program is also unique in that it is the only SBA program not limited to small businesses.

Providing disaster assistance in the form of loans, instead of grants, eliminates an incentive for property owners to underinsure against risk. Loans require the owners of the disaster-damaged properties to pay back the assistance. The primary costs to taxpayers result from loan defaults and interest subsidies. The interest subsidy is the difference between the interest rate SBA offers (typically 4 percent or less) and the Treasury borrowing rate.

Loans Are Not Limited to Small Businesses

SBA offers two major types of disaster loans:

- Physical Disaster Loans, which finance the permanent rebuilding or replacement of uninsured, underinsured or uncompensated damaged property. These loans are available to home owners and renters, and to businesses of all sizes, as well as to non-profit organizations.
- Economic Injury Disaster Loans, which are available to small businesses, provide working capital to cover operating expenses until the businesses can return to normal operation.

Historically, about 80 percent of SBA disaster loans go to homeowners and renters.

Table 2-2. Maximum Disaster Loan Amounts

SBA Disaster Loans	Maximum Amounts
Physical Disaster Loans - Personal Property	\$40,000
Physical Disaster Loans - Primary Home	\$200,000
Physical Disaster Loans - Business	\$1.5 million
Economic Injury Loans	\$1.5 million

Note: The aggregate amount cannot exceed \$1.5 million; there are exceptions to the \$1.5 million limit for businesses that meet SBA’s Major Source of Employment (MSE) criteria.

In Presidential disaster declarations, homeowners and renters with disaster losses who do not qualify for the SBA disaster loan program are referred to FEMA’s Individual and Family Grant Program for possible grant assistance. FEMA works to meet immediate health and safety needs during the initial phase of disaster recovery while SBA works to support the long term recovery of the area.

SBA assumes risks that private lenders are unwilling to take by applying more lenient credit standards. Even so, SBA adheres to fundamental credit practices, and determines that an applicant is likely to repay the loan before the agency lends the funds. To receive SBA disaster loans, applicants must also meet certain “character” requirements, such as compliance with child support obligations and repayment of other federal debt (e.g. student loans).

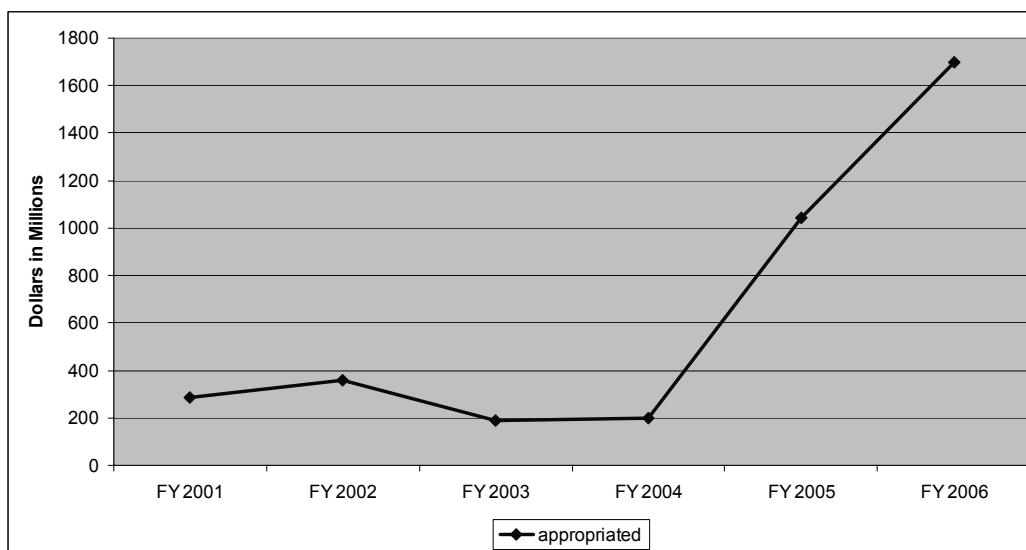
Many program requirements are set legislatively. For example, Congress has defined what constitutes a disaster, set maximum interest rates and repayment periods for the loans, set maximum amounts for the loans, and required that subsidized loans go only to those who could not qualify for credit elsewhere. SBA policies guide other aspects of the program, such as defining what constitutes evidence of the borrower’s ability to repay the loan and requiring collateral to secure some loans.

The Office of Disaster Assistance (ODA)

As described above, ODA was created in 1981 to improve SBA’s delivery of the disaster loan program. Organizationally, the Associate Administrator of ODA reports directly to the Administrator of SBA. Likewise, ODA’s four field offices,⁹ as well as the Administrative Support Center and the DCMS Operations Center in Herndon, Virginia, report directly to the ODA Administrator; SBA regional and district offices are not directly involved in the disaster loan program. ODA is largely a self-contained entity within SBA.

The Disaster Assistance Program also has its own appropriation. The size of ODA’s workload varies with the size and number of yearly declared disasters. To meet this fluctuating demand, much of ODA’s funding is provided through supplemental appropriations after major disasters are declared, rather than through the regular congressional budget process. The \$1.4 billion appropriated in FY 2005, for example, included \$930 million in supplemental appropriations. Figure 2-1 demonstrates the fluctuations in appropriations in recent years.

Figure 2-1. Disaster Loan Appropriations, FY 1002-2006¹⁰



Source: SBA/ODA, Office of the Associate Administrator (February 2007) and SBA FY 2008 Presidential Budget Request and background documents

⁹ Until recently ODA had four Disaster Area Offices. As discussed below, in 2005 the functions and names of those offices were changed.

¹⁰ The increase in FY 2005 was largely in response to four hurricanes that hit Florida in 2004. FY 2006 appropriations include over \$700 million in transfers from the Department of Homeland Security in addition to supplemental appropriations.

Along with ODA’s funding, staffing for the Disaster Assistance Program fluctuates, sometimes dramatically. The program has received special hiring authority from the Office of Personnel Management; staffing of the program differs significantly from that of the agency at large. ODA day-to-day staffing consists of a few—in April 2007 there were 21—permanent career federal personnel and a much larger number—historically around 350—of “cadre” staff. The cadre staff are career civil servants, hired under special hiring authority as “on-call seasonal” workers. Though most work year-round, under SBA policy they are guaranteed only six months of work each year. Officials said there have only been a few times when any cadre staff have been put in non-pay status due to lack of work.

When workload exceeds the capabilities of its permanent and cadre staff, SBA hires temporary workers. As shown in Table 2-3 below, the number of workers, especially temporary workers, varies significantly, depending on the level of disaster response needed. The “on-board” numbers may mask the total number of hires. For example, though the peak number of temporary employees in 2006 was 3,994, officials estimated that they hired about 7,000 employees who worked for varying lengths of time.

In the past, SBA has also maintained a Disaster Reserve Corps of employees to be deployed on short notice in disasters. Corps members are recruited and hired by the agency and maintained in an uncompensated status until called up. In recent years Corps membership declined significantly, to an estimated 25 members in 2004. As shown in the table, and discussed later in this chapter, the agency has increased the size of the reserve significantly in the last year.

Table 2-3. Changes in Disaster Loan Staffing, Calendar Years 2002-2007

	2002		2003		2004		2005		2006		2007
	Low	Peak	Low	Peak	Low	Peak	Low	Peak	Low	Peak	Current
Permanent	8	8	8	8	8	11	11	11	12	12	21
Cadre on board	329	353	347	357	331	354	279	331	234	358	384
Temporary	379	602	270	517	75	2,354	469	3,672	2,317	3,994	1,886
Reserve	200 (est.)	320 (est.)	70 (est.)	115 (est.)	25 (est.)	70 (est.)	25	310	310	700	905

Source: SBA/ODA, Office of Disaster Personnel (May 2000)¹¹

An important difference between the rest of SBA and ODA is that, while most employees of SBA are members of a bargaining unit, ODA personnel are not. ODA officials believe having a non-unionized staff allows much greater flexibility to meet emergency demands; they see union provisions as limiting the extent to which staff in other parts of SBA can support ODA in meeting its staffing and other resource needs during post-disaster mobilizations. For example,

¹¹ Data are maintained as of the end of each month; slightly higher or lower numbers could have occurred within months.

ODA staff often must deploy to the disaster location and work long hours—actions not stipulated in job descriptions for bargaining unit staff—to meet the urgent needs of applicants.

HOW THE PROCESS WORKS

A Disaster is Declared

SBA is one of many federal departments and agencies that respond to major disasters declared by the President. State and local governments and non-profit agencies generally are the initial responders. If these initial responders determine that additional resources are needed for recovery, the governor can request the President to issue a major disaster declaration. FEMA coordinates the federal response, evaluates the situation and recommends action to the White House. This can take hours or weeks, depending on the situation.

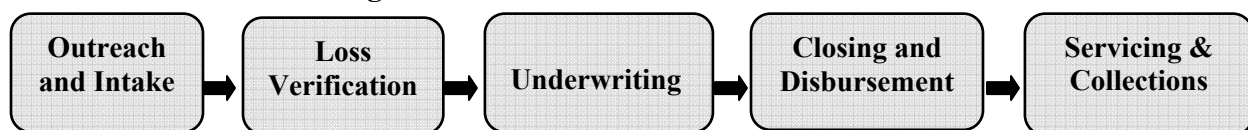
Once the President has made a disaster declaration that includes individual assistance, FEMA establishes a Joint Field Office, a Joint Information Center and Disaster Recovery Centers (DRC) and notifies as many disaster victims as possible about the locations of the centers and the disaster assistance programs represented at each center. SBA disaster loans constitute one of those programs. SBA has, in almost all cases, met its goal of having representatives on the ground in disaster areas within 3 days of the declaration.¹²

The needed staffing, facilities, and system requirements differ from disaster to disaster. SBA does not maintain a workforce of sufficient size to meet large disaster needs. Consequently, once a disaster is declared, SBA must quickly activate members of the reserve corps and/or hire and train staff in sufficient numbers to meet the anticipated need, as well as obtain office space, computers and other support. Staff are deployed to each DRC in the disaster area to counsel victims about disaster loans, disseminate disaster loan applications, and help individuals complete disaster loan applications and close loans.

The Disaster Loan Process

Though the size of disasters varies significantly, the SBA business process and interaction with clients—for each type of loan—are essentially the same. SBA’s disaster loan business process can be divided into five key stages, as shown in Figure 2-2.

Figure 2-2. Disaster Loan Business Process



¹² For other types of declared disasters, SBA establishes offices near the disaster area and the process is, otherwise, similar to responses to Presidential disaster declarations.

The following discussion briefly describes the key stages in the process. It is followed by a synopsis of how the process looks from the client's-eye-view, including how clients viewed the process in the aftermath of the Gulf Coast hurricanes. A more complete discussion of these stages is provided in Chapter III of this study.

Outreach and Intake

The first step for any individual home owner or renter seeking post-disaster federal assistance is to register with FEMA. (The processes for business applicants are discussed below.) Registration can be completed in person at a disaster center, by telephone, or online. FEMA's application includes a section on pre-disaster income. If the applicant's income is high enough to meet a threshold established by SBA, FEMA automatically refers the applicant to SBA. SBA mails an application to all applicants referred by FEMA.

Potential applicants who visit a Disaster Recovery Center are encouraged to meet with an SBA Customer Service Representative who can provide information about the program and assist applicants in filling out applications. When a completed application is returned to SBA, Customer Service Representatives also perform a preliminary screening to determine the potential applicant's ability to repay a loan.

This screening looks not only at reported pre-disaster income, but at the applicant's monthly reported fixed debt. If the applicant passes this test, the Customer Service Representative ensures that the application is complete and then sends it by express mail to a central location for processing. This analysis and application review is conducted at the Fort Worth, TX, Disaster Assistance Processing and Disbursement Center (PDC) for applicants who apply by mail.¹³

SBA's Intake Process For Disaster Loans	
✓	Publicize SBA services
✓	Counsel and screen potential applicants: <ul style="list-style-type: none">○ Refer ineligible applicants back to FEMA○ Provide assistance in completing applications
✓	Accept completed applications
✓	Enter applications into data base
✓	Screen applicant based on credit score <ul style="list-style-type: none">○ Refer declines to FEMA○ Request IRS information and forward application for loss verification

Customer Service Representatives in Disaster Recovery Centers conduct "Home Loan Interviews" to determine the home loan applicant's loan repayment ability. Those applicants found not qualified for a disaster loan are referred back to FEMA for possible assistance under its Individual and Family Grant Program. Customer Service Representatives also provide assistance to home loan applicants who are asked to complete subsequent paperwork after their applications are received by the PDC.

Potential applicants for business physical disaster or economic injury loans need not register with FEMA. The initial eligibility screening described above is not applied to business disaster loan applicants, or to home loan applicants who are self employed, have household income that includes rents, farms or other non-salary sources, or have household incomes above \$50,000,

¹³ As discussed later in this chapter, in FY 2005 SBA brought on-line a new data processing system, and centralized processing and disbursement into one office. Before that, each of four disaster area offices was responsible for processing loan applications related to disasters in its geographic area.

because the applicant's financial circumstances are considered to be too complex for the screening test.

As noted above, disaster loan applications are either mailed by individual applicants or by the Field Operations Center to the Processing and Disbursement Center. Information from the paper applications is keyed into DCMS and accompanying supporting documents are scanned into the system. At this point, SBA again assesses both individual and business applicants' potential ability to repay, based on each applicant's credit history. If the applicant's credit score fails to meet certain criteria, the application is declined. Otherwise, the application is forwarded to the Loss Verification Department and, at the same time, an inquiry is faxed to IRS asking for transcripts of the applicant's tax returns. (Part of the application package includes a separate form that the applicant must execute that authorizes IRS to share information with SBA.)

Loss Verification

Loss Verifiers conduct on-site loss verification inspections in order to verify the physical loss and the cost to rebuild or replace the damaged property. These visits:

- Determine the estimated cost of repair or replacement of real, personal, and business property.
- Estimate replacement and pre-disaster fair market value of property.
- Gather information to help Loan Officers establish applicant eligibility.
- Determine if property is located in areas requiring special insurance.
- Provide estimated values of undamaged real property offered or required as collateral.

Generally, the applicant is required to be present at the site of the damaged property when the Loss Verifier is conducting the inspection. The estimate of the cost to repair or replace is a critical one. Since physical loss loans require collateral, the estimate of the value of undamaged property also is critical. SBA loans are generally made for the amount required to rebuild or repair the home or business, so if an applicant is deemed unable to repay a loan amount sufficient to accomplish that, the loan application is denied. An assessment of the applicant's repayment ability is made during the underwriting process that is conducted following loss verification inspections.

Applications for business economic injury loans are not subject to loss verification. Instead, SBA staff review documentation provided by the applicant about the business's prior earnings and expenses as an indication of ability to repay. Disaster victims may find these documents difficult to obtain, and may need to work with SBA staff to reconstruct the necessary information.

Underwriting

At the underwriting stage, SBA decides whether to approve a loan. Loss Verifiers estimates the amount of damage the property has sustained, as well as the cost to rebuild it to its pre-disaster condition. Loan officers examine the applicant’s credit quality and income to determine his or her ability to repay a loan that is of sufficient size to repair or replace the home or business. The standards and procedures for this determination are shaped by statute, historical program experience, and, in some cases, the disaster itself. Affordability and the determination whether a borrower can receive credit elsewhere are paramount in deciding whether the loan is approved and the terms of the loan.

A key element of this process is the “credit elsewhere test.” The authorizing legislation establishes different interest rates for home and business loans, depending on the applicant’s ability to recover without the assistance of the federal government. The lower interest rate, capped at 4 percent, applies to home owners, renters, businesses and non-profit organizations that SBA determines do not have the financial capacity to recover using their own resources; that is, they have “no credit elsewhere.” The higher interest rate, often referred to as the “market rate,” is capped at 8 percent and applies to borrowers determined to qualify for credit elsewhere. Table 2-4 below shows interest rates for the fourth quarter of FY 2005.

Table 2-4. Disaster Loan Rates for 4th Quarter FY 2005¹⁴

Type of Loan	Interest Rate and Maximum Pay Back Period	
	No Credit Elsewhere	Credit Elsewhere
Physical Damage-Homeowners	2.687 % for up to 30 years	5.375% for 30 years
Physical damage—Businesses and Non-Profits	4.000% for up to 30 years	6.557% for 3 years
Economic Injury Loans-Small Businesses	4.000% for up to 30 years	(loans not available)

For home disaster loans, SBA uses pre-disaster income and credit scores, along with other information, such as the applicant’s liquidity and net worth, to determine whether the applicant has the personal resources to recover from the disaster without the assistance of the federal government. For businesses, the information considered includes credit scores, available working capital and net worth. For applicants with no credit scores, SBA staff often must spend considerable time making phone calls or writing letters to landlords and others, seeking historical data that can be used to make a “credit elsewhere” determination. SBA staff estimate that the “credit elsewhere” process constitutes 10 percent of their loan processing workload.

Applicants that SBA determines have credit elsewhere are unlikely to accept an SBA disaster loan, due to the higher interest rate and the short repayment period. Since 1996, less than 4

¹⁴ SBA, ODA, Memoranda #05-25, “Interest Rates: Fourth Quarter FY 2005.” Interest rates are set for the disaster loans at the time of the disaster declaration.

percent of SBA disaster loans went to applicants who qualified for “credit elsewhere.”¹⁵ Less than two percent of the Gulf Coast Hurricane applicants were deemed to have “credit elsewhere.”

The underwriting stage ends with approval or decline of the application. Table 2-5 shows loan approval rates for the last 10 years.

Table 2-5. Disaster Loan Approval Rates 1997-2006

Year	Applications	Withdrawals ¹⁶	Approvals	Percent of Applications Approved
1997	107,526	15,598	47,135	51.3%
1998	76,300	14,038	30,147	48.4%
1999	104,641	25,340	35,288	44.5%
2000	62,651	12,291	27,302	54.2%
2001	122,599	24,417	47,192	48.0%
2002	48,937	11,883	18,789	50.7%
2003	69,474	16,985	24,082	45.9%
2004	85,885	18,633	26,719	39.7%
2005	189,094	43,210	58,821	40.3%
2006	369,910	71,721	169,534	56.8%

Source: SBA/ ODA, Office of the Associate Administrator (April 2007)

Applicants are notified in writing of the decline decisions, including all reasons for the decline action and their right to ask SBA to reconsider its lending decision. Applicants who have been declined have six months to ask for reconsideration of the decision. An SBA employee who was not involved in the original decision will review the case, including the additional information supplied to overcome the previous decline action. If the decision is to decline the application again, the applicant has 30 days to appeal the decision to the office director, who makes the final decision.

Closing and Disbursement

Once the underwriting process is completed and SBA has determined that the applicant can repay a loan of sufficient size to accomplish the goal (e.g., repair or replace damaged property), it will approve the loan, assuming the applicant meets other eligibility requirements. At this point, SBA prepares the closing documents which are mailed to the applicant or the field for loan closings in SBA locations. The applicant then must sign the documents to close on the loan—either in person or by mail—after which SBA will begin disbursing funds, usually within 5 days

¹⁵ Source: SBA/ODA, Office of Associate Administrator, as of December 2006.

¹⁶ In calculating approval rates, SBA does not include applications that have been withdrawn from the process before a decision can be made. Applications may be withdrawn by the applicant, but may also be withdrawn by SBA because the agency does not have sufficient information on which to base a decision. For example, the applicant may not have filed an income tax return or provided necessary documentation.

of closing. These Loan Closing Documents cover only the unsecured portion of the loan, as discussed below.

SBA policy requires that physical disaster loans for over \$10,000 and business economic injury loans over \$5,000 be secured by collateral. At the first stage of closing, SBA will disburse the unsecured amount (\$10,000 or \$5,000) to the borrower providing the borrower is ready to receive funds and all initial loan disbursement requirements have been met. However, to receive additional disbursements, borrowers must first provide the required collateral and satisfy any insurance requirements. (Discussion of this process can be found in Chapter III.) This additional closing stage can sometimes be difficult to complete, since title documents and other relevant documentation may have been destroyed. Again, much of this is a paper process transacted through the mail. It can also be confusing to borrowers who believe that the completion of paperwork for the release of the initial unsecured payment was all that was required of them.

Once collateral is secured and insurance conditions have been met, SBA will make further loan disbursements. SBA usually disburses the full amount of the economic injury loans at this point. By contrast, physical disaster loans are considered construction loans. The industry practice is to disburse construction loans in segments,

SBA's Closing and Disbursement Process

- ✓ Prepare closing documents and mail to borrower
- ✓ Obtain borrower's signature
- ✓ Disburse unsecured portion of loan
- ✓ Obtain proof of collateral to secure remained of loan
- ✓ Prepare and obtain signatures on collateral documents
- ✓ Disburse part of loan (or all of economic injury loan)
- ✓ Obtain evidence of progress on repairs or construction
- ✓ Disburse additional loan increments

as progress is made, in order to prevent cost overruns or fraudulent use of loan funds. Before each subsequent disbursement, borrowers must spend at least 80 percent of their current disbursement, and mail copies of paid invoices and receipts to SBA as evidence that the loan proceeds have been used properly. SBA may conduct on-site progress inspections,¹⁷ audit receipts, speak with contractors, and in some cases, obtain affidavits from borrowers or contractors before a subsequent disbursement, particularly before the final disbursement on major construction projects.

SBA does not have historical data on the time it takes to fully or partially disburse disaster loans. Data for loans in 2006, however, show very long disbursement times. For example, by July 2006, of the 153,000 loans approved for the Gulf Coast hurricanes, over 60,000 had had no disbursement, and another 60,000 had been only partially disbursed. There were several external factors that precluded borrowers from requesting disbursements including borrowers not being ready to rebuild, or who decided to relocate or wait for grant funds before making a decision to take their loan funds.

¹⁷ Progress loss verification inspections are conducted by ODA Loss Verifiers rather than the Field Inspection Team.

Loan Servicing and Collection

Once the final disbursement is made on disaster loans, responsibility for managing the loans is transferred from ODA to SBA's Office of Capital Access. The Office of Capital Access works to ensure borrower information is kept current, and modifies loans when appropriate, for example, when a paid insurance claim is received, the size of the loan needed is reduced.

This office's primary focus is collection of delinquent loans. In carrying out its mission, the office recognizes that borrowers are disaster victims and works with them in a variety of ways during the loan repayment period to help ensure borrowers make timely payments and to help delinquent borrowers bring their loans current. Staff may recommend ways to make loan repayment terms more affordable. Options include deferring loan payments, extending loan maturity, reducing loan payments for a temporary period, changing the borrower's interest rate, or accepting less than the full amount of the balance due. Calls to the delinquent borrowers begin within two weeks of the first missed payment.

- The first call—which is automated—and letter requesting payment occur when the payment is 11 days delinquent.
- Weekly automated calls, and several additional letters, continue until the 60-day delinquency date. Then an SBA employee calls and a letter clarifying options is sent.
- Another, more strongly worded letter is sent at 90 days.

Ultimately, Capital Access decides whether to foreclose on defaulted loans. After a loan is 110-120 days delinquent, SBA will begin the liquidation process, although Capital Access continues to work to collect the payment during this process. At that point, borrowers are notified that liquidation will begin in 60 days and are warned that their loans could be referred to the Treasury Offset Program for offset against certain federal payments that the borrower otherwise might receive. Data provided by SBA show that from January 2005 until the present, the number of disaster loans in liquidation ranged from a high of 3,904 in August of 2005 to a low of 1,943 in September of 2006; in April 2007 there were 2,329 loans in liquidation.¹⁸

Under the Debt Collection Improvement Act of 1996, the Treasury Department is charged with withholding or reducing certain federal payments to satisfy delinquent non-tax debts, including unpaid SBA disaster loans. The law specifies referrals to Treasury be made once the loan is 180 days delinquent, but includes a provision which allows SBA (and other agencies) to delay referral if it is still negotiating and working with the borrower to obtain payment. SBA refers loans to Treasury only after it has determined they can get no more from the borrower. Ultimately, loans without collateral, and those for which liquidation is complete but with a remaining balance on the loan, are referred.¹⁹

¹⁸ Source: SBA/Office of Capital Access, Office of Financial Assistance (May 2007).

¹⁹ *Financial Management: State and Federal Governments Are Not Taking Action to Collect Unpaid Debt through Reciprocal Agreements*, U.S. Government Accountability Office, Washington, DC (GAO-05-697R, July 26, 2005).

It has been estimated that over 40 percent of businesses fail to recover following a disaster,²⁰ and the default rate on SBA disaster loans can be high. For example, the President's Budget Request for FY 2008 reports a lifetime default rate on these loans of 24 percent. Therefore, a relatively large number of SBA borrowers may find themselves in significant difficulty. Borrowers' credit worthiness for other purposes can be affected, since SBA reports the status of disaster loans to credit bureaus throughout the life of the loan. Loans which are ultimately referred to Treasury can be put in the hands of a collection agency. Additionally, Treasury can withhold or reduce a wide variety of federal payments to delinquent borrowers, including federal payments to contractors, Social Security benefits, federal income tax refunds, federal retirement benefits, and federal pay.²¹

THE CLIENT PERSPECTIVE

The size of the loss incurred by disaster victims can vary considerably. One person may need only to replace a roof, while another may need to rebuild a home from the ground up. One may be able to live with relatives and continue working, while another may have no near-by support network, and may no longer have a job or business. The more severe and widespread the disaster, the less likely other personal sources of help will be available.

Finding out What Help Is Available

Information flow can be confused and chaotic after any major disaster. Victims may hear about possible assistance from a wide variety of sources. FEMA, state and local government officials and SBA directly advertise and work with the media and the community to inform the public about the available assistance. Victims also may learn of the programs through friends or other individuals. FEMA has an on-line registration process. During the Gulf Coast hurricanes many victims registered on-line and did not have the benefit of personal interviews with FEMA or SBA representatives.

Victims arriving at a state-federal disaster recovery center receive information about available state and federal programs. They learn, for example, about grants from FEMA, loans from SBA, disaster unemployment assistance, and food stamps, all of which have different eligibility requirements and purposes. This information can be confusing. In addition, at least in this early stage, victims may be unsure of what, if any, insurance settlement they can expect.

Businesses may learn about the SBA loans by going to FEMA, or through the media, but they may also hear about them from other sources, such as SBA's website or SBA's Disaster Call Center. They also might contact their district or regional SBA office to find out if help is available. Also, the local office of the Department of Commerce as well as business development non-profits in the disaster area usually work to inform people about SBA's disaster loans.

²⁰ House Report accompanying HR 1361, 110th Congress (March 2007).

²¹ Op Cit. GAO-05-697R. IRS rescinds debt for a variety of reasons, such as the debtor having paid the debt in full or the debtor having filed for bankruptcy protections, which makes the debt ineligible for collection through the program.

Applying for an SBA Disaster Loan

SBA Customer Service Representatives work to explain the eligibility rules and application process. But even if the applicant understands the requirements, the process can be frustrating. For example, even when SBA is successful in making quick referrals to FEMA—helping to ensure quicker service to home owners and renters ineligible for SBA assistance—the fact of having been referred to SBA, only to be turned down and referred back to FEMA, can be exasperating.

Figure 2-3. Assisting Prospective Disaster Loan Applicants



Source: Academy Staff Photo, January 2007

Applicants may contact SBA to inquire about the status of their loan or to notify SBA of a change in their circumstances. SBA may contact applicants about incomplete or unclear applications. Consequently, at this point, applicants could be dealing with a Customer Service Representative in a DRC—not necessarily the representative they met with originally—or with someone from the Processing and Disbursement Center or Customer Service Center; or they might have contacted their local SBA office in an effort to get clarification, not realizing the distinction between SBA district offices and disaster loan staff. Often, small businesses have relationships with the local SBA offices, and it is natural for them to contact these offices. In many cases, however, staff in these offices do not know details of disaster loan requirements, and certainly do not have knowledge of specific applicants' cases. Again, frustration can grow.

Proving that Applicants Qualify for a Disaster Loan

During the loss verification and underwriting stages applicants may be involved in trying to recreate records, or locate papers and people who could help prove their loss and that they have the ability to repay a loan. They are usually required to accompany the Loss Verifiers to the damaged property location. At the same time, they may be working with FEMA and other agencies to get short-term emergency assistance, looking for work, and deciding if they need to relocate, even temporarily, away from the disaster area.

Generally, this process—from application submission to loan approval—takes only a few days, limiting, but not eliminating, applicant uncertainty and frustration. The average time varies by type of loan and size of disaster, but SBA tries not to let the process take more than 21 days. In fact, SBA reports that in 2004, 85 percent of loans were processed to this point in 11 days for home loans, 14 days for business physical loss loans, and 13 days for business economic loss loans.

If, for whatever reason, the process takes longer, frustration can grow, as occurred in the aftermath of the Gulf Coast hurricanes. SBA reports that in 2006 average approval times, for 85 percent of applications, grew to 74 days for home loans, 66 days for business physical loss loans, and 29 days for business economic injury loans. Some applicants complained that the process was made more difficult because documents were lost in the mail, or information was not entered into the DCMS system, thereby requiring the applicant to resubmit the information. They also complained about getting conflicting and unclear answers to questions.

Closing the Loan and Receiving Payment

Once approved, applicants may not be sure that they actually want to take the SBA loan. They may be waiting, for example, to see what their insurance settlement will be and when they will receive it. Or they may expect the state to create a grant program for which they might be eligible. SBA generally gives applicants 60 days to return the closing documents and decide whether to accept the loan. But after the Gulf Coast hurricanes, the average time before closing was much, much longer; at one point it was 337 days. SBA granted lengthy extensions to the closing deadline because of the extreme uncertainty about whether and when communities would recover in the aftermath of those storms.

Once loans are closed, SBA reports that in well over 90 percent of cases the initial disbursements, those for unsecured amounts and economic injury, are made within 5 days. In the aftermath of the Gulf storms, however, even this rate fell to 55 percent. And the amounts of those initial disbursements may be disappointing. Borrowers are sometimes surprised to find that they will not get the full amount of the loan at closing. Some, most often home owners, find the initial loan amount (\$10,000 for homeowners) too low to be useful.

The process of finding the documents needed to secure a loan and obtain insurance coverage can be difficult. After the Gulf Coast storms this was especially difficult. For example, SBA found that a large number of approved loans were not being disbursed because borrowers in Orleans Parish had difficulties obtaining copies of the title to their homes; the Parish office responsible

for issuing them had huge backlogs. Delays also occurred because building permits were at times hard to obtain and because home owners and businesses found it difficult to find contractors. Though data are not available, SBA recognizes that, given the complexity and burden of this process, many just gave up and looked elsewhere for assistance.

SBA'S RESPONSE TO THE GULF COAST HURRICANES

SBA was overwhelmed in the immediate aftermath of the Gulf Coast storms. But in the years preceding that catastrophe, the Disaster Assistance Program had, by SBA measures, been operating reasonably well. Even so, before the storms hit, the agency had begun implementing changes intended to improve efficiency and service. Unfortunately, SBA faced its greatest challenge ever while in the midst of those changes. Changes intended to improve service actually contributed to delays and confusion. To its credit, however, SBA has proved itself flexible enough to make adjustments once problems were identified.

Past Performance Metrics Indicated Sound Performance

Before the Gulf Coast hurricanes, the Disaster Assistance Program was performing efficiently, according to the measures SBA includes in its annual *Performance and Accountability Report*. For example, since at least 1999, SBA reported having at least a 98 percent success rate in establishing a “field presence in 3 days” after a disaster declaration. Likewise, since 2002 it has reported over a 95 percent success rate in making initial loan disbursements within five days of closing the loan.

SBA was also meeting or exceeding its timeliness goals for loan processing. It reported that in FY 2000-FY 2002 over 90 percent of applications were processed to an approval/decline decision within the agency’s goal of 21 days. Since FY 2004, SBA has reported more detailed timeliness metrics, with goals for processing 85 percent of each of three types of applications. Those goals were significantly exceeded in FY 2004. SBA reported processing 85 percent of home loans in an average of 11 days, business physical loans in 14 days, and business economic injury loans in 13 days. SBA recognized, however, that the lack of disaster loan activity for most of 2004 probably contributed to the fast processing times.

Measures related to efficiency, such as cost per application processed, have varied significantly over time, as Table 2-6 demonstrates. This measure also includes the cost of disbursing approved loans. There are several factors which contribute to the variability in recent year-to-year costs, including the number and magnitude of disasters, the reorganization ODA was going through during 2005 and 2006, changes to ODA’s technology along with related training and equipment costs, and changes to loss verification processing.

Table 2-6. Cost per Application Processed, FY 2001-2006

	2001	2002	2003	2004	2005	2006
Cost per application processed ²²	\$1,752	\$3,506	\$2,644	\$1,994	\$2,775	\$4,000
Percent change from prior year		↑ 100%	↓25%	↓24%	↑ 39%	↑ 44%

SBA also reported relatively high success in achieving its disaster response mission. In FY 2004, SBA began reporting the percent of businesses and homes that were restored within 6 months after final disbursement of the loan. As shown in Table 2-7, below, SBA reported that in most cases over 70 percent of borrowers were restored within 6 months. In all but one case (renters in 2005) results were above the agency’s goal.

Table 2-7. Disaster Loan Program Outcomes, FY 2004 and 2005

	FY 2004	FY 2005
Percent of businesses sustaining economic injury restored within 6 months	95%	93%
Percent of businesses sustaining physical damage restored within 6 months	74%	72%
Percent of homeowners restoring their homes within 6 months	77%	75%
Percent of renters restored within 6 months	85%	70%

Despite this performance, there were signs that improvements could be made. Most significantly, in FY 2003 and 2004, customer surveys pointed to the application process as the area in which changes could most effectively improve overall customer satisfaction. In 2003 SBA began including applicants who had been denied loans in its customer satisfaction survey. As it expected, satisfaction dropped from previously reported levels—from 80 percent to 59 percent. The FY 2004 survey reported an increase in satisfaction, to 67 percent.²³ In both years, however, the ease of the process and the timeliness of decisions ranked lowest in customer satisfaction. Generally, the professionalism and courtesy of the staff ranked highest.

Data from the FY 2005 customer survey again began to show declines. Satisfaction dropped in most categories, though the overall rate fell only one point, to 66 percent. Again, the ease of the process and the timeliness of decisions ranked lowest in customer satisfaction. SBA’s performance metrics also fell. Application processing timeliness goals were not met. Processing

²² Source: SBA *Performance and Accountability Report*, FYs 2002-2006.

²³ The data for every year since 2003 show that those who receive loans are much more satisfied than those who do not. They also show that the level of complaints to SBA was too low for surveyors to determine how well complaints were handled or how difficult it was to file a complaint.

times doubled or nearly doubled for all three categories for which goals were set.²⁴ The situation deteriorated in FY 2006, when most of the claims for the Gulf storms were processed.²⁵ As discussed later in this chapter, even before the FY 2005 data were available, SBA initiated a workforce transformation program designed to improve ODA's service and efficiency.

SBA's Largest Disaster Challenge Ever

The Gulf Coast storms were devastating. They not only generated almost twice the number of loan applications as the previous "record" disaster, but did so dramatically faster. As noted above, SBA deals with many smaller disasters yearly. Major catastrophic disasters are relatively rare. Between 1990 and August 2005, SBA responded to 7 disasters that resulted in over 15,000 new closed loans, each. The largest of these was the 1994 Northridge earthquake in California. That quake generated over 250,000 disaster loan applications, and resulted in over 124,000 loans totaling \$4.0 billion.

Hurricane Katrina, followed by Rita and Wilma, far exceeded that previous record. Ultimately, over 422,000 applications were received and over 169,000 loans were approved, totaling over \$10.8 billion. But even more dramatic was the rate at which applications were received. While the Northridge earthquake yielded about 7,500 applications in the first three months, Katrina yielded almost 35,000 applications in the first month alone, and over 280,000 by the end of the third month.²⁶ The Gulf Coast storms were unique in other ways. The declared disaster area for Katrina alone was approximately 90,000 square miles; there was high loss of life; critical infrastructure was devastated, roads and bridges destroyed and basic utilities and communication systems wiped out.²⁷ Many victims moved far from the disaster area, making contacting them difficult.

Ultimately, ODA staff, which consisted of about 880²⁸ people in August 2005, swelled to over 4,200 five months later. But in those early months, staffing did not keep pace with workload.²⁹ Backlogs grew at every stage in the process.

Changes Underway Before Katrina

In April 2005 ODA announced a workforce transformation plan intended to improve its ability to serve disaster victims. The announcement followed a year-long study of the program, processes, and organization. By consolidating staff and functions, and implementing a new data system,

²⁴ Hurricane Katrina hit at the end of the fiscal year and it's difficult to say how much impact those applications had on SBA 2005 performance. The 34,500 applications received by September 30, 2005 constituted about 12 percent of total applications received during the fiscal year. During 2005 SBA processed applications resulting from four hurricanes that occurred in Florida during 2004. Together, those hurricanes generated an unusually high number of applications, about 180,000.

²⁵ Likewise, outcome measures showed declines in FY 2006—reflecting services in 2005—in three of the four areas.

²⁶ Data provided by SBA Office of Disaster Assistance, Herndon, VA; from the DCMS *Disaster Activity Report*.

²⁷ July 17, 2006 letter from Herbert L. Mitchell (Associate Administrator, ODA) to William B. Shear, GAO; cited in GAO 06-860 (July 2006).

²⁸ About half were full-time or cadre staff and half temporary staff who had come on board to process claims from the four 2004 hurricanes that hit Florida.

²⁹ SBA *Performance Accountability Report*, 2006.

ODA expected to operate more efficiently, at less cost and in less space. The plan sought to consolidate responsibilities previously carried out at each of the agency's four disaster area offices, as well as to deploy a new data processing system.

The changes were to be implemented in two phases and to be completed by October 2006. Key elements of the plan to be implemented in 2005 included:

- Consolidating customer support functions in the Buffalo office by September 2005.
- Fully implementing the new computer system, the web-based Disaster Credit Management System (DCMS), for all new disasters by December 2005.
- Creating a Support Center—co-located with the DCMS Operations Center—to house the Field Inspection Team (FIT), Disaster Personnel, and the Administrative Support functions.

By October 2006, other changes were to be made:

- creation of two Field Operations Centers (East and West) responsible for field operations (on-the ground disaster response), loss verification activities, and Congressional and public information activities
- centralization of all loan processing, including loan closing and disbursement functions, into the Fort Worth, TX office

ODA also announced that it intended to re-establish the Disaster Reserve Corps. Corps members are pre-screened and selected through competition, and commit to being deployed if SBA needs them in a disaster. The agency expected that the Corps would enable it to staff up more quickly and to do so at less cost.³⁰ ODA also had planned for expansion of some facilities in times of major disasters.

The April 2005 announcement indicated that the centerpiece of the plan was intended to be the consolidation of loan processing in the Disaster Assistance Processing and Disbursement Center (PDC) located in Ft. Worth, TX. It said that:

...ODA will achieve both efficiencies of scale as well as consistency of loan application and closing functions, consistent application of ODA policy...ODA believes this will lead to lower and more consistent loan processing times and efficient use of the DCMS loan processing system.

Caught in Transition

Hurricanes Katrina, Rita and Wilma could not have occurred during a more vulnerable time for

³⁰ For example, they would not need to advertise for new hires or move personnel staff to disaster locations to perform recruiting and hiring tasks.

the SBA Disaster Assistance Program. They hit while SBA was undergoing its planned office and staffing transformation process, and shortly after SBA introduced its new automated DCMS system. Moreover, SBA's application intake and loan processing staff were at historically low levels.

In January 2005, SBA began using DCMS to process applications for all new disaster declarations. DCMS automated parts of SBA's previously paper-based application processing system. The agency planned to complete migration from its old system to DCMS by the end of the year. Until August, 2005 had been a year of fairly limited disasters, so the system had not been tested in a major mobilization. Both GAO and the SBA Inspector General have reported that DCMS had significant deficiencies. For example, it was not capable of handling the capacity required in the Gulf Coast response, and hardware problems caused major downtime, resulting in less efficient application processing. ODA officials acknowledge these and other problems, but believe that, even with those problems, DCMS supported the process during the crisis better than its legacy system would have.

During the summer of 2005, ODA's northeast office moved from Niagara Falls, New York, to Buffalo and began transforming from an area office—responsible for application entry, loss verification, loan processing and approval, and loan closing and disbursement—to a National Call Center. This new Disaster Assistance Customer Service Center was made responsible for fielding inquires from disaster victims, which included calls transferred from FEMA's tele-registration center on an as-requested basis. The center also mailed out applications when asked to do so in support of the mail out function.

SBA also took the initial steps to consolidate loan processing tasks into the Fort Worth, TX Processing and Disbursement Center which assumed responsibility for loan processing on June 13, 2005.³¹ The agency experienced considerable turnover during this period as long-term, expert cadre staff that chose not to relocate left the agency. When Hurricane Katrina occurred, SBA was still trying to hire middle and upper-level managers for the PDC. Katrina prompted officials to expedite the consolidation. The PDC needed to hire a large number of employees in a short period of time, going from a staff of 300 immediately before Hurricane Katrina to a peak of 2,686 employees by August, 2006. Many of these new employees were hired and asked to relocate to Fort Worth within two weeks of the storm. Consequently, the new PDC had a wave of middle and upper-level managers in new positions, implementing the consolidated system for the first time. The large volume of new employees required significant training and did not allow for adequate supervisory staff. Employee turnover following the Gulf Coast hurricanes was high—approximately 80 employees each pay period—and competent new hires were often quickly promoted into supervisory positions.

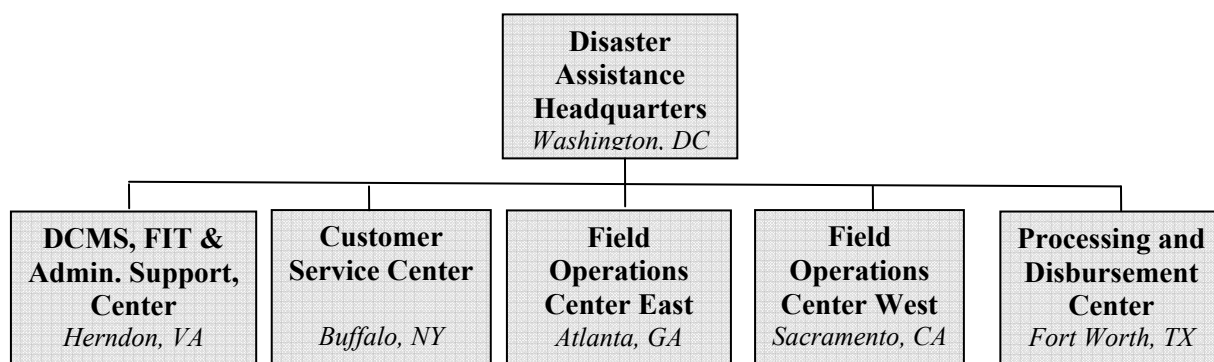
The loss verification process also underwent a major organizational and operational change at this time. During the spring and summer of 2005, SBA conducted an A-76 competition for the

³¹ Legal functions were centralized in the PDC in September 2005.

loss verification function. The ODA Most Efficient Organization,³² the Field Inspection Team (FIT), was ultimately awarded the contract in July 2005. This new organization officially came on-line on October 1, 2005, assuming responsibility for all initial on-site inspections conducted within the continental United States. According to the head of the organization, the anticipated phase-in period was to have started April 1, 2005; however, the contract was not awarded until July, substantially reducing the phase-in period.

Under the terms of the contract, FIT staff were also centralized, moving the function out of the previously existing four disaster area offices. The organization’s staffing plan allows for a limited number of permanent employees with an emphasis on term employees maintained on interim schedule appointments. This provides a group of employees who are available on an as-needed basis, without the need for them to be rehired every time they are deployed. Additionally, under the contract, Loss Verifiers use new hand-held technology that enters their reports directly into the DCMS system. This technology was new to both the SBA staff and the new term employees hired by the FIT.

Figure 2-4. ODA Organization Chart after 2005 Workforce Transformation



Reacting to the Backlogs

The speed with which applications came in probably would have caused early processing difficulties under most circumstances, but those difficulties were compounded both by the challenges presented by organizational and systems changes, and the sheer level of the devastation and uncertainty about the future of the disaster impacted area.

Initial Changes

As backlogs grew, ODA took several steps to speed up processing. GAO reported that some of these changes were effective, while others were not.³³ Some of the most effective changes,

³² OMB Circular A-76 establishes guidance for federal agencies seeking to contract out for goods and services that are not “inherently governmental,” when cost effective. A Most Efficient Organization is a federal agency’s in-house staffing plan for an A-76 competition, representing the most efficient and cost-effective organization. This organization’s bid is compared to bids submitted by private-sector companies competing for the contract.

³³ *Small Business Administration: Actions Needed to Provide More Timely Disaster Assistance*. U.S. Government Accountability Office, Washington, DC (GAO- 06-860, July 2006).

implemented in October or November 2005, included:

- Establishing a satellite office to process loans; increasing staff at the satellite location from about 40 to 250 by February 2006.³⁴
- Reducing paperwork required with applications for business loans; for example, ODA stopped requiring 3 years of tax returns and monthly sales analyses from EIDL applicants.
- Authorizing loss verification staff, in certain circumstances, to use third party documentation and no longer requiring the applicant to be present.
- Using the DCMS to conduct an automated analysis of credit scores to facilitate faster decision-making.

The agency also quickly took steps to increase the capacity of the DCMS system, including requiring the contractor to provide the correct hardware and working double shifts to operate the system around the clock. As noted above, the capabilities of DCMS were marshaled to facilitate decision-making.

After applications are accepted and entered into DCMS, but before they are sent to loss verification, SBA uses an automated process to assess both individual and business applicants' potential ability to repay, based on their credit history. ODA had for several years obtained applicants' credit scores, and reviewed them manually. In an effort to speed up processing after the Gulf Coast hurricanes, the agency began making automated "pre-processing declines" (PPDs) based on applicants' credit scores.³⁵ If the applicant's credit score is below a specified value, the application is automatically declined. All pre-processing declines are reviewed by a Supervisory Loan Officer who determines whether or not to accept the decline.

SBA also introduced an automated "expedited" processing step in the underwriting stage. For applicants with especially high credit scores, their scores were used to determine maximum loan amounts. If applicants applied for loans greater than the automatically determined amount, they were sent to standard processing, where underwriting determined the maximum loan for which they would qualify.

It took time for these changes to have an impact. By January 2006, when almost 340,000 applications had been received as a result of the Gulf Coast storms:

- The backlog in loss verifications was about 115,000.
- Over 200,000 applications awaited a decision.

³⁴ As part of the workforce transformation initiative, SBA was in the process of closing the former Sacramento Disaster Area Office, and turning it into one of two regional field operations centers. This satellite office processed over 100,000 claims following the Gulf storms.

³⁵ In January 2005, a new automated system was brought on line that automatically obtains these credit reports. Before that time the credit search was done manually and the information manually entered into the system.

Yet by summer 2006, progress was evident. By July 2006 there no longer was a significant backlog in loss verification,³⁶ and decisions had been made on about 416,000 of the 420,000 applications. However, post-approval bottlenecks still existed.

Later Changes

When a new SBA Administrator was appointed in July 2006, he was confronted by a bogged down process. During his confirmation hearings he had been encouraged to focus quickly on disaster assistance. And he did so. He found that, although decisions had been made on most applications, significant loan processing backlogs remained—especially loans awaiting modifications, such as changed addresses or changed loan amounts—and that most of the approved loan funds had not been disbursed.

The Administrator convened a 3-day leadership meeting with headquarters and PDC staff, facilitated by an outside contractor with experience in business process design. This group identified problems and potential solutions to the existing issues facing the agency. In September 2006 the Administrator appointed one of SBA's regional administrators to oversee improvements. A series of brain-storming sessions and focus groups followed. The immediate steps taken, embodied in the Accelerated Disaster Response Initiative, included:

- **Revamping the post-approval process** by creating case management teams with staff from each key area (loan processing, legal, etc.). The emphasis was on customer service and accountability, with each approved loan assigned to a team and an individual case manager. According to the Administrator, creating the teams required shifting 1300 staff.
- **Proactively contacting approved applicants** to determine their status. SBA contacted about 94,000 borrowers and found that many no longer wanted the loan and could be taken out of the queue; others needed assistance in providing the information needed to allow SBA to continue loan processing to closing and disbursement.
- **Developing better metrics**, using DCMS capabilities, to track the applications and loans and better identify bottlenecks and solutions.
- **Taking direct action to address backlogs.** For example, when SBA determined that many applicants were having difficulty in obtaining titles, the agency sent SBA personnel to work on site in the appropriate parish offices to help expedite that process for SBA disaster loan borrowers.

³⁶ The head of the new loss verification unit said that, although the transition of the loss verification function to the Field Inspection Team caused problems, the team ultimately had considerable success in dealing with the backlog of applications. The organization conducted 29 training classes through the course of the declaration, and inspected over 300,000 locations in the six month period ending March 31, 2006. He pointed out that, in the first month after the hurricanes, SBA, under the predecessor loss verification system, completed 3,700 verifications with about 200 staff members. In October, the first month after the new organization assumed responsibility, over 33,700 verifications were conducted and production increased steadily from that point forward.

Officials reported that loans in process decreased from about 115,000 in July 2006 to less than 30,000 in December and less than 20,000 by March 2007. For many of the remaining undisbursed loans, according to officials, borrowers are unsure about whether to take the loans. Many disaster victims are waiting for insurance recoveries or state grants before deciding to pursue loan disbursements.

Beyond the immediate concern of breaking through the backlog and getting funds to those who needed—and had qualified for—they, SBA began considering ways to learn from the 2005 hurricane experience to improve disaster response and preparedness. These efforts are discussed later in this chapter.

GULF OPPORTUNITY PILOT LOAN PROGRAM

SBA established the Gulf Opportunity Pilot Loan Program (GO Loan) on an emergency basis to try to expedite the availability and delivery of moderate-sized small business loans in areas affected by the Gulf Coast hurricanes.³⁷ The GO Loan program is modeled after the *SBAExpress* 7(a) loan guarantee program policies and procedures, and borrowers must meet the same eligibility requirements. Under *SBAExpress*, approved lenders use an abbreviated application, develop their own underwriting criteria, charge a 2 percent upfront fee (of which SBA receives 1.5), and apply interest rates within a range of Prime plus 6.5 percent, depending on the loan size. While the GO Loan program has adopted several *SBAExpress* procedures, the pilot has several substantive differences, including:

- The GO Loan program is limited to businesses located in or adjacent to counties and parishes included in the presidentially declared disaster affected by the Gulf Coast hurricanes.
- GO Loans are limited to \$150,000, instead of \$350,000 under *SBAExpress* and the \$1.5 million under the SBA disaster loan program for businesses.
- GO Loans receive SBA's full 85 percent guarantee, as opposed to *SBAExpress* loans which are limited to a 50 percent guarantee.
- If a GO Loan is used to refinance existing debt, the loan need not increase the applicant's cash flow by 20 percent, as it must under the *SBAExpress* program.

SBAExpress lenders electronically submit streamlined application documents to SBA for processing. The Processing and Disbursement Center completes a quick review of the documentation and determines if the applicant meets SBA's requirements. SBA does not perform additional credit analysis, since this has been delegated to the lender. Loans are serviced and liquidated in conformance with *SBAExpress* lenders' procedures for non-SBA commercial loans.³⁸

³⁷ Unlike the other disaster loans, these loans are not administered by ODA.

³⁸ U.S. Small Business Administration Procedural Notice "Gulf Opportunity Pilot Loan Program" 9/29/2006

Through April 30, 2007, over 565 GO Loans totaling \$48 million had been approved. Loans average \$84,000, with interest rates averaging 9.4 percent during fiscal year 2006 and 9.6 percent in FY 2007. The average maturity of the loans is 6.6 years. Forty-seven percent of GO Loans were made to start-up businesses.³⁹ As of April 2007, 0.71 percent of GO Loans were past due and 4.25 percent were delinquent. The pilot expires September 31, 2007.

It is too early to assess the performance of the GO Loan program or its level of utilization. However, it is likely that the volume of GO loans remained low because of the availability of direct disaster loans, which carried lower interest rates and offered better loan terms. As part of its regular oversight process, the Office of Lender Oversight collects current credit information - borrower and business credit—on all loans in the 7(a) portfolio, but it does not have any plans to monitor or conduct any special analysis on the credit performance of GO Loans. In the office's view, the GO Loan portfolio is small relative to the overall size of the Section 7(a) program; therefore, a comparison of the credit scores would not be statistically valid.⁴⁰

KATRINA REVEALED PROBLEMS AND IDENTIFIED OPPORTUNITIES

The nation was not prepared for Hurricane Katrina and her sisters, and it is apparent that SBA, along with other federal, state and local agencies and nonprofit organizations, needs to improve planning for catastrophic events. In addition, though the circumstances of the Gulf Coast storms and the problems with the response were unique, the experience revealed problems and identified opportunities for improvements that can improve service to all disaster victims.

Planning to Respond to Catastrophes

SBA had not anticipated a disaster of this magnitude. The number of applications received, the speed with which they arrived, and the size of the workforce and related space and support services needed, were unprecedented. SBA did not have a plan to meet the demand. The agency acknowledged that the method it used to forecast activity resulting from disasters did not anticipate anything approaching the scope of this disaster. It relied on estimates based on prior experience, especially the 1994 Northridge, California, earthquake, which had been the largest disaster before 2005. That event generated less than half of the value of loans approved following the Gulf Coast hurricanes.

GAO reported in February 2007 that SBA had engaged in limited logistical disaster planning before the Gulf Coast hurricanes, and that insufficient planning likely contributed to initial challenges faced in the agency's response. GAO pointed out that SBA did not use sophisticated approaches, such as catastrophic risk modeling or disaster simulations, to prepare a comprehensive disaster plan, even though such techniques are available in the private sector and are used by some government agencies.

³⁹ SBA data provided by the Office of Financial Assistance.

⁴⁰ E-mail exchange with Office of Lender Oversight staff.

As GAO reported, the DCMS system did not have the planned capacity to meet needs such as those resulting from the Gulf Coast hurricanes. Likewise, there was no clear plan to increase staffing or find necessary facilities on such a scale.⁴¹

SBA officials indicated that they lacked the funds needed to estimate system requirements using more sophisticated techniques. They also expressed their belief that logistical planning at the national level offered limited benefit, and that local agency officials were in the best position to estimate logistical requirements. But as GAO reported, field offices had not prepared plans either.

As discussed later in this chapter, SBA is taking steps to anticipate future catastrophic disasters.

2005 Storms Raise More Fundamental Issues

The lessons learned from the agency's Gulf Coast experience go beyond concerns about responding to similar catastrophic events. These lessons also pointed to ways in which service can be improved in "normal" disaster circumstances. When the Panel reviewed the disaster program structure and policies in the context of the agency's experience after the Gulf Coast hurricanes, it recognized opportunities for fundamental improvements.

The changes seek to ensure that SBA fully harnesses the potential of SBA-wide resources, process reengineering, and automation to achieve its disaster response mission. These changes are discussed in Chapter III. Further, the Panel recognizes that catastrophic events, such as experienced in 2005, may overwhelm the current program structure no matter what procedures are used. Consequently, as discussed in Chapter IV, the Panel seeks to identify alternative ways in which SBA could achieve its mission objectives. Especially with the prospect of possible homeland security events in addition to natural catastrophes, the SBA's ability to help homeowners and businesses recover from a major disaster becomes increasingly important.

The following sections summarize the experiences that the Panel believes demonstrate significant areas where the Disaster Assistance Program needs to be improved.

The Gulf Response Stressed the SBA Disaster Assistance Process

The Gulf storms stressed the disaster loan processing system and highlighted specific issues that had not been previously identified or addressed. Some of the key operational problems encountered in serving victims of the Gulf Coast hurricanes are summarized below.

- GAO reported that SBA had only limited success in using its district office staff and obtaining private sector assistance in loan processing. For example, SBA solicited proposals from local commercial banks and other entities to process disaster loan applications and decided to make three awards. However, it received queries from several unsuccessful entities and decided it could not go forward until those protests were resolved.⁴²

⁴¹ Op. cit. GAO 06-860, July 2006.

⁴² Ibid.

- Although the DCMS system automates key aspects of the loan processing system, it was not designed to take full advantage of opportunities to maximize efficiency. Essentially, the agency automated the existing paper process. It did not reengineer the system.
- The DCMS contractor failed to provide the hardware that SBA had contracted for. Inadequate hardware contributed to the outages and capacity limitations that plagued the agency's initial response. SBA took steps early to obtain the correct hardware from the contractor and to increase capacity and stability of the system.
- Since 2004, applicants using FEMA's online registration had been referred to SBA for possible loan assistance if they did not provide an estimate of their income. When no estimate of income was reported, FEMA automatically referred the applicant to SBA for an eligibility determination (referred to as "0 income" referrals).⁴³ This resulted in considerable added and unnecessary work for SBA, especially following the Gulf Coast hurricanes. The agency mailed applications to all of those referred and many of them ultimately applied for an SBA loan. SBA then denied many of these applicants because they had inadequate income to qualify for a loan. SBA worked with FEMA, which added new business rules to the online application in October 2006 that eliminated the option to decline to provide an estimate of income.
- Bottlenecks occurred at almost every phase of the system. Backlogs grew at different times and different rates in loss verification, underwriting, loan closing, and disbursement.
- Staffing up to the level needed would have been difficult in any similar scenario, but it was made harder, not only because of the reorganization underway, but because following 9/11, SBA had allowed its Reserve Corps to dwindle to an estimated 25 members.

Underlying Issues Contributed to Problems

These problems were compounded by the unusual circumstances presented by the total devastation of a wide area, including the extensive relocation of victims, the number of documents lost, and the delay in getting deeds and permits from the local governments. But, they also resulted from ODA's paper-dependent process and limited contingency planning.

The Panel believes that, when viewed in the context of the Program's overall structure and policies, these specific problems are symptomatic of more basic issues: the insular nature of ODA operations within SBA and the need for a comprehensive vision that rises above the details of particular procedures.

⁴³ See Chapter III for a more complete discussion of these referrals.

Insular operation

When Katrina struck, ODA did not have plans in place to tap into alternative sources of support to meet the heavy workload demands brought by the disaster. The absence of such plans reflects ODA's insular nature and what appears to be a culture of self-reliance. As noted earlier, to a great extent ODA functions apart from the rest of SBA. For example, ODA was not included in the SBA-wide workforce transformation begun as early as 2001; ODA's workforce transformation began in 2005. Similarly, SBA district office staff did not have access to DCMS and therefore had to process disaster applications manually; paper applications had to be mailed and PDC staff had to make corrections to returned applications and key the information into the system.

On the one hand, the insularity of ODA reflects the proud tradition of an office that has responded admirably to most of the challenges that it faced before Hurricane Katrina. ODA officials maintain that limitations on the use of SBA's unionized workforce are a deterrent to mobilizing other SBA staff during especially large disaster responses. On the other hand, the SBA Inspector General's office sees value in integrating ODA with the rest of SBA to a greater extent. The Assistant Inspector General for Auditing recommended that ODA fully utilize SBA personnel in responding to catastrophic disasters, rather than rely solely on ODA. She stated that access to DCMS should be expanded to those in SBA, as well as third-parties, that could support the agency in a catastrophe. SBA agreed with these recommendations.⁴⁴

Need for a comprehensive vision

SBA makes relatively frequent changes to its disaster loan operating procedures, learns from experience, and solves problems in specific practices and procedures. The Panel, however, believes that the agency has not looked comprehensively enough at the entire disaster assistance program. Limited vision was evident not only in the lack of a disaster plan, but in ODA's failure to reengineer its processes. It has not effectively looked at its process as a whole to identify opportunities for improvements. The development of DCMS is a case in point. Although planning for DCMS had been underway for many years—and ODA staff told the study team that some process reengineering had been implemented before the system was established—ultimately, the new system essentially automated the existing paper process.

Process reengineering should identify significant improvements that would make the loan program more responsive to clients and easier for staff. Adopting and adapting best practices of private sector lenders, such as automated underwriting, offers the promise of increased efficiency and better service. Likewise, a comprehensive review of the loan process will undoubtedly identify additional opportunities for other improvements through automation. Too much of the current process still depends on paper. The "automated" DCMS system was fed by paper applications that had to be mailed from disaster centers to the PDC. Throughout the process, papers and documents had to be mailed or faxed (and sometimes re-mailed) between clients and ODA, between SBA offices, and between SBA and other agencies.

⁴⁴ SBA, Office of Inspector General, Advisory Memorandum #06-31 (September 25, 2006).

The potential benefits from automating more of the process were demonstrated during the Gulf Coast storm disaster response. For example, loss verification backlogs were broken, at least in part, when ODA loan officers used handheld processors to enter information directly into DCMS. Likewise, using DCMS to automatically obtain and analyze credit scores helped to speed the approval/denial process.

The Panel has identified other fundamental changes that can be made in policies and procedures to better serve disaster victims. These changes are discussed in Chapter III. The Panel also considered the limitations of the program, as currently designed, to meet the needs of catastrophic disaster victims and developed alternatives for consideration by Congress and SBA. These alternatives are discussed in Chapter IV.

As discussed below, SBA is already making changes based on the Gulf Coast storm experience. Many are on track with those being recommended by the Panel. But as will be discussed in later chapters, SBA's current plans do not take the agency as far as the Panel believes it can go.

ADDITIONAL CHANGES ARE PLANNED OR UNDERWAY

SBA has initiatives underway or planned that, according to the Administrator, will fundamentally change ODA's organization and program. Many of the initiatives begun in response to Katrina will be continued or expanded, but the vision goes further. The SBA Accelerated Disaster Response Initiative team is looking for ways to tap into the private sector, both to learn from it and to obtain its support during major disaster responses. Additionally, within ODA, three business process reengineering teams are working to develop new approaches to key aspects of ODA's operation: Administration, Personnel, and Loan Processing and Disbursement. Several initiatives are already being developed.

Three themes frame these changes: (1) maximize use of automation, (2) integrate ODA more effectively into SBA (but without sacrificing the esprit de corps and strength of the current ODA culture), and, (3) reach out beyond ODA in times of major disasters. Three of the most important changes are briefly described below, including moving to an on-line application, developing a disaster plan and a related field engagement plan, and adjusting the organizational structure.

Automation and On-line Registration

SBA had been thinking about instituting an on-line application for several years, and the concept was again under consideration in early 2005. But it was not developed, at first because of the stress of the 2005 hurricanes, and later because the new SBA Administrator saw more fundamental problems in the loan approval and disbursement process; problems addressed, in part, by the changes discussed earlier.

The initiative is once again moving forward. The Administrator expects that the on-line application process will be tested by the end of 2007. According to an ODA official, the prototype is already working and technical requirements should be completed soon. SBA's

Business Technology Investment Council and the Office of Management and Budget have approved the proposal to automate the application process. If current estimates are correct, the new process will be available by the 2008 hurricane season. In addition, the Administrator stated that work will continue on redesign of the whole “front end of the process” for another 9-12 months.

Additionally, as recommended by the Inspector General, work is underway to expand access to the web-based DCMS system to others in SBA who could support the agency’s disaster response.

Disaster Response Planning

SBA recently completed its Disaster Recovery Plan. (Panel members did not have the opportunity to review the Plan before the completion of this study). Officials explained that, historically, SBA relied on the expertise and skill of ODA’s leadership, and the dedication of its staff, to ensure effective disaster response. The Gulf Coast storms, however, pointed to a need for a more organized, formal, and pre-planned approach. SBA officials also said that through the process of formulating the plan they have developed innovative approaches to carry out their mission, focusing more on automation and reaching out beyond SBA for help.

The Disaster Response Plan will provide standard operating procedures governing preparations for, and responding to, declarations of disasters of various dimensions. Additionally, a Field Engagement Plan will spell out how staffing will be accomplished in disasters of different magnitudes. SBA officials explained that, together, these plans seek to ensure the agency will be able to staff up to a “catastrophic” level with as few totally new staff members as possible, maximizing the use of existing facilities and systems. The plans will address staffing, facilities, and system capacity, as well as coordination on the ground with the media and other federal, state, and local responders. Officials identified several key aspects of the plans that are expected to enhance the agency’s response capabilities.⁴⁵

Facilities

New approaches are being used to ensure that necessary and appropriate space is available for staff mobilized in a catastrophic disaster. In this regard, SBA has identified opportunities to expand currently used office space to accommodate additional staff when needed in emergencies. It has also “mothballed” space it no longer needs, keeping it in reserve for possible expansion in a disaster. This alternative, however, may prove to be too costly in the long-run. Consequently, SBA intends to maintain an on-going relationship with the General Services Administration (GSA) to ensure that GSA has a clear understanding of the kind of space and support SBA needs for different disaster scenarios, and to work periodically to identify what space might be available under various circumstances.

⁴⁵ The Panel did not review SBA’s own plans for operating in an emergency, for example if one of the offices was unable to operate because of a fire or other disaster. However, SBA officials indicated that each facility has in place a plan to ensure resumption of operations as quickly as possible. For example, the DCMS database is backed up in almost real time. Should the need arise, an alternate facility located in Tempe, Arizona, would be brought on-line, the backup database accessed, and SBA staff would then log onto the alternative system. Based on recent tests, officials estimated they could accomplish this in 6-8 hours.

Reserve Corps

SBA has had a Reserve Corps for many years. The Corps, however, was not maintained at sufficient levels to meet catastrophic needs. Essentially, the Reserve Corps is comprised of competitively selected, pre-trained individuals who are hired and remain on the rolls in a non-pay status and agree to be called up and deployed to disaster areas on 48 hours notice. This facilitates quick staff build-up because SBA does not need to advertise and recruit this staff after a disaster occurs, and because Corps staff do not have to undergo many of the pre-hiring screenings required of new employees. They are already trained to participate in the disaster response. They can serve in a variety of positions, including Customer Service Representative, Loss Verifier, legal, and loan processing staff.

As shown in Table 2-3 above, SBA began to expand the Reserve Corps in 2005, but according to officials, the process was not fully implemented by the time of the Gulf Coast storms. Efforts are again underway, however, to re-engineer the Reserve Corps. In revitalizing the Corps, SBA is taking a two-tiered approach. The “ready reserve” consists of personnel who had been hired relatively recently. (There are several thousand current and former temporary employees who have significant experience as a result of work during the Gulf Coast hurricanes.) These people would not need to be trained before being deployed, at least in the near future; however, unlike other reservists, they have not committed in advance to being deployed. “Active reserve” members, in contrast, have agreed to deployment on 48 hours notice. As of April 2007, SBA reported about 900 active reservists on the rolls. Personnel in this category will receive about one week of training each year.⁴⁶

Use of SBA-Wide Staff

Plans are being made to make much greater use of SBA staff outside of ODA during catastrophic disasters. As currently envisioned, staff will be called up in the following order: current ODA staff, Reserve Corps members, other SBA staff (and perhaps volunteers from other federal agencies), and new (temporary) hires. In order to facilitate participation by other SBA staff, several changes are being contemplated:

- Staff in SBA district offices will be cross-trained to perform disaster program tasks. SBA is working to define what this training will entail. The district offices, officials said, appear to be eager to participate.
- Most of the staff members in other SBA offices are unionized; their job descriptions do not explicitly allow for deployment during emergencies. Consequently, SBA staff cannot be deployed to other geographic areas unless they volunteer. SBA officials intend to change the job descriptions for new employees to include the possibility of mandatory deployment. Officials are considering working with the unions to change job descriptions of existing employees to include the possibility of deployment.

⁴⁶ Officials indicated that the FIT also has a Reserve Corps, numbering about 200 in April 2007. Unlike other Corps members, these personnel are “intermittent” employees” who, when in pay status are hourly workers, and do not receive benefits.

- Absent changed job descriptions, officials will work to identify volunteers in advance from among existing SBA staff.
- Access to DCMS will be expanded to other SBA staff.

Reaching Beyond SBA

SBA has contracted with three loan service providers to provide support in underwriting and closing loans during major disasters. The agency is considering other types of support that might be available from commercial banks and other financial institutions. Though far from making a decision, other roles could include, for example, disbursing funds—from an escrow account set up by SBA—or actually making loans.

SBA “partner” organizations—the Service Corps of Retired Executives (SCORE), Small Business Development Centers (SBDCs), and Women’s Business Centers (WBCs)—have in the past been involved in disaster response, especially in support of outreach to the small business community. SBA is looking for ways to involve these organizations more effectively and more expansively in communicating information about loan availability and procedures in the aftermath of major disasters.

Better Forecasts of Resource Needs

In support of this planning effort, the agency reports that it has enhanced its capability to forecast application volumes when disasters strike, as well as its ability to better determine resource needs—financial, human capital, and logistics—to maximize its response when confronted with different levels of application volumes. GAO questioned, however, whether this effort went far enough. In February 2007 GAO recommended that SBA set timeframes for implementing its disaster management plan—for example cross-training staff—and that it further assess whether the use of disaster simulations or catastrophe models, rather than reliance on agency expertise and previous disaster experience, would enhance the agency’s disaster planning process.⁴⁷ According to SBA officials, the agency is still exploring the use and value of the external modeling that GAO recommended, but simulations are included in the new plans. Officials said they conducted their first simulation exercise in May 2007.

Difficulties Must Be Overcome

Many of these ideas are not new and, when tried in the past, have had only limited success. ODA officials point to problems in using SBA-wide staff, noting that different personnel authorities—especially those affected by union contracts—limit the extent to which non-ODA staff can be deployed to meet the high demands of disaster response situations. They noted that in the aftermath of Hurricane Katrina, few SBA staff volunteered to be mobilized. Moreover, as discussed earlier, the Reserve Corps has existed for some time, but membership has waxed and waned; it is difficult for Corps members to maintain their knowledge and skills if there are long

⁴⁷ *U.S. Small Business Administration: Additional Steps Needed to Enhance Agency Preparedness for Future Disasters*, GAO-07-114 (February 2007).

periods of relatively low disaster activity. Likewise, SBA has had little success in mobilizing private sector entities, especially commercial banks, to support it in a large mobilization. The success in contracting for help in loan processing is, however, promising.

Better Integration of ODA into SBA

SBA Administrator Preston believes that to most effectively implement the integrated approach envisioned by these plans—especially participation by district staff in disaster loan processing and the necessary cross-training and access to DCMS—ODA must be better integrated organizationally into SBA. The organizational alignment has already been changed, making ODA one of five program offices reporting to the Administrator, rather than being a more distinct entity, as it had been.

The Administrator emphasized, however, and the Panel concurs, that these changes must be made carefully, to protect ODA's culture from unnecessary disruption. The separate IT and personnel offices were established to better ensure that services could be delivered quickly during disaster response. SBA officials recognize that ODA has operated effectively in most situations for many years. The existing staff have considerable expertise and experience and have been able to effectively respond in most situations. These officials also point to the important esprit de corps and true dedication that drives the ODA staff to work 18-hour days and do whatever is needed during disaster response. That is too important an asset to jeopardize, and must be considered as changes in the relationship of ODA to the rest of SBA are proposed or implemented.

CHAPTER III

THE DISASTER ASSISTANCE BUSINESS PROCESS

This chapter describes in some detail the current business processes used by the Small Business Administration to process disaster loans. It considers the major steps in a making a disaster loan: outreach, intake services, loss verification, loan underwriting, loan closing and disbursement, and loan servicing and collections. Each of these areas has undergone, or will undergo, significant changes, many due to the unprecedented effects of the 2005 Gulf Coast hurricanes on the disaster loan process.

DISASTER LOAN OUTREACH

Following any Presidential major disaster declaration that includes individual assistance, the Federal Emergency Management Agency (FEMA) sets up Disaster Recovery Centers (DRC's) at the request of the governor(s) of the state(s) where the disaster occurred.⁴⁸ FEMA, state and county programs, and the SBA disaster loan program are represented in each DRC. FEMA representatives, state officials and SBA Public Information Officers (PIOs) work together to advertise the disaster assistance services they provide on local television and radio stations, and in a variety of local venues such as community centers, Chambers of Commerce, work sites and religious institutions. As part of their public outreach, SBA Public Information Officers explain the disaster loan program, disseminate disaster loan fact sheets, and provide Disaster Recovery Center location information and the toll-free number for the Disaster Assistance Customer Service Center in Buffalo, New York.

Following presidentially declared natural or man-made disasters SBA Customer Service Representatives (CSRs) are available in each Disaster Recovery Center to assist people inquiring about disaster loans. CSRs:

- Provide information about the disaster loan program.
- Disseminate business and home loan applications.
- Assist loan applicants to fill out their applications.
- Screen and accept completed applications.
- Send applications overnight daily to SBA's Processing and Disbursement Center in Fort Worth, TX.
- Answer questions relating to subsequent paperwork requested by the PDC following application submittals.

⁴⁸ FEMA often provides Disaster Recovery Centers outside disaster areas where there are concentrations of displaced individuals due to a disaster (e.g. there were DRCs in Houston, TX following Hurricane Katrina).

- Perform loan closings.

SBA disaster loan fact sheets and toll-free number are also available in each Disaster Recovery Center, and SBA posts DRC locations and hours of operation on the agency website.

People inquiring about disaster loans who do not visit a Disaster Recovery Center can call SBA's toll-free number and speak with a Customer Service Representative. CSRs at the Buffalo Customer Service Center can answer questions about the disaster loan program, provide Disaster Recovery Center location information, and review applicants' electronic case files to address case specific questions. The Buffalo Customer Service Center provides a Spanish queue staffed by Spanish speakers and utilizes an interpretation service provider to assist those callers who speak languages other than English or Spanish. SBA's Disaster Assistance web site provides information about the location of Disaster Recovery Centers, the toll-free number for the Buffalo Customer Service Center, and SBA disaster loan fact sheets.

Disaster Loan Outreach Following the Gulf Coast Hurricanes

SBA faced challenges in its outreach efforts following the Gulf Coast hurricanes due to the extent of damage and the widespread displacement of those affected by the hurricanes. In the Gulf Coast hurricane disaster areas, Public Information Officers (PIOs) from Field Operation Centers East and West informed the public about the Disaster Assistance Program by advertising in newspapers, and on television, radio, and the Internet, and by holding meetings at community and faith-based organizations, work sites, Chambers of Commerce and congressional offices. According to a February 2007 GAO report,⁴⁹ SBA Public Information Officers conducted outreach through approximately 600 organized events, substantially larger than the number conducted for other disasters. These events were held for audiences ranging in size from just a few to more than 5,000 people, and included Latino, Vietnamese, and Hmong people. SBA staff also traveled on a number of occasions with high ranking elected and appointed officials to provide disaster assistance to the constituents in the affected areas.

In response to displacement of people resulting from the Gulf Coast hurricanes, Public Information Officers advertised the Disaster Assistance Program in local newspapers, and on television and radio stations in locations outside the disaster areas that hosted significant populations of displaced individuals. FEMA also set up Disaster Recovery Centers in such areas, and SBA Customer Service Representatives were stationed in each one.

Academy staff field interviews revealed three primary shortfalls of SBA outreach following the Gulf Coast hurricanes. First, SBA officials and Customer Service Representatives stated that due to the large volume of disaster loan applications and limited agency resources, SBA Customer Service Representatives were unable to make a sufficient number of follow-up calls to individuals who received disaster loan applications. These follow-up calls, which are generally conducted following most disasters, are an important tool for informing applicants about the disaster loan program and application process, and for offering assistance in application

⁴⁹ *Additional Steps Needed to Enhance Agency Preparedness for Future Disasters*, U.S. Government Accountability Office, Washington, DC, February 2007, p. 25.

completion. Second, officials from SBA and FEMA said that following the Gulf Coast hurricanes, there was much public confusion about SBA being the provider of home disaster loans because people generally associate SBA with providing support to businesses only. Finally, representatives from business development and micro-finance non-profit organizations in Louisiana said that SBA did not effectively reach out to the Vietnamese population in New Orleans and surrounding parishes (particularly Plaquemines Parish), and language barriers were a problem. SBA officials stated that this need was recognized, and SBA led several events targeting the Vietnamese population.

The Role of SBA District and Branch Offices Following Hurricane Katrina

ODA did not make use of the existing SBA field network to the extent possible following Hurricane Katrina. During interviews with study team members, officials from the SBA New Orleans District Office and SBA Gulfport Branch Office reported that they were not part of ODA's disaster plan and although they offered their services to ODA, they were not included in the disaster recovery effort. Due to population displacement challenges, the Director of the SBA New Orleans District Office was eventually asked to assist ODA's Public Information Officers to conduct outreach because he was a familiar face to many residents of Orleans, St. Bernard, Jefferson, and Plaquemines parishes.

Following Hurricane Katrina, business owners frequently contacted the New Orleans and Gulfport SBA offices inquiring about the disaster loan program. Representatives at these offices however could only suggest that people call SBA's toll-free number. Representatives from both offices said that business owners in their communities did not understand the distinction between their local SBA office and ODA, and it was frustrating for the local office not to have been a part of the outreach process for the Disaster Assistance Program.

An ODA official stated that it is customary in any disaster to contact the regional and district SBA offices. These offices are provided with pertinent disaster information including Disaster Recovery Center locations, application deadlines and disaster loan statistics. Because many SBA regional and district office staff do not have adequate knowledge of the disaster loan program, they were asked to refer any inquiries they received to ODA's Buffalo Customer Service Center. This was done in an attempt to minimize the dissemination of incorrect disaster loan information.

Officials interviewed from local SBA offices in New Orleans and Biloxi stated that, in the future, they would like to have their Managers and Public Information Officers work directly with ODA staff from the beginning of disaster declarations. SBA district, regional and branch offices know their communities and have established relationships with local business owners and banks, and thus could be a valuable resource to ODA field staff who are often new to areas affected by disasters. ODA could benefit from utilizing Managers and Public Information Officers from SBA offices as liaisons with residents of the disaster areas they are serving. SBA offices in areas with large populations of displaced individuals from a disaster could also be called upon to conduct outreach about the disaster loan program. The SBA Administrator has undertaken steps to utilize a more "One-SBA" approach to disaster assistance. In support of this approach, the Panel recommends that:

District, regional and branch offices be included in SBA's disaster planning, and local office Managers and Public Information Officers be used to assist ODA in providing outreach following catastrophic disasters.

SBA district, regional and branch offices' community knowledge and presence could also be utilized to form and maintain a network of local organizations and large employers that is annually primed to provide information about the Disaster Assistance Program in the event of a catastrophic disaster. During such annual training, current disaster loan outreach materials could be distributed to participating members of these networks for dissemination to their constituents or employees. Enabling local organizations and large employers to provide disaster loan outreach in their communities following catastrophic disasters could assist SBA in extending its outreach to unbanked households and businesses. The Panel recommends that:

In cooperation with ODA, SBA district, regional and branch offices form, maintain, and annually coordinate with a network of organizations in their regions to be available to provide disaster loan information to their constituents.

Disaster Loan Fact Sheets and Applications Should be Available in Multiple Languages

FEMA fact sheets explaining the agency's disaster recovery programs are printed in English on one side and Spanish on the other. FEMA also can download and print its fact sheets in a wide variety of languages corresponding to the demographics of the population they are serving.

SBA fact sheets and the home loan application are available in English and Spanish, and SBA is in the process of translating a business loan application into Spanish. Information about the Disaster Assistance Program is also available in Spanish on SBA's web site. However SBA does not have disaster loan applications and fact sheets available for downloading in other languages spoken within the United States. In order to provide outreach to a wider range of Americans following a disaster, the Panel recommends that:

SBA translate disaster loan fact sheets and applications into multiple languages, and have them available for Customer Service Representatives and Public Information Officers to download and disseminate as needed to serve residents of disaster areas.

SBA contracts with an interpretation service provider that is accessed via the telephone. An interpreter from this contractor can be called to participate in a three-way call between an SBA staff member and an SBA customer. While all SBA offices can use this interpretation service provider when the need arises, the primary user of this service is the Buffalo Customer Service Center. SBA also employs staff who are multi-lingual, and their language skills are utilized when interpretation and translation services are needed.

Providing a One-Page Explanation of the Disaster Loan Process

Study team members led focus groups and conducted individual interviews with home and business disaster loan borrowers in Biloxi, MS and New Orleans, LA. One common complaint among home and business disaster loan borrowers was that SBA did not provide them with information about the various steps in the disaster loan process—from application submittal to final disbursement— before they applied for their disaster loans. These borrowers would have liked to better understand the disaster loan process before submitting an application so they would know which part of the process was coming next as they went through it. Having such information in advance not only provides borrowers with a more realistic and comprehensive view of the process, it could also reduce communication breakdowns that have plagued the current disaster loan process. Accordingly, the Panel recommends that:

SBA prepare a one-page explanation of the disaster loan process, from application submittal to final disbursement, to be disseminated to potential disaster loan applicants as part of the outreach process.

DISASTER LOAN INTAKE SERVICES

Applying to the SBA Disaster Assistance Program

As noted in Chapter II, before receiving any type of federal disaster assistance, individuals first register with FEMA. FEMA refers those homeowners and renters with incomes above the minimum income levels, stated in SBA's Income Test Tables, to the Disaster Assistance Program. Businesses owners and non-profit organizations may apply for an SBA business disaster loan without FEMA referral.

Disaster applicants are generally encouraged to speak with SBA Customer Service Representatives at Disaster Recovery Centers rather than complete the application process on their own. For home loan applications, Customer Service Representatives conduct "Home Loan Interviews" to determine whether home loan applicants lack repayment ability using a technique SBA calls the "fixed debt method" (FDM). SBA generally will not issue or accept an application when the household's gross annual income is \$25,000 or less and monthly fixed debt exceeds 45 percent of gross annual income, or when gross annual income is above \$25,000 and monthly fixed debt exceeds 55 percent of gross annual income. FDM is not applied to business loan applicants, or home loan applicants who are self employed, have income from rents, farms or other non-salary sources, or have household incomes above \$50,000 because their financial circumstances are considered to be too complex to be subject to those rigid guidelines.

Disaster Loan Application Screening and Submittal

Customer Service Representatives screen all disaster loan applications that are submitted to Disaster Recovery Centers to ensure that they are complete before they are sent to the Processing and Disbursement Center (PDC). Applications mailed independently by applicants are screened by Loan Officers at the PDC for completeness and, for home loan applications the fixed debt

method is applied. Incomplete applications are mailed back to applicants to complete, and Summary Decline letters are mailed to home loan applicants with applications that do not meet SBA minimum income criteria.

Complete home and business loan applications are manually entered into SBA's Disaster Credit Management System (DCMS) by data entry staff at the Processing and Disbursement Center. Currently, SBA offers only a paper application and accepts only paper loan documents. Processing and Disbursement Center staff manually scan all loan documents into DCMS.

SBA is in the process of creating on-line home and business disaster loan applications, and provisions have been made in SBA's 2008 budget to implement an on-line application in the next fiscal year. Customer Service Representatives will be equipped with lap-top computers in Disaster Recovery Centers to assist people to apply on-line, and Customer Service Center staff will be able to take applications over the telephone. The on-line applications will be linked to DCMS and should significantly decrease the amount of entry of manual application information in the intake process. Supporting loan documents will continue to be manually scanned into DCMS by Processing and Disbursement Center staff. SBA will also have paper applications available in case access to the Internet is hindered due to a disaster, and for applicants who are unfamiliar with the Internet.

Preliminary Financial Analysis

Once applications are entered into DCMS, Loan Officers conduct preliminary financial analyses to determine the likelihood of approval. DCMS automatically declines home and business loan applicants with credit scores between 1 and 539, and applicants with credit scores between 540 and 619 or a credit score of zero are reviewed for credit and repayment ability before loss verification, and may result in Preprocessing Declines (PPDs).⁵⁰ All Preprocessing Declines are reviewed by a Supervisory Loan Officer (SLO). If the SLO decides to approve the Preprocessing Decline, the applicant is mailed a decline letter. If the SLO overrides the Preprocessing Decline, the application is routed to the Loss Verification Department. Applications with credit scores above 620 are automatically routed to loss verification. Applications routed to loss verification are sent to standard processing⁵¹ following an on-site loss verification inspection.

⁵⁰ A credit score of zero means the applicant does not have a reported credit history and therefore does not have a credit score.

⁵¹ Following the Gulf Coast hurricanes, SBA introduced an expedited processing pilot program for disaster loan applications with credit scores of 620 and above. The expedited processing pilot program is currently under revision.

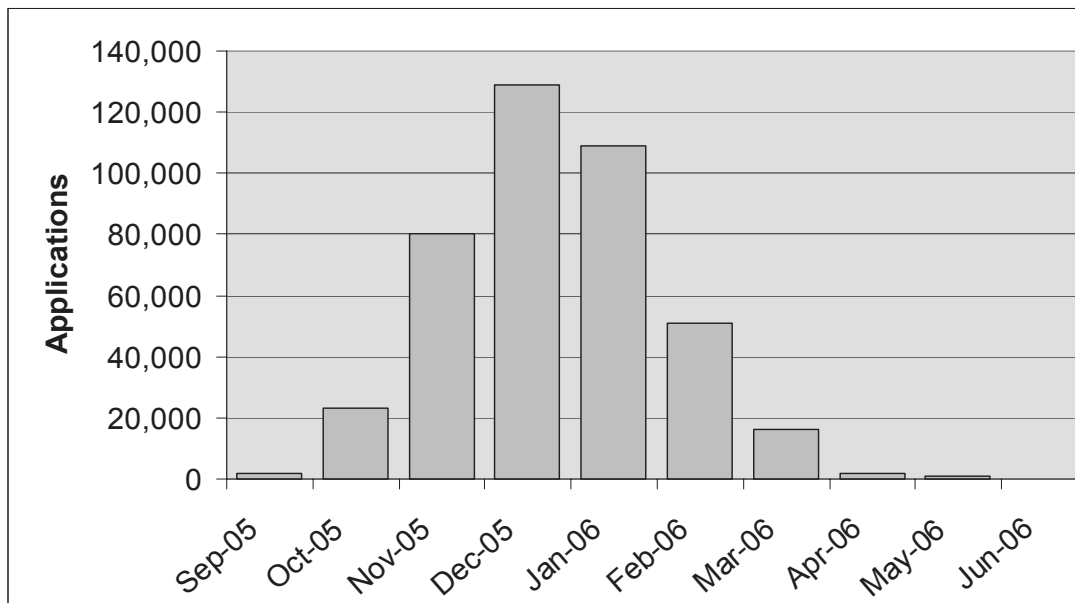
Table 3-1. Credit Scores

CREDIT SCORE	ACTION TAKEN
0	DCMS generates a Preprocessing Decline. SLO reviews PPD and makes final determination.
1 - 539	DCMS automatically declines.
540 - 619	DCMS generates a Preprocessing Decline. SLO reviews PPD and makes final determination.
620 and above	Application is sent to loss verification and then to standard processing.

Large Volume of Disaster Loan Applications Following Gulf Coast Hurricanes

The volume of disaster loan applications from those affected by the Gulf Coast hurricanes far exceeded the corresponding volume from the Northridge earthquake, the largest disaster in SBA’s history before Hurricane Katrina. SBA mailed approximately 2.2 million disaster loan applications to those affected by the Gulf Coast hurricanes, almost four times the number issued following the Northridge earthquake. Of these 2.2 million applications, about 423,000 were completed and returned to the Processing and Disbursement Center by January 2007. SBA received approximately 280,000 completed applications by the end of November 2005, and approximately 402,000 by the end of March 2006. In one day during the first three months following Hurricane Katrina, SBA received 12,000 applications, more than the total generally received during a mid-size disaster.

Figure 3-1. Applications Received Following the Gulf Coast Hurricanes



Source: SBA

Homeowners who are referred to SBA by FEMA but do not visit a Disaster Recovery Center, do not go through a Home Loan Interview with a Customer Service Representative. Consequently, the Fixed Debt Method is not applied to such applicants to determine their repayment ability before their applications are sent to the Processing and Disbursement Center. In turn, Loan Officers at the Processing and Disbursement Center receive numerous applications that should have been declined in the field. This contributed to the large volume of disaster loan applications received by the Processing and Disbursement Center following the Gulf Coast hurricanes.

SBA also received a significant number of “\$0 income” referrals from FEMA’s Internet site. An “Income Unavailable/Refused” option was available on the on-line FEMA registration form for those who did not wish to, or could not, provide their income. FEMA automatically referred such applicants to the disaster loan program, and in compliance with SBA’s referral process, also automatically referred those who claimed to be self-employed. Approximately 17 percent of disaster victims referred to SBA following Hurricanes Katrina and Rita chose the “Income Unavailable/Refused” option, and 17 percent claimed to be self-employed.⁵²

The FEMA “\$0 income” referral process caused a significant number of applications that did not meet SBA’s Income Test Table threshold to be sent to Loan Officers for screening and preliminary financial analysis, only to be later entered into DCMS as Summary Declines. This additional and unnecessary workload slowed service to other eligible applicants. According to SBA’s Office of Inspector General (OIG), many “\$0 income” referrals failed disaster loan eligibility tests and resulted in Preprocessing Declines.⁵³ The OIG summarized the impact of these referrals as follows:

- increased costs incurred by mailing loan applications to individuals who normally would not have been referred to SBA’s Disaster Assistance Program
- increased costs incurred from receiving disaster loan applications that would not normally be submitted to SBA, including costs associated with application entry and scanning of loan documents into DCMS, and Loan Officer resources
- delayed response times for those applicants who qualified for SBA disaster loans
- increased transaction flows through DCMS, which was near maximum capacity

Following the Gulf Coast hurricanes, SBA worked with FEMA to correct the “\$0 income” referral process. In October 2006, FEMA changed its on-line registration business rules making it mandatory for applicants to state their pre-disaster yearly income. If FEMA registrants do not provide their pre-disaster yearly incomes, they will not be able to proceed with the registration

⁵² *Actions Needed to Provide More Timely Disaster Assistance*, Government Accountability Office, Washington, DC, November, 2006, p. 13.

⁵³ U.S. Small Business Administration, Office of Inspector General, “Disaster Application Referrals with \$0 Income from FEMA Online Registration Have Increased Costs and the Demand for SBA Resources,” Advisory Memorandum 06-12, February 2006.

form, and instead will be instructed to call FEMA's toll-free number for assistance. FEMA representatives work with applicants to determine their pre-disaster yearly income and finish the registration process over the phone.⁵⁴ SBA officials report they are pleased with FEMA's response to the "\$0 income" referral issue, and consider the problem solved.

On September 23, 2007, FEMA also plans to add a series of pop-ups to its on-line registration form that will aid registrants who have difficulty providing income information. If the pop-ups do not help the registrant answer income related questions, the registration form will be saved and the registrant will be instructed to call FEMA's toll-free number for assistance.

Improving the Reserve Corps

As noted in the previous Chapter, the Reserve Corps is comprised of competitively selected, pre-trained individuals who are hired but are on the rolls in a non-pay status and agree to be called up and deployed to disaster areas on 48 hours notice. They are already trained to participate in disaster responses and serve as Customer Service Representatives, Loss Verifiers, legal staff, and loan processors. This "ready reserve" is an important element of SBA's disaster response capabilities but the agency has often had difficulty maintaining an adequately sized force. There were as few as 25 members in 2004 while there are approximately 900 in the program today. If there are long periods of relatively low disaster activity, Corps members' knowledge and skills can decline and their interest in the program can fade.

For SBA to properly respond to a catastrophic disaster, it should have the ability to provide the incentives necessary to keep the Reserve Corps staffed and trained to serve during these periods of inactivity. Incentives for Corps members to maintain their involvement in the program during extended periods of inactivity could include small annual payments for maintaining membership or other types of inducements. SBA officials noted that the agency is researching various potential inducements, including ways to allow Corps members to maintain federal health insurance coverage during periods of inactivity.

SBA officials also stated that many Reserve Corps members who are currently employed may not be able to leave their positions to help with disaster assistance without some guarantee that they will have a job to return to after they are done helping SBA. Changing the law to provide Disaster Corps reservists with similar job retention rights as military reservists could provide a successful incentive for maintaining the reserve workforce. The Panel recommends that:

SBA take steps to secure funding, statutory changes or other authorities to provide incentives for maintaining the disaster Reserve Corps.

Small Business Development Centers Could Provide Additional Support to SBA Following Catastrophic Disasters

All U.S. states and territories have Small Business Development Centers (SBDCs) to provide

⁵⁴ Those that are self employed may either disclose their pre-disaster yearly income over the Internet and proceed with the on-line registration form or call FEMA's 800 number for assistance if they are unsure of their pre-disaster yearly income.

technical assistance to small business owners. SBA provides funding to SBDCs, which the recipient organization is required to match.⁵⁵ SBDC offices are located throughout each state to ensure that all areas are covered, and are generally situated in state universities, colleges or community colleges. Like SBA regional and district office representatives, SBDC counselors know their communities and have established relationships with local business owners and banks.

Following most disasters SBA utilizes SBDC representatives in Business Assistance Centers⁵⁶ to provide business management counseling. SBA set up Business Assistance Centers following Hurricane Katrina; however, in response to the urgent need for credit by business owners, Louisiana and Mississippi SBDC counselors approached SBA field representatives about working in the Disaster Recovery Centers to counsel business owners on completing business disaster loan applications and assist with subsequent paperwork requirements. Some SBA field representatives allowed SBDC representatives into Disaster Recovery Centers; others did not. SBDC counselors interviewed by Academy staff who were not permitted in Disaster Recovery Centers following Hurricane Katrina said SBA representatives did not desire their assistance. An SBA Headquarters official stated that often space limitations in Disaster Recovery Centers do not allow for SBDC counselors to co-locate with SBA.⁵⁷ Those SBDC counselors who were not permitted to work in Disaster Recovery Centers worked through their offices disseminating business disaster loan applications, counseling business owners in completing applications and subsequent paperwork requested by the Processing and Disbursement Center, and providing business management assistance. They also counseled business owners in completing their home loan applications.

Following the Gulf Coast Hurricanes, Louisiana and Mississippi SBDC counselors did not receive training in disaster loan application completion similar to that provided by SBA to Customer Service Representatives. SBA provided one PowerPoint presentation to SBDC counselors following Hurricanes Katrina and Rita which explained the Disaster Assistance Program and provided instruction on completing the SBA business loan application. In turn, SBDC counselors primarily relied on training from SBDC counselors from other states who had provided SBA disaster loan application counseling following disasters in their communities. Some of this training was outdated because SBA documentation requirements had changed for Hurricane Katrina. Louisiana and Mississippi SBDC counselors permitted to sit in Disaster Recovery Centers learned about paperwork changes faster than those SBDC counselors working out of

There are pages and pages of things that I have sent in, and they have it in the computers where they are scanned but sometimes they don't look at everything. Also, they don't look at the comments that previous people make on the computer so they can catch up with what has been done. If they had a check list of what I needed to have sent, it might simplify the process.
—Gulf Coast Hurricane Disaster Loan Applicant

⁵⁵ SBDCs, in many cases, overmatch the SBA funding and therefore, receive less than 50 percent funding from SBA.

⁵⁶ Business Assistance Centers generally have SBA, SBDC, SCORE and WBC representatives available to provide business management counseling and business development workshops.

⁵⁷ SBA works with the state-federal partners to negotiate space in Disaster Recovery Centers, however ultimately the decision is beyond SBA's control.

their offices. SBDC counselors interviewed by Academy staff in Louisiana and Mississippi stated that in the future they would like to be part of SBA's disaster plan, receive up-to-date training similar to that provided to SBA Customer Service Representatives, and work closely with SBA representatives in Disaster Recovery Centers.

Business disaster loan applicants are required to provide accounting records, but it is not uncommon for such records to be destroyed in a disaster. One of the primary complaints of business disaster loan borrowers interviewed in New Orleans and Biloxi was that the paperwork required to obtain their loans was both complicated⁵⁸ and time consuming. Most had lost their accounting records in Hurricane Katrina and were required to reproduce these records as part of the disaster loan application process. For many small business owners, reproducing accounting records was beyond their ability. SBDC counselors provided assistance to business owners in reproducing their accounting records, and could have been more extensively utilized by SBA to assist business disaster loan applicants in this process.

Another common complaint of business disaster loan borrowers interviewed in New Orleans and Biloxi was that Customer Service Representatives in Disaster Recovery Centers often could not answer their questions about the business disaster loan application process and the associated paperwork; consequently, they felt unsupported by SBA. An SBA official from a Field Operation Center said that SBA tries to provide one Customer Service Representative in each Disaster Recovery Center who has extensive knowledge⁵⁹ of the business disaster loan process, but this is not always possible, particularly following catastrophic disasters.

SBDCs were not part of SBA's disaster plan following the hurricanes, and SBDC counselors received a mixed welcome into SBA's disaster recovery effort. SBDC counselors could have been utilized at a higher capacity to augment SBA's Customer Service Representative Reservist pool and better support business and non-profit owners affected by the hurricanes. The Panel recommends that:

SBA include Small Business Development Centers in its disaster planning, and utilize the services of SBDC representatives to assist business owners through the disaster loan application process following catastrophic disasters.

How SBDCs Could Provide Support

Following catastrophic disasters, SBDC counselors could work in Disaster Recovery Centers alongside SBA Customer Service Representatives to bridge the business disaster loan information gap. SBDC counselors could cover all business disaster loan inquires and provide counseling in completing business disaster loan applications and associated paperwork. In turn,

⁵⁸ Paperwork for business disaster loan applications is generally more complicated than paperwork for home loan applications. However, home disaster loan borrowers interviewed by Academy staff also found paperwork associated with the disaster loan process to be complicated.

⁵⁹ Although SBA Customer Service Representatives are equally trained in the home and business disaster loan application processes before they enter the field, business disaster loan applications are more complicated and often have more documentation and paperwork requirements than home loan applications.

SBA Customer Service Representatives could concentrate their resources on disaster home loan disaster loan applicants. Each Disaster Recovery Center could have two SBA stations, one for business owners and non-profits and one for homeowners and renters. People could receive assistance in completing both the business and home disaster loan application processes at the same station, making it a “one-stop-shop” for business owners and non-profit leaders. In cases where there is not enough space available at SBA stations in Disaster Recovery Centers, SBDC counselors could provide disaster loan application counseling through their own offices.

The primary mission of SBDCs is to provide technical assistance to small businesses in the region they cover. When working in Disaster Recovery Centers following a catastrophic disaster, SBDC counselors could also provide technical assistance to potential business disaster loan applicants that specifically relates to the new post-disaster economic climate. SBDC counselors could work with these people to evaluate their options and conform to the rules of SBA business disaster loans, to help ensure that “getting back to business” is the best option for the business owner.

SBDC counselors have knowledge of the SBA 7(a) business loan program and have experience assisting their clients with bank loan applications. They are strong candidates for SBA Customer Service Representative training. SBDC counselors could be trained in both the business and home loan application processes to enable them to counsel business owners who are applying for both business and home disaster loans. SBA could provide annual Customer Service Representative training for SBDC counselors attending annual Association of SBDCs meetings, as well as train SBDC counselors alongside newly hired Customer Service Representatives following a catastrophic disaster. Ideally, SBDCs could have staff available in all Disaster Recovery Centers and in their offices following a catastrophic disaster.⁶⁰

Women’s Business Centers and Service Corps of Retired Executives Could Provide Additional Support to SBA Following Catastrophic Disasters

The SBA Women’s Business Centers (WBC) program is a national network of non-profit small business development organizations that strive to increase economic independence for women. WBCs achieve this goal by providing small business and professional development training and technical assistance, career assistance, networking, and access to applicable resources. Programs and workshops at WBCs are taught by professionals with direct experience in small business and professional development. There are WBCs in nearly every U.S. state and territory, and almost all receive SBA funding.

Service Corps of Retired Executives (SCORE), “Counselors to America’s Small Business,” is a non-profit government chartered corporation and SBA resource partner. SCORE focuses on entrepreneur education and training, and the creation, growth and success of small businesses nationwide. Executives and business owners, both working and retired, donate time and share their expertise as business counselors for the SCORE program. SCORE has 389 chapters in locations throughout the United States and its territories, with over 10,500 participating volunteers nationwide. Following Hurricane Katrina, SCORE volunteers in New Orleans and

⁶⁰ Provided that the SBDCs do not lose their offices in the disaster, which was the case for some of the SBDC offices in Louisiana and Mississippi following Hurricane Katrina.

Biloxi continued to counsel small business owners and conduct business development workshops, even though many of these volunteers lost their businesses and homes in the hurricane.

Following most disasters SBA utilizes representatives from WBCs and SCORE chapters in Business Assistance Centers to provide business management counseling and workshops. To augment strained Reservist pools following catastrophic disasters, representatives from WBCs and volunteers from SCORE could be utilized to provide information at SBA stations in Disaster Recovery Centers about the business disaster loan program, counsel business owners in completing their business and home disaster loan applications and associated subsequent paperwork, and provide business development technical assistance relevant to the new post-disaster economic environment.

Department of Defense Office of Small Business Programs Could Provide Support

The Small Business Act authorizes the Small Business Administration to establish the 8(a) Business Development Program. This program promotes the creation and development of small businesses owned and controlled by socially and economically disadvantaged individuals, and provides support to such businesses so they can compete in the mainstream U.S. economy. The SBA and the Department of Defense (DOD) have a Partnership Agreement, which delegates SBA's 8(a) contract execution functions to DOD. This provides DOD contract activities with a greater amount of involvement and responsibility in awarding 8(a) contracts. The Partnership Agreement between SBA and DOD adds flexibility to the 8(a) Business Development Program, creating more opportunity for DOD to select and award 8(a) contracts to small and disadvantaged U.S. businesses.

The individual services and defense agencies of DOD all have Offices of Small Business Programs (OSBP), and contract management and procurement offices located throughout the United States. Each contract management and procurement office employs Small Business Development Specialists to assist small businesses, including small disadvantaged businesses, women-owned small businesses, small businesses located in Historically Underutilized Business Zones (HUBZone), veteran-owned small businesses, and service-disabled veteran-owned small businesses in marketing their products and services to DOD. Small Business Development Specialists provide information and counseling on how to: be placed on DOD solicitation mailing lists; identify prime and sub-contract opportunities with DOD; determine the appropriate buying office for their products; locate sales opportunities within DOD defense procurement regulations and procedures; and, obtain relevant data on present or future DOD procurements.

An official from the Department of Defense Office of Small Business Programs told the study team that DOD OSBP could potentially be of assistance to the SBA Disaster Assistance Program following catastrophic disasters. However, the two agencies would need to work out in advance the parameters of what could be accomplished. Given the proper training, DOD Small Business Development Specialists could provide information about business disaster loans, and counsel business owners in completing their business and home disaster loan applications and associated subsequent paperwork following catastrophic disasters.

Government Agencies and National Volunteer Organizations Could Provide Support

SBA also could manage cross-agency cooperation with government agencies that could potentially provide staffing assistance to SBA following catastrophic disasters. As part of their surge planning efforts, SBA could meet with government agencies that have a large field presence such as the Department of Defense, the General Services Administration, the Department of Veterans Affairs and the Social Security Administration, to learn more about their capabilities and the potential role they could play in the implementation of the Disaster Assistance Program. For example, the National Guard could be utilized to inform those in a disaster area of the location of the nearest Disaster Recovery Center, and that SBA representatives are providing home and business loan applications at these locations.

SBA could also potentially partner with national volunteer organizations to address staffing needs following catastrophic disasters. Two such organizations are:

- The Corporation for National and Community Service—more than 35,000 National Service participants from the Corporation’s AmeriCorps, VISTA, Senior Corps, National Civilian Community Corps, and Learn and Serve America programs contributed more than 1.6 million hours to the Gulf Coast hurricane relief effort. SBA could form a partnership with the Corporation to utilize National Service volunteers following future catastrophic disasters.
- Crisis Corps—a Peace Corps program that offers short-term assignments (generally 3-6 months) to Returned Peace Corps Volunteers, typically in overseas posts. Following Hurricane Katrina, FEMA partnered with Crisis Corps and utilized 272 Crisis Corps Volunteers. Approximately 1,000 Returned Peace Corps Volunteers applied to these Crisis Corps-FEMA Hurricane Katrina volunteer positions. If SBA negotiated a partnership with Crisis Corps, Returned Business Development Peace Corps Volunteers with backgrounds in banking, credit programs or business management could be called on to fill SBA positions following catastrophic disasters.

DISASTER LOAN LOSS VERIFICATION INSPECTIONS

Disaster loan applications that are not declined through the summary or preprocessing decline process are routed to loss verification, and require on-site loss verification inspections. During their on-site inspections, Loss Verifiers:

- Determine the estimated cost of repair or replacement of real, personal, and business property.
- Estimate replacement and pre-disaster Fair Market Value (FMV) of property.
- Gather information to help Loan Officers establish applicant eligibility.

- Determine whether the property is located in Special Flood Hazard Area (SFHAs) or within the Coastal Barrier Resources System (CBRS).
- Provide estimated values of undamaged real property offered or required as collateral.

Loss verifiers determine the SBA total disaster-related loss, which is the estimated physical loss of the damaged properties they inspect. Loan officers use these estimates to determine eligible physical disaster loan amounts for loans they approve through the underwriting process.

Loss Verification Inspections Following the Gulf Coast Hurricanes

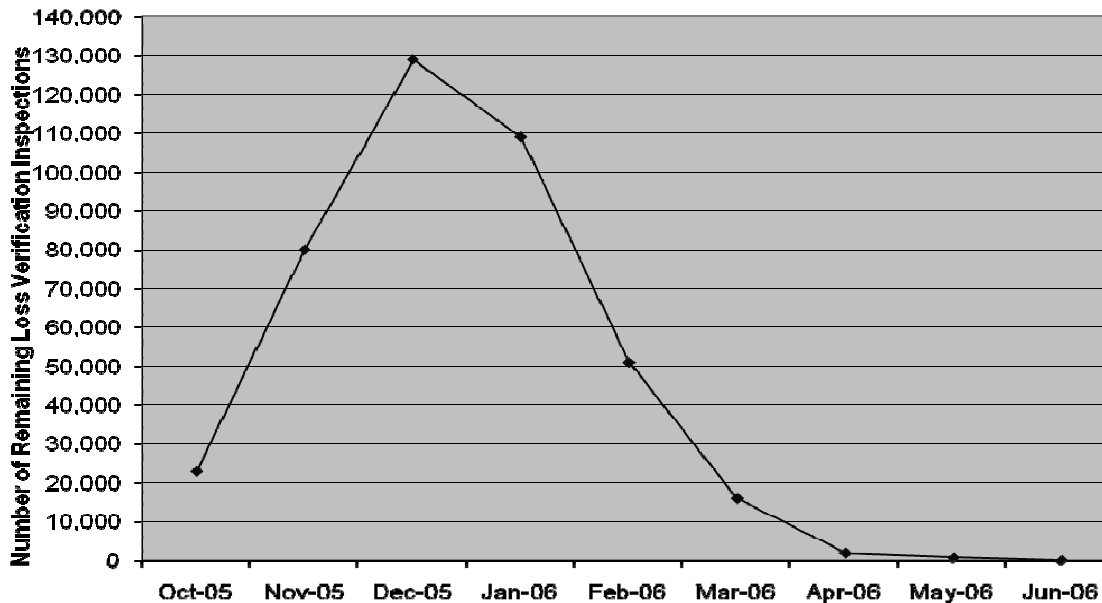
Before the Gulf Coast hurricanes, SBA employed federal Loss Verifiers. When Hurricane Katrina occurred, SBA was undergoing the Office of Management and Budget's (OMB) A-76 process for the loss verification function. ODA's federal Loss Verifiers bid themselves as the Field Inspection Team (FIT) and were awarded the contract. FIT, which is located in Herndon, VA, took over on October 1, 2005 and is responsible for conducting the initial on-site loss verification inspections.⁶¹

FIT developed a large backlog of applications in the loss verification stage of the disaster loan process following the Gulf Coast hurricanes. This backlog peaked in early December 2005 at approximately 129,000⁶² applications. From October 2005 to March 2006, the loss verification backlog remained above 15,000 properties. By April 2006, the backlog had fallen below 5,000 properties; in May 2006, it was less than 1,000 properties; and by June 2006 it was below 100 properties. As of late January 2007, FIT had completed approximately 323,000 loss verification inspections of properties affected by the Gulf Coast hurricanes.

⁶¹ SBA's Field Operations Centers and the Processing and Disbursement Center employ Loss Verifiers who are not part of FIT. These employees complete loss verification backflow actions for files that have already been verified but may require on-site progress, re-verification, relocation or mitigation inspections. Field Operations Centers are also responsible for initial on-site loss verification inspections for states and territories outside the continental United States.

⁶² When FIT took over the initial loss verification inspections on October 1, 2005, it inherited a backlog of approximately 18,000 applications from applicants affected by the Gulf Coast hurricanes.

Figure 3-2. FIT Loss Verification Backlog Following Gulf Coast Hurricanes



Source: SBA

Converting to the FIT in October 2005, in the midst of peak inspection activity following Hurricane Katrina, was a contributing factor to the Loss Verification backlog. Loss Verifiers use tablet personal computers with software that allows them to complete and submit reports electronically in DCMS. Like other SBA employees, Loss Verifiers were learning the new DCMS system when Hurricane Katrina occurred. They also encountered problems accessing DCMS when DCMS reached maximum capacity following the influx of Gulf Coast hurricane loan applications. During the initial months following the Gulf Coast hurricanes, Loss Verifiers inspected properties in the order they appeared on a list, rather than inspecting properties in close proximity to one another. For example, a loss verifier might go from inspecting a property in Biloxi, Mississippi to a property in New Orleans, Louisiana in the same day. This caused Loss Verifiers to spend substantial time in transit. FIT eventually deployed its Loss Verifiers to inspect properties grouped according to their proximity, which increased the efficiency of the process.

FIT is in the process of automating on-site loss verification scheduling in order to assign files in an appropriate and expeditious fashion. Currently, FIT's system includes the direct importation of file addresses and zip codes into an internal scheduling program which enables Loss Verifiers to inspect properties in closest proximity to one another. The system is still under development with the objective of maximizing productivity and resource management.

The primary factor that contributed to the loss verification backlog was simply the large volume of Gulf Coast hurricane applications that SBA received. By the end of January 2007, approximately 323,000 on-site loss verification inspections had been completed. Of these, about 160,000 loan applications were later approved, 105,000 were declined, and the remainder were

withdrawn. The principal reasons Gulf Coast hurricane disaster loan applications were declined in the underwriting stage following loss verification were lack of repayment ability or unsatisfactory credit. Two common reasons disaster applications were withdrawn from the disaster loan process were borrowers were unable to provide information required by SBA or they had not filed all required Federal Income Tax returns.

It would be more efficient and cost effective for on-site loss verification inspections to occur after as many underwriting decisions as possible have been made. At a minimum, Loan Officers should determine whether applicants meet statutory eligibility and character requirements⁶³ before files are routed to loss verification. Loan Officers could potentially make further underwriting decisions on files before on-site loss verifications are conducted. In order to obligate a physical disaster loan, Loan Officers need the estimated physical loss amount on damaged properties obtained from loss verification inspections. Loan Officers could conduct most of the underwriting process according to the loan amount each applicant could potentially qualify for. Those applications that do not qualify in this underwriting process would receive decline letters, and those that do, would be routed to loss verification. Following loss verification inspections, applications would be routed back to Loan Officers who would recalculate loan amounts, and make final loan approval and obligation decisions.

Making as many financial underwriting decisions before the loss verification stage in the disaster loan process would reduce the likelihood of future loss verification backlogs following catastrophic disasters and improve SBA's customer service. Following the Gulf Coast hurricanes, this would have eliminated the need for up to 105,000 inspections for applicants who were later denied loans during the underwriting stage of the process. The Panel recommends that:

SBA make preliminary financial underwriting decisions before proceeding with the loss verification stage of the disaster loan process whenever possible.

Loss verification inspection backlogs following catastrophic disasters could also be reduced through the use of available technology. On-site loss verification inspections are necessary in cases of partially destroyed property in order to establish the extent of loss. In cases where it is possible to confirm there has been total destruction in specific locations, on-site loss verification inspections are not needed and only delay processing of disaster loan applications.

According to a FIT representative, FIT currently uses the Tax Assessor Database (TAD) to obtain pre-event data on the details of the property under consideration. It also utilizes Geographic Information System (GIS) maps when available. In addition, FIT uses the services of Pictometry Inc., a company that provides pre-event views of properties and details including type of construction, quality of construction, and building measurements.⁶⁴ Google Maps, Yahoo Maps, Google Earth and similar programs also have proven to be of value. FIT currently uses these resources as mechanisms to check the accuracy and quality of their on-site loss verification inspections.

⁶³ Eligibility for disaster loans is also determined through certain character requirements such as compliance with child support obligations and repayment of federal debt, such as student loans.

⁶⁴ This service is limited to areas that are served by Pictometry, Inc.

It is possible that in limited circumstances (e.g. total destruction of property), reliance on FEMA loss verification reports,⁶⁵ conversations with applicants, previous on-site inspections in the area, Pictometry, post-event geo-spatial imaging, and on-line media could provide an acceptable degree of accuracy, eliminating the need for on-site inspections. In addition, however, in cases where there is an absence of property to inspect following total destruction from a disaster, Loss Verifiers currently conduct on-site loss verification inspections. The Panel recommends that:

In cases where there may be an absence of property to inspect following total destruction from a disaster, SBA use available technology and FEMA loss verification reports whenever practical in place of on-site loss verification inspections.

DISASTER LOAN UNDERWRITING

Under SBA's Disaster Assistance Program, underwriting standards and procedures are shaped by statute, historical program experience, and, in some cases, the disaster itself. Affordability and the assessment whether a borrower can receive credit elsewhere are key factors in determining whether the loan is approved and how the loan is structured. Before the Gulf Coast hurricanes, Loan Officers calculated loan payment amounts based on each applicant's ability to pay. The loan maturity, available up to 30 years, was determined based on how many years were needed to amortize the payment at a level the borrower could afford. Interest rates were set based on the statutory caps of 4 and 8 percent, depending on whether the borrower qualified for credit elsewhere.

Expedited Processing and the Use of Credit Scores

After the Gulf Coast hurricanes, the SBA disaster loan program processed an unprecedented 441,631 applications. To more efficiently address the large backlog of applications, SBA used credit scores to "triage" applications, as described above. For those applications not automatically declined or screened out during the preprocessing review, applications with credit scores of zero or between 540 and 619 proceeded to standard processing following loss verification.⁶⁶ Those with credit scores at or above 620 automatically advanced to expedited processing after loss verification if their credit score matched the pre-designated loan amounts set by SBA. For example, if an applicant's credit score was 620 he or she qualified for a \$50,000 loan. If that applicant sustained uncompensated losses above \$50,000 however, the application would be flagged for standard processing.

SBA arrived at the preset loan amounts of \$50,000, \$150,000 and \$250,000 tiered by credit score through surveying the lines of credit offered by credit card, commercial, and mortgage lenders. Threshold credit scores were also informed by examining the scores on past loan approvals in

⁶⁵ FEMA and SBA damage inspections processes differ. FEMA does not record repair/replacement costs for all disaster-related damages and does not inspect businesses.

⁶⁶ Credit score thresholds were adjusted several times in the months following the Gulf Coast hurricanes. The scores referenced here were published in ODA memorandum #06-45 published on September 15, 2006.

combination with professional judgment.⁶⁷ According to SBA officials, this use of credit scores did not change the credit quality of its pool of borrowers, but was instituted strictly to expedite application processing. Processing changes were assumed to be neutral to the credit risk of the program. For this reason, the program's default rates and credit subsidy rates were not adjusted to reflect the possibility that the overall credit quality of borrowers might have changed.

For applications approved during FY 2006, SBA approved 52 percent of home disaster loans and 41 percent of business disaster loans through expedited processing.⁶⁸ Loan officers could process almost twice as many applicants in a day with the new procedures. However, SBA still reviewed the remaining half of all applications using lengthier standard procedures.

The Credit Elsewhere Test During Standard Processing

Statute requires SBA to conduct a *credit elsewhere* test to determine whether applicants have the financial capacity to recover from the disaster without the assistance of the federal government. If applicants are deemed not to qualify for credit elsewhere they receive a lower interest rate, capped at 4 percent, which is referred to by SBA as the *no credit elsewhere* (NCE) rate. The interest rate for those qualifying for credit elsewhere in the market is capped at 8 percent. Under standard processing, if home disaster loan applicants have a credit score of less than 700 and fail a lengthy liquidity test they are determined not to have credit elsewhere. Similarly, if applicants' credit scores are equal to or greater than 700 and they fail lengthier cash flow and available net worth tests they are determined not to have credit elsewhere. Business disaster loan applicants must fail working capital and available net worth tests to qualify for the no credit elsewhere interest rate.

The Credit Elsewhere Test During Expedited Processing

SBA modified the credit elsewhere test for applicants approved under expedited processing.⁶⁹ Under the truncated test, home disaster loan applicants with credit scores under 700 automatically qualify for the NCE rate, while those with scores above 700 must also fail an adjusted asset test of \$500,000 or less before qualifying. For businesses, the same credit score rules apply, but the business qualifies for NCE if it has \$500,000 or less in adjusted net worth.

Ninety-eight percent of all borrowers qualified for the lower rate of 2.687 percent for home disaster loans and 4.0 percent for business disaster loans following the Gulf Coast hurricanes.⁷⁰ Over fifty percent of home and business disaster loan borrowers had credit scores higher than 700. To put it into context, the national median credit score is 723⁷¹ and the national average

⁶⁷ SBA began collecting credit scores for its borrowers with the implementation of DCMS in January 2005.

⁶⁸ SBA Disaster Loan data obtained from DCMS.

⁶⁹ U.S. Small Business Administration, Office of Disaster Assistance, Memoranda #05-82 "Expedited Business Loan Pilot Processing Revision 1," December 2, 2005 and Memoranda #05-80 "Expedited Home Loan Pilot Processing Revision 1" December 2, 2005.

⁷⁰ U.S. Small Business Administration, Office of Disaster Assistance, Memoranda #05-25 "Interest Rates: Fourth Quarter FY 2005." These interest rates were in effect for all disasters occurring on or after August 1, 2005.

⁷¹ My Fico (the consumer division of Fair Isaac, the company that invented the FICO credit risk score that lenders use.) www.myfico.com/crediteducation, February 11, 2007

credit score is 673 while the average for the region is 650.⁷² Banks typically offer borrowers with credit scores of 700-850 their best (i.e., lowest) interest rates.

Historically, SBA has not been able to retain borrowers who qualify for the market rate, that is, have credit elsewhere. Cancellation rates among businesses have been particularly high since statute limits them to a three-year repayment term if they qualify for the market rate. From 1992 to 2005, sixty percent of businesses deemed to have credit elsewhere canceled their loans while 55 percent of home loan applicants canceled after being informed that they would receive the higher interest rate.⁷³

The credit elsewhere test, in most cases, is currently calculated manually because DCMS was not designed to capture all the information required to conduct the test as currently written.⁷⁴ As a result, the credit elsewhere test consumes what some SBA officials estimate to be 10 percent of Loan Officer time and resources. The credit elsewhere test is amenable to automation and should be incorporated within DCMS to render a decision within seconds. The Panel recommends that:

SBA revise the credit elsewhere test by basing it on borrower credit scores, net assets, and the applicant's ability to afford loan payments at the market rate through a cash flow analysis; and

Automate and incorporate the credit elsewhere test fully within the loan processing system.

Underutilizing Technology

SBA automated its loan approval process without taking advantage of the opportunity to reengineer it first. As a consequence, SBA continued a loan approval process that is inconsistent with mortgage or commercial lending practices and built a system that does not take full advantage of automated underwriting capabilities. Some examples include:

- In the case of businesses, Loan Officers pull one of three credit files or business credit reports. Reports are printed, reviewed, and then scanned back into DCMS. If data from the reports are going to be used interactively within DCMS they must be manually keyed into the appropriate fields in addition to the scan. Instead, credit reports could be electronically uploaded to DCMS through a data integration interface. Pricing for the reports is comparable regardless of the method used to obtain them. While there are annual licensing fees associated with these types of interfaces, they would likely be offset by the time and money saved by forgoing printing and scanning each credit report. Other benefits include improved accuracy by removing human error and the ability to capture and manipulate data at the loan level for future evaluations.

⁷² Experian National Score Index, www.nationalscoreindex.com, February 11, 2007

⁷³ Data provided by SBA's Office of Disaster Assistance.

⁷⁴ In cases where the applicant qualifies for expedited processing and has a credit score of 700 or less, the CET is conducted automatically within DCMS.

- For applicants without credit scores, Loan Officers determine their credit risk through time-consuming phone calls and letters to landlords and utility companies. Six percent of 2005 and 10 percent of 2006 disaster loan applicants had credit scores of zero.⁷⁵ Instead, SBA could use credit reports which feature composite credit scores based on non-traditional credit indicators such as rent, utility, and insurance payments. While not all data can be verified electronically, the credit bureau, instead of SBA Loan Officers, would take the time to manually verify them.

Income Verification

To fully automate lending decisions and render them quickly and completely, applicant incomes must also be reported or verified electronically. Currently, SBA obtains Federal Tax Return (FTR) transcripts from the Internal Revenue Service for individuals and businesses applying for disaster loans. Applicants complete IRS Form 8821, which authorizes SBA to obtain their tax filing information from the IRS. SBA and IRS are operating under an agreement in which SBA faxes the IRS signed forms for each applicant to an office within the IRS dedicated to responding to SBA inquiries within 48 hours. If the applicant has filed a tax return using IRS Form 1040, then the IRS emails a copy of the return to a designated point of contact at SBA. The information is converted to a PDF file and entered into DCMS. Business filings utilizing other IRS forms are faxed back to SBA, scanned, and then uploaded into DCMS.

The use of IRS Form 8821 to release tax filing information is required by federal law unless the agency has a statutory exemption which allows the release request to be included as part of the client's application. SBA does not have such an exemption, so disaster loan applicants need to complete this additional paperwork and additional manual steps are required to secure the information from IRS.

To expedite decisions for the applicant, reduce errors in processing, and more fully automate financial underwriting decisions, SBA should enter into an agreement with IRS to establish a more comprehensive electronic exchange of information that eliminates the manual steps built into the current process. SBA should also seek the statutory authority to include the tax filing release request on disaster loan applications. The Panel recommends that:

SBA and IRS set up a process to fully automate electronic exchange of applicant tax information for the purpose of expeditiously processing disaster victims loan applications.

SBA officially request statutory authority that would allow disaster loan applicants to authorize SBA to verify tax filing information with IRS by simply completing the disaster loan application form.

Automation Goals

SBA was overwhelmed by the extraordinary volume of applications that needed to be reviewed after the Gulf Coast hurricanes. Expedited processing, triggered by credit scores, was an efficient

⁷⁵Source: SBA Office of Disaster Assistance program data.

method of sorting through the enormous workload. However, for the other half of approved loans and all files with a credit score of zero, SBA still took the traditional time-consuming approach to reviewing historical data, which in some cases had been lost or damaged in the disaster. SBA and the borrower then painstakingly tried to recreate past income or earnings for a future that is uncertain.

Instead, it would seem beneficial for SBA to deploy an automated underwriting system that both reduces processing time on almost all loans, as well as utilizes more sophisticated modeling techniques that examine patterns of behavior and more precisely assesses and targets the level of risk SBA wants to assume. Automated underwriting would allow SBA to make underwriting determinations on the vast majority of its applicants negating the need for separate “expedited processing” for select applicants meeting narrow eligibility criteria.⁷⁶

SBA should set a goal to automate the approval or declines of 80 percent of its disaster home loan underwriting decisions. Given the increasing application of automated underwriting to mortgage loans, it would seem likely that most disaster home loan decisions eventually can be automated while the automation of business loan underwriting, as is true in private lending, will likely be more difficult.

To achieve this, SBA should automate the entire underwriting process for the disaster home loan program by utilizing an automated underwriting system. Fannie Mae and Freddie Mac automated systems set the standard for underwriting the majority of conventional mortgages. Other organizations and credit bureaus have credit scoring services and predictive analytical models able to make credit decisions on borrowers who have limited credit files. These services could be incorporated into DCMS to further automate and strengthen its risk assessment and decision capabilities.

To achieve processing efficiency for business loans, SBA should electronically upload business credit reports to auto-approve or auto-decline disaster loans up to a specified threshold. Depending on the report, they can provide business credit scores, financial stress indicators, analysis of financial stability by modeling payment histories, and recommendations on potential credit lines to extend. Based on this information, SBA could automate approval and decline decisions on amounts ranging up to \$250,000, \$500,000, and possibly \$750,000, depending on a business’ corresponding prior year sales volume.

Automated Underwriting

Automated underwriting (AU) systems involve more than an examination of credit scores. They are statistically based, objective measurements of risk that, although based on the same type of information that Loan Officers have used for years, use actual performance of similar loans to weigh multiple factors. Those factors come from borrower credit reports, loan applications, and other sources, and can include loan-to-value ratios, property type, borrower-debt ratios, and proprietary market forecasts. “By focusing solely on those mortgage or credit characteristics relevant to repayment, statistically based automated underwriting systems can offset variables

⁷⁶ ODA has suspended the expedited processing pilot and is currently revising loan processing procedures.

indicating higher risk with other factors in the application that have proven statistically to reduce risk.”⁷⁷

The Panel believes that once the relevant algorithms have been tested on suitable datasets and a process has been developed for continuing improvement of the predictive quality of scores, automated underwriting of disaster loans has the potential to provide significant efficiency and cost saving benefits to SBA, and faster service to loan applicants, without restricting access to credit. In addition, automated underwriting has the potential to reduce extensions of credit to borrowers likely to default, while increasing extensions of credit to borrowers whose applications currently are declined, but who in fact are likely to repay their loans.

Common Industry Practice

It is estimated that as many as 90 percent of mortgages in the United States are approved through automated underwriting systems.⁷⁸ While the prevalence of automated decision making is not as widespread for commercial loans, approximately 30 to 35 percent of loans are underwritten through an automated decision tool and many in the industry are hopeful that figure will increase to 50 percent within the next year or two. For banks that just offer business credit cards, this number is even higher at approximately 85 percent.⁷⁹

Automated underwriting systems are not reserved merely for the conventional borrower. Neighborhood Housing Services of America (NHSA), NeighborWorks America’s⁸⁰ secondary market arm, in its effort to serve lower income borrowers, offered several mortgage products that it subjected to manual underwriting at considerable cost. To reduce the need for manual underwriting for lower income borrowers’ loan applications, NHSA and its e-commerce subsidiary, Just Price Solutions, along with private partners jointly developed a web-based automated underwriting system for non-standard borrowers including individuals with poor, thin, or no credit files. Their system can return a decision within minutes. In developing an automated underwriting system for disaster loans, SBA still will be able to give weight to the special social and humanistic factors that are inherent in this statutorily mandated lending program.

Benefits of Using an Automated Underwriting System

Automated underwriting systems evaluate loan applications, deliver credit risk assessments to the lender, and provide a preliminary answer to a prospective borrower in a matter of minutes. If SBA were to use an automated underwriting system, disaster loan applicants could be confident that receipt of their loan application would quickly be followed by an answer. This would mean precious time saved allowing the applicant to accelerate the re-building process in the case of an approval or to look for another funding solution in the case of a decline. From a public policy perspective, switching from a manual underwriting system to an automated one would allow

⁷⁷ Susan Warton Gates, Vanessa Gail Perry, and Peter Zorn, “Automated Underwriting in Mortgage Lending: Good News for the Underserved?” *Housing Policy Debate*, Volume 13, Issue 2, Fannie Mae Foundation 2002: 372.

⁷⁸ Steele, Bill, “Automated underwriting speeds mortgage approval,” *Chicago Sun Times*, December 15, 2002.

⁷⁹ Risk management industry leading source(s).

⁸⁰ NeighborWorks America is a national nonprofit organization created by Congress to provide financial support, technical assistance, and training for a national network of more than 240 community-based member organizations in 50 states.

SBA to get disaster loan funds into the hands of borrowers more quickly after disasters, particularly following catastrophic disasters. As private lenders may do, SBA could generate a preliminary credit decision that would be confirmed once the borrower provided the necessary documentation to verify the facts presented in the application.

Reducing average processing times translates into reduced operating costs. Utilizing an automated underwriting system would allow SBA to employ fewer processing staff, provide less training, and decrease the need to hire skilled Loan Officers. The majority of loan applications could be processed by junior-level staff, while experienced Loan Officers could be reserved for more complex or unique loan applications requiring manual review. Such labor and training cost savings could allow SBA to provide loans to a greater number of borrowers than they presently do, including more under-represented borrowers. Also, reducing the number, skill-level and training needs of disaster loan processing staff would help alleviate hiring and training pressures faced by the Processing and Disbursement Center following catastrophic disasters.

Automated underwriting removes much human error and bias from underwriting decisions. Increasingly, private companies and government agencies are called upon to demonstrate that their lending decisions are not arbitrary and instead are consistent and follow established procedure. Customers and lenders benefit from the consistency and accuracy brought by automated underwriting systems. An increase in the consistency and accuracy of SBA underwriting decisions on disaster loans could decrease the Disaster Assistance Program's 24 percent default rate, which would lead to cost savings, while making more credit available for disaster loan applicants who have a greater likelihood of repaying their loans.

Chapter IV recommends that following a catastrophic disaster, SBA should pilot a disaster loan program utilizing private lenders to process, close and disburse direct loans. The chapter also provides a discussion on structuring the Disaster Assistance Program as a loan guarantee. One risk of implementing either option would be unscrupulous underwriting practices made by participating private lenders. If SBA were to switch to an automated underwriting system, this system could also be used by private lenders processing SBA disaster loans, which would potentially reduce the possibility that some lenders might game the system with risky loans that should not be accepted.

While SBA would not utilize the full capabilities of an automated underwriting system, such as the ability of the system to price loan interest rates according to borrower risk or the ability of the system to place loans in securitized pools, it could benefit from the ability of the system to render a credit decision consistently within minutes and eliminate the time-consuming process of manually creating a credit profile for those applicants lacking a credit score. The Panel recommends that:

SBA begin the process of developing an automated underwriting system with the goal of making underwriting determinations on at least 80 percent of its disaster home loan applications.

Developing an Automated Underwriting System for Disaster Loans

Before a contracting agency can develop a statistical model for an automated underwriting system tailored to the Disaster Assistance Program's underwriting standards and goals, SBA will need to collect historical underwriting and servicing data. In order to obtain good modeling results, the time series needed for such data should cover at least two years and probably, four or more years per loan. The longer the underwriting and servicing data time series are, the more robust the automated underwriting model can be.

Collecting historical underwriting and servicing data needed to construct a robust statistical model for an automated underwriting system will be a time consuming and challenging process for SBA. Disaster loan borrower information and underwriting records were automated only after the Gulf Coast hurricanes in 2005, and consequently, SBA may need to collect some data from paper files. Also, SBA began using credit scores as part of the manual underwriting process only after the Gulf Coast hurricanes. Historical FICO score data by state can be purchased from credit bureaus; but this can be costly. Another challenge is that historically, SBA has processed less than 500,000 disaster loan applications per year, and consequently, SBA sample sizes will not be as robust as those used in other automated underwriting systems. For example, Freddie Mac's automated underwriting system takes random samples, usually of several hundred thousand, from a dataset of loans in the tens of millions.

SBA should contract with an automated underwriting modeling firm to learn which specific types of underwriting and servicing data to collect and how to accurately collect them for the future development of an automated underwriting system. If these data are not consistently and accurately collected, there is no way to track information relevant to measure and evaluate the Program's underwriting standards, and an automated underwriting model could not be developed. The Panel recommends that:

SBA, with the assistance of a contracted automated underwriting modeling firm, should consistently and accurately collect loan-level data needed for the development of an automated underwriting system tailored to the post-disaster performance of home disaster loans, and eventually business disaster loans.

Once SBA collects sufficient historical underwriting and servicing data, the statistical modeling process can begin. Creating a statistical model for an automated underwriting system can take 2-6 months. One of the primary challenges is to organize the data used in the model to produce accurate underwriting results that meet SBA's loan making goals. Significant issues modelers will face when organizing SBA disaster loan data are: the demographics of disaster loan applicants, and the types and severity of disasters that occur differ from year to year.

The implementation phase of the automated underwriting model can take up to 2-3 years and involves testing the model over time to ensure it produces the results SBA hopes for. It is probable that initially, the results of the new automated underwriting system will differ from those of SBA's manual underwriting system. For example, the automated underwriting system may approve or decline applicants that the past manual underwriting system would not have. Some of these results might be considered by SBA to be more accurate, and others less accurate.

SBA would need to analyze the results of the new automated underwriting system over time and work with the modelers to refine the system to meet SBA's underwriting standards and goals.

DISASTER LOAN CLOSING AND DISBURSEMENT

Disaster loan applicants are assigned a case manager following loan approval who is the applicant's primary contact and guide through the loan closing and disbursement processes. Case managers work in integrated teams with legal staff and Loan Officers to move their case-load of applicants from approval to final disbursement.

Disaster Loan Closing

Following loan approval, disaster loan applications are transferred to the legal department, where the loan closing documents (LCDs) are prepared. LCDs are mailed either directly to the applicant to sign and return by mail or to a Disaster Recovery Center for the applicant to review and sign in the presence of an SBA representative. Required legal documentation for loan closing ultimately depends on the loan terms, but for the most part, consists of the Note and the Loan Authorization and Agreement (LAA).

SBA considers signed loan closing documents to mark the end of the loan closing stage. Signed LCDs however entitle the borrower only to the disbursement of the unsecured portion of the loan, which is \$10,000 for physical disaster loans and \$5,000 for economic injury disaster loans. Borrowers with secured loan obligations also must satisfy additional collateral and insurance conditions, which typically occurs after loan closing. SBA disburses the unsecured portion of a disaster loan before the borrower has satisfied collateral conditions as a way to get money more swiftly into the hands of homeowners, renters, businesses and non-profits following a disaster.

Disaster Secured Loan Collateral and Insurance Requirements

To receive the secured portion of a disaster loan, borrowers must provide additional legal documentation, which generally relates to collateral. Most collateral for disaster loans is real estate, and borrowers provide their ownership deeds so that the legal department can prepare the mortgage or deed of trust. The requirements for secured physical damage and economic injury disaster loans are as follows:

- \$10,001-\$50,000—Proof of lien document recording is required.
- \$50,001-\$250,000—Proof of lien document recording, title search showing SBA lien record owner, and other liens, and obligations on property being used as collateral are required.
- \$250,001 and up—Lenders policy of title insurance is required.

For disaster loans used to purchase property for relocation, a lender policy of title insurance is generally required, regardless of loan amount.

In addition to these collateral documentation requirements, secured disaster loan borrowers must also meet insurance requirements. SBA requires hazard insurance on secured loans to protect all insurable collateral. If collateral property other than the damaged property is securing the loan, hazard insurance is required on both the damaged property and the pledged collateral. Borrowers must obtain hazard insurance equal to at least 80 percent of the insurable value of the property to be insured, and maintain the coverage throughout the entire term of the secured loan.

Under the national Flood Insurance Reform Act, the SBA also requires flood insurance for all insurable collateral located in Special Flood Hazard Areas (SFHA) used to secure loans. Borrowers located in an SFHA must obtain and maintain flood insurance for the full insurable value of the property or the maximum coverage available, whichever amount is less.

Loan Modifications

Any changes that need to be made to an approved and obligated disaster loan must be made through a loan modification.⁸¹ Most loan modifications are initiated by the legal department and all loan modifications are completed by Loan Officers. Currently, there are 24 types of loan modification, including address change, name change, adverse information, alternate use of proceeds, loan cancellation, collateral change, decrease loan amount, increase loan amount, defer payment, extend disbursement period, extend documents return date, first payment due date change, flood insurance change, insurance recovery, lower interest rate, lower payment, mitigation, no action, payoff information, possible delinquency, reinstate loan, relocation, subordination, and undisclosed liens.

Disaster Loan Disbursement

SBA physical disaster home and business loans are construction loans and therefore are disbursed in incremental amounts in order to prevent fraudulent use of disaster loan funds. Because no physical repairs are associated with economic injury disaster loans or relocation loans, SBA generally makes full disbursement for these loans once collateral and insurance requirements are met.

After collateral and insurance conditions are met and all required collateral documents are signed and returned to the Processing and Disbursement Center, disbursement of the secured portion of physical disaster loans can begin. Secured loan disbursements come in increments of up to \$40,000. For each subsequent disbursement, borrowers must account for at least 80 percent of their current disbursement, and submit a Borrower's Progress Certification form itemizing expenditures and copies of receipts for those costing \$1,000 or more to the Processing and Disbursement Center. SBA may require additional on-site progress inspections from Loss Verification,⁸² may audit receipts, speak with contractors, and in some cases, may require affidavits from borrowers and/or contractors before a subsequent disbursement, particularly for the final disbursement on major construction projects.

⁸¹ Changes that need to be made to an applicant's file before loan approval and obligation can be made without a loan modification.

⁸² Progress loss verification inspections are conducted by SBA Loss Verifiers rather than FIT Loss Verifiers.

90/45 Campaign and Case Management Model

In August 2006, one year after Hurricane Katrina, SBA had approximately 94,000 unresolved approved loans.⁸³ In September 2006, the Processing and Disbursement Center launched the 90/45 Campaign to reduce this large backlog of undisbursed and partially disbursed loans. The goal of the campaign was to proactively contact 90,000 approved loan applicants in 45 days. Until the 90/45 Campaign, SBA staff had taken a passive approach and waited for applicants to contact them.

Before September 2006, SBA loan files moved in an assembly line-like fashion, from station to station according to the status of the loan, and often passed through a variety of hands at each station with little accountability to the applicant. When applicants called with questions regarding legal paperwork or the status of their loan closing or disbursement, they often spoke with a different person each time, and consequently did not always receive consistent responses to their inquiries.

In the summer of 2006, the new SBA Administrator hired a consulting firm to interview Hurricane Katrina business loan applicants to better understand the prevalent issues loan applicants faced following the Gulf Coast hurricanes. The lack of consistent information from Processing and Disbursement Center staff was a primary complaint of the applicants interviewed.

Everybody I have dealt with have been the most courteous, helpful people. But the paperwork is another thing. First my paperwork went to Sacramento, then to Texas. They have lost my paperwork three times...just got my closing papers three weeks ago; I applied six weeks after Katrina.

—Gulf Coast Hurricane Disaster Loan Applicant

The 90/45 Campaign reorganized Processing and Disbursement Center staff using a case management team model to resolve approved loans of Gulf Coast hurricane borrowers, a model which SBA now applies to all disasters. Case management teams cover post-approvals only, and consist of case managers, legal staff and Loan Officers. Portfolios stay with one case manager until the loan is fully disbursed or canceled, ensuring that applicants have one point of contact; case managers are held accountable for their assigned portfolios. Case managers are also expected to take a proactive approach and call their applicants regularly.

Case management teams can provide more consistent information about the post-approval process, identify applicant problems more efficiently, and resolve loan files at a faster rate than was possible using SBA's previous method. Since implementing the new case management system, the Processing and Disbursement Center reduced the number of unresolved loans from approximately 94,000 in August 2006 to 33,000 in December 2006. As of July, 2007 the number of unresolved loans had been further reduced to 11,499.

Consistent with the business loan borrowers interviewed by SBA before implementation of the case management model, common grievances among home and business loan borrowers interviewed by Academy staff in New Orleans and Biloxi were the lack of consistent information from Processing and Disbursement Center staff, and the need to send completed paperwork more

⁸³ According to SBA, an "unresolved" loan is an approved loan that is undisbursed or partially disbursed.

than once because Processing and Disbursement Center staff did not file it properly the first time it was sent. Borrowers in New Orleans and Biloxi agreed that once they were assigned a case manager, they received more consistent responses to their inquiries, and paperwork sent to the Processing and Disbursement Center was handled more efficiently. Many however complained of high turnover among their case managers which led to the same complaints about inconsistent information that characterized the previous ‘assembly line’ work process.

Disaster Loan Closing Following Gulf Coast Hurricanes

In May 2006, SBA received signed and completed loan closing documents from borrowers affected by Hurricanes Katrina and Rita approximately 35 days after loan approval. In September 2006, the average processing time increased to 173 days, and by March 2007 the average was 337 days. These long delays in loan closure primarily reflect borrowers’ uncertainty about rebuilding homes and businesses, or waiting on insurance company reimbursements and state-funded grant programs. In response, SBA granted extensions to the standard 60-day closing period for Gulf Coast hurricane borrowers.

Typically, in commercial lending, the loan applicant meets collateral requirements for secured loans before closing. By contrast, SBA does not issue collateral documents or require a search of official title records until after loan closing has occurred. Home and business disaster loan borrowers interviewed in New Orleans and Biloxi aired many common grievances related to fulfilling collateral and insurance requirements following loan closing. One common complaint was that they had expected to receive their loan immediately after loan closing, and were surprised by the legal process that followed. Most home loan borrowers interviewed said they could do little with the \$10,000 unsecured physical disaster loan they received following loan closing, and resented having to pay interest on this amount during the time it took to meet secured loan collateral and insurance requirements.

Most business loan borrowers said the unsecured \$10,000 physical damage and \$5,000 unsecured economic injury loans were helpful but that a larger loan amount would have been more helpful. Borrowers said that the paperwork requested by the legal department after loan closing was confusing and voluminous; the time it took to complete the paperwork was a significant bottleneck in the disaster loan process. SBA could not provide data on the average amount of time between borrowers returning signed loan closing documents and signed collateral documents to measure the magnitude of this bottleneck, and consequently, evidence of it is anecdotal, but nonetheless compelling.

Legal staff in the Processing and Disbursement Center informally refer to the SBA loan closing and the process of fulfilling secured loan collateral requirements as a “two-stage closing.” If the two processes were combined into one closing, the result would be similar to that of a commercial bank closing. Confirming disaster loan borrowers’ complaints, legal staff said that borrowers often assume they are finished with the legal documentation process after they sign loan closing documents and feel like SBA is making them jump through one hoop after another when they then are asked to supply further collateral and insurance documentation. Borrowers often do not understand that SBA has divided the closing process into “two stages.”

For secured loan files, document generation staff in the legal department must prepare two sets of legal documents—loan closing documents and collateral documents. Most document generation staff spend between 10 and 20 minutes⁸⁴ reviewing loan file details before they can prepare legal documents. By the end of January 2007, approximately 116,000 Gulf Coast hurricane disaster loans had been either partially or fully disbursed. Of these loans, approximately 12,000 were limited to the unsecured loan amount of \$10,000 or less. Thus, approximately 104,000 files received two reviews by legal staff in order to prepare unsecured and secured closing documents. If each review took 15 minutes, the review time expended to prepare two sets of closing documents would be equal to 52,000 hours. If the document generation staff had to review each file only once to prepare one set of closing documents, up to 26,000 labor time hours, or 325 8-hour working days, might have been saved. Also, a single set of loan closing documents per file would enable SBA to cut in half the number of mail packages associated with these documents, saving additional time and money.

The Panel concludes that, by issuing one complete set of closing documents, SBA would achieve three principal benefits. First, SBA's loan closing process would be similar to the more familiar standard commercial loan closing process, and thus would be more understandable to the disaster loan borrower. Second, borrowers would avoid paying interest on idle unsecured disaster loan funds while they complete collateral and insurance documentation requests. Third, requiring a single set of closing documents would be more efficient and cost effective, and could reduce the legal documentation bottleneck following catastrophic disasters. The Panel recommends that:

SBA issue at one time the complete set of disaster loan closing documents, including documents on collateral and proof of insurance for secured loans.

Some disaster loan applicants may find a smaller unsecured disaster loan useful while they wait to receive a larger secured loan. Applicants who want to receive an unsecured loan before they obtain a secured disaster loan should have this option. Thus, the Panel recommends that:

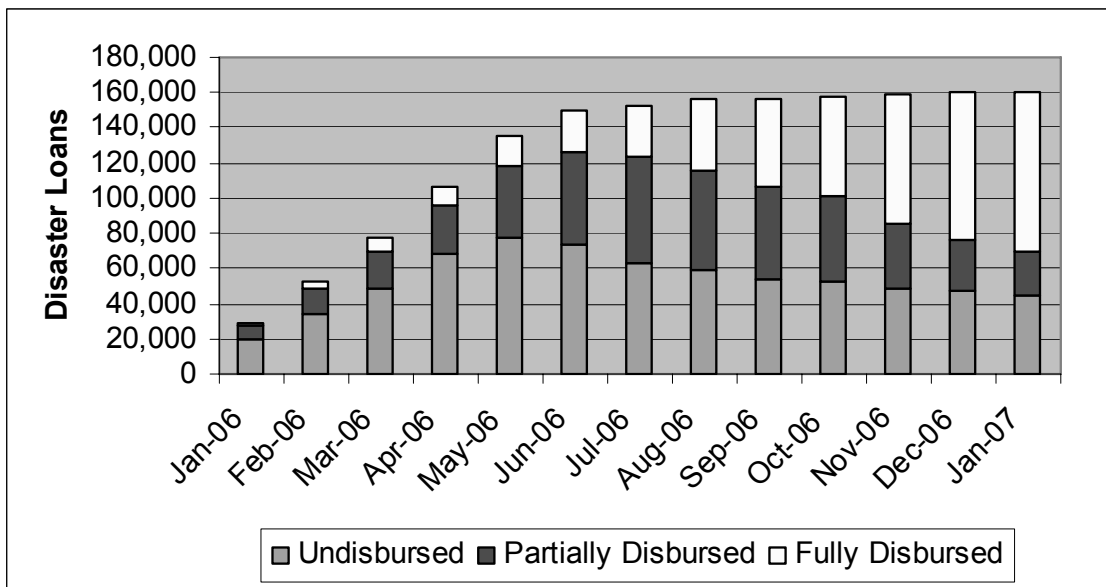
SBA provide disaster loan borrowers with the option to receive an unsecured disaster loan while they complete the loan closing process for a secured loan.

Disaster Loan Disbursement Following Gulf Coast Hurricanes

In January 2006, out of approximately 29,000 Gulf Coast hurricane disaster loans approved, 2,000 were fully disbursed, 7,000 partially disbursed, and 20,000 undisbursed. Six months later, SBA had approved approximately 153,000 Gulf Coast hurricane disaster loans, of which 30,000 were fully disbursed, 60,000 partially disbursed, and 63,000 undisbursed. By January 2007, out of approximately 160,000 Gulf Coast hurricane disaster loans approved, approximately 95,000 were fully disbursed, 21,000 partially disbursed and 45,000 undisbursed. Thus, in January 2007, 59 percent of approved Gulf Coast hurricane loans had been fully disbursed, 13 percent had been partially disbursed, and 28 percent were undisbursed.

⁸⁴ Estimate provided by an SBA upper-level manager from the Processing and Disbursement Center.

Figure 3-3. Distribution of Disaster Loan Disbursements Following Gulf Coast Hurricanes



Source: SBA

By January 2007, SBA had approved approximately \$10.8 billion in disaster loans for Gulf Coast hurricane borrowers and disbursed about \$5 billion in funds. According to SBA, there are several primary reasons for its less-than 50 percent disbursement rate. A portion of the undisbursed funds are reserved for borrowers who have not yet obtained title documents required to meet collateral requirements. In Orleans Parish, there is currently a four-to-five month wait for borrowers to obtain title documents needed to qualify for disbursements on secured loans of \$50,000 or more. Also some borrowers said they could not afford the flood or hazard insurance required for secured loans. Other borrowers were waiting for state grant assistance or insurance settlements before signing loan closing documents or requesting subsequent disbursements. Delays in the issuing of building permits due to not-yet-finalized FEMA flood maps were another contributing factor to borrowers not receiving secured loan disbursements. Some borrowers either canceled or still had not decided to close on their approved loans due to pending decisions on rebuilding or business reopening. SBA predicts that it will be difficult for some Gulf Coast hurricane borrowers to receive full loan disbursement during the standard 12-month disbursement period and plans to grant extensions to those who pass credit reviews.

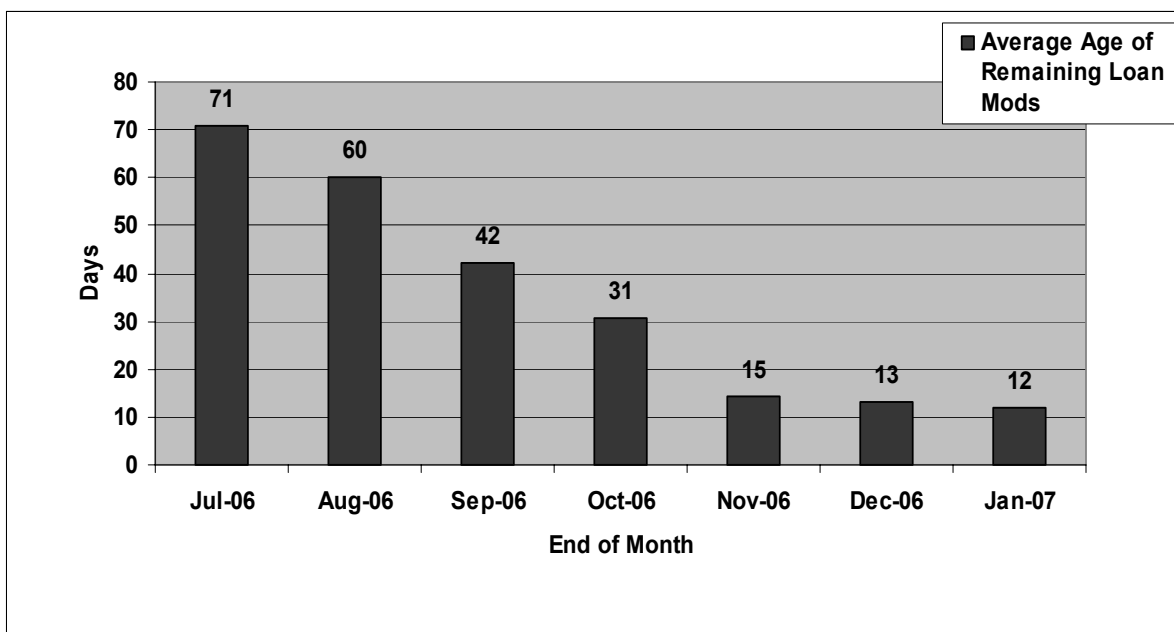
Home and business physical disaster loan borrowers interviewed in New Orleans and Biloxi who went through or were still involved in the secured loan disbursement process said they would have preferred to receive their loan in its entirety rather than in disbursements of \$40,000. They also believed larger disbursement increments would have been helpful. These borrowers said the time it took between submitting the Borrower's Progress Certification form to the Processing and Disbursement Center and receiving their next disbursement slowed down the rebuilding process. Most experienced at least one construction stoppage, and for some, parts of their homes were left exposed during these stoppages, which resulted in further physical damage. Borrowers also said contractors often moved on to rebuild other properties in between loan disbursements causing

further delays in the rebuilding process. Despite the disbursement difficulties physical disaster loan borrowers faced following Hurricane Katrina, the Panel believes that it is prudent for SBA to continue to disburse the secured portion of physical disaster loans in increments of \$40,000 following catastrophic disasters in order to ensure that disaster loan funds, in fact, go towards rebuilding.

Loan Modification Backlogs Following Gulf Coast Hurricanes

Loan modification backlogs contributed to the length of time it took to close and disburse approved loans following the Gulf Coast hurricanes. Once a disaster loan has been approved, needed changes must be made through a loan modification. Loan modifications range from address changes to increases or decreases in the obligated loan amount. While a Loan Officer is completing a loan modification for an application, the application process essentially stops. In July 2006, it took Loan Officers an average of 71 days to complete a loan modification. In October 2006, following the 90/45 Campaign and implementation of the case management team model, it took an average of 31 days to complete a loan modification, By November 2006, the average was 15 days, and by January 2007 it had dropped to 8 days.

Figure 3-4. Loan Modification Backlog Aging Following Gulf Coast Hurricanes



Source: SBA

DISASTER LOAN SERVICING AND COLLECTIONS

SBA Servicing Practices

Servicing a loan includes a wide range of activities from a borrower updating contact information to inquiring about loan payoff amounts, loan payment history, total interest paid, and

other information. More involved servicing actions include loan modifications, subordinating or releasing collateral, and collecting on delinquent loans.

ODA is responsible for necessary servicing actions including collecting delinquent accounts, required until final disbursement is made and the loan is transferred to SBA's Office of Capital Access. Disaster loans typically have a six-month deferment period between disbursement and when the first payment is due. For the Gulf Coast hurricanes, borrowers were given a 12-month deferment. Once in payment status, Capital Access' primary responsibility is the on-time collection of payments. Ninety-five percent of the disaster loan portfolio is current (i.e., paying on time), while the remaining portion is in various stages of delinquency or default.⁸⁵

SBA's Office of Capital Access services delinquent and defaulted guaranteed SBA loans, primarily 7(a) loans and 504 loans, and all disaster loans. Disaster loans are serviced separately out of three centers each staffed by from 25 to 40 people. The Birmingham and El Paso centers service loans while the Santa Ana office manages loans in liquidation. Each center services between 60,000 and 70,000 loans, and is receiving one to two thousand new loans a week in the aftermath of the Gulf Coast hurricanes.

Handling Delinquent and Defaulted Disaster Loans

The primary use of resources in loan servicing centers of the Office of Capital Access is for the collection of delinquent accounts. While orderly repayment of loans is important, Capital Access' efforts to strictly enforce repayment are tempered by recognition that the borrowers are disaster victims and the office's action or inaction can have a significant impact on the borrowers' financial recovery.⁸⁶

Capital Access advises that collection efforts on loans at the earlier stages of delinquency should be standardized as much as possible. Capital Access' calls and letter writing during the earlier stages of delinquency are automated. In addition to the various payment methods available to borrowers, Capital Access is expanding electronic payment options. It is implementing a new interactive voice response calling system that will allow borrowers to pay their accounts instantly over the phone using a variety of payment methods or to schedule payment for a date within the following 10 days. Borrowers are also able to set up an automatic payment schedule or to make one-time payments on-line at www.pay.gov.

For loans under 60 days delinquent, SBA contractors place calls and accept payment information over the telephone. SBA employees call borrowers who are over 60 days delinquent in order to make arrangements to bring the loan current. Workout options for the program include: deferring loan payments, extending loan maturity, reducing loan payments for a temporary period, changing the borrower's interest rate, or compromising on the debt (i.e., accepting less than the full amount).

⁸⁵ Information obtained from an interview with the Office of Capital Access staff.

⁸⁶ U.S. Small Business Administration, *Disaster Assistance Program Standard Operating Procedures 50-52-1*, Washington, DC, 2002.

While there are procedures in place for handling delinquent accounts, an Inspector General report found that the Office of Capital Access was not consistently sending pre-demand or demand letters⁸⁷ to delinquent borrowers.⁸⁸ In response, Capital Access revised the timeline for sending out pre-demand and demand letters. The process for delinquent loans is as follows:⁸⁹

- 11 Days Delinquent—The borrower receives an automated call and a letter requesting payment of the late installment.
- 25 Days Delinquent—If no payment is received, automated weekly calls continue and another letter is sent clarifying borrower options.
- 40 Days Delinquent—Weekly calls continue and another letter is sent clarifying borrower options.
- 61 Days Delinquent—An SBA employee calls the borrower and the letter is revised to clarify borrower options.
- 90 Days Delinquent—Final pre-demand letter with stronger language is sent. The letter provides a 15 day response time.
- 110–120 Days Delinquent—Loans with collateral and loans in litigation will be sent to the Santa Ana center for liquidation processing. However, loans in any amount that are unsecured are charged off⁹⁰ and transferred to the Treasury Department’s Debt Management Services after a 60-day due process letter.
- 120 Days Delinquent—All loans not charged off will be automatically sent a 60-day due process notice advising of possible referral to the Treasury Department. At 180 days, all loans (unless coded “do not refer” because of workout, bankruptcy, or foreclosures) will be referred to the Treasury Department.
- 120–220 Days Delinquent—The Santa Ana Center sends an acceleration letter notifying the borrower that foreclosure proceedings will commence within a specified number of days.
- Over 220 Days Delinquent—Liquidation continues on all cases, including those with judicial or summary foreclosure on loans with collateral having worthwhile equity, and pursuit of deficiency balances from collectable guarantors. Litigation is usually handled by the appropriate district office in coordination with Santa Ana. Loans are charged off

⁸⁷ A demand letter is a formal notice demanding that the borrower pay a sum of money on a delinquent loan within a specified time. The letter gives the recipient a chance to perform the obligation without being taken to court.

⁸⁸ U.S. Small Business Administration Office of Inspector General, “Management Advisory Report on Pre-Demand and Demand Letters for Delinquent 9/11 Disaster Loans.” Report Number 5-09, January 11, 2005.

⁸⁹ U.S. Small Business Administration, Office of Capital Access response to the IG management advisory report.

⁹⁰ A charge off is the process by which SBA recognizes a loss and removes the uncollectible account from its active receivable accounts.

when all cost-effective recovery actions have been concluded. All loans that are legally collectible will be automatically referred to the Treasury Department.

Industry Servicing Standards

For high-risk loans, which many disaster loans could fairly be considered, private servicers practice highly targeted, technologically sophisticated, and aggressive tactics to service fully disbursed loans. Those techniques include:

Counseling

Best industry practice for high-risk loans involves borrower counseling, which starts by establishing a relationship with “welcome calls” made to borrowers notifying them when their first payment is due and the methods by which they can make payments. During the initial call, servicers explain the need for prompt payments and the impact on borrower credit histories if payments are received late. The servicer can take the opportunity to emphasize the importance of the obligation, financial budgeting, and establishing repayment of the loan as one of their top priorities, as well as notifying the borrower of ways in which the servicer can assist them. The servicer can also refer borrowers to non-profit credit counseling organizations for more in-depth education on budgeting, preserving credit quality, and other financial tools that prevent or assist in the recovery from stressed financial conditions.

Targeting

Private lenders and servicers, often operating under guidelines set by Fannie Mae or Freddie Mac when servicing mortgages, stratify loans based on credit scores and risk grades, stress indicators such as borrower payment behavior, and lien positions so as to target early and assertive intervention for the borrower with a higher risk profile. Approaches are adopted based on those risk categories. For example, servicers might begin calling high-risk borrowers when they are between 2 and 8 days delinquent and call low-risk borrowers when they are 45 days delinquent. Similarly, loss mitigation efforts or foreclosure proceedings would begin earlier for the high-risk borrower.

For servicing disaster loans, credit scores might not be the only or most appropriate indicator of how likely a borrower is to repay a loan. In the context of a disaster, considering the type of employment and the nature of the industry may be more predictive of a disaster victim’s ability to perform on the loan. For example, SBA might find that following a disaster, businesses that are in an industry that serves an urgent or essential need may have the economic means to perform better on their loans than a luxury or nonessential service provider would. Geographic region and/or the nature of the disaster itself may also be more predictive than a credit rating. For example, the nature of the damage caused by an earthquake may increase the likelihood of those disaster loans staying current compared to loans made in an area destroyed by a hurricane or tornado where damage is more severe and the recovery time is longer. No one factor will be adequately predictive. SBA will need to monitor and evaluate loan level data on that basis to determine the factors that best capture post-disaster loan performance and target its servicing efforts accordingly.

Early Intervention and Loss Mitigation

Loss mitigation and early intervention are critical tools in delinquency and default management. Early intervention plays a critical role in protecting borrowers from the full consequences of loan default because high-risk borrowers often do not have access to the financial resources needed to reinstate a seriously delinquent loan. Early intervention is called for when expected events do not occur or when prompted by analytical systems that raise other red flags.

For Neighborhood Housing Services of America, early intervention means utilizing loss mitigation options when the loan is 75 days instead of 90 or more days delinquent. Other private servicers receiving top ratings also apply loss mitigation interventions 10 to 15 days earlier than their peers.

Automation

Workflow management technology built into a servicing system guides servicers through the mitigation process. “Prompts for information and pre-scripted narratives nested within the automated process ensure that mitigation efforts are handled in a consistent way throughout the organization.”⁹¹ The prompting system should also allow the servicer to understand the borrower’s likely intent and ability to bring the loan current.

A more rigorous approach to servicing by SBA would help borrowers to keep their homes and businesses and preserve their access to credit. Early intervention greatly increases the likelihood that delinquent loans will be brought current. Ultimately, borrowers must be held accountable for their obligations. Otherwise they may lose much of their incentive to repay. A 24 percent default rate for the program, as at present, is very high; reducing this rate can place the program on an improved financial footing. While everyone wants to help disaster victims regain their homes and livelihoods, it is not fair for taxpayers to bear the costs of defaulted loans to those borrowers who in fact have the resources to make more complete repayment, but simply choose not to do so. The Panel recommends that, similar to leading industry practice, SBA should:

Improve loan servicing by:

- **contacting disaster loan borrowers before they enter repayment status,**
- **automating the servicing workflow**
- **targeting servicing interventions based on a borrower’s risk profile,**
- **intervening with loss mitigation options at an appropriate time (i.e., before 90 days’ delinquency), and,**

⁹¹ “Profitable Subprime Loan Servicing” All Business: www.allbusiness.com/print/307769-1-22eeq.html.

- **collecting with the rigor of the commercial sector on defaulted loans.**

Increased Accountability and Risk Management

Mortgage and commercial lenders are held accountable for the performance of the loans they underwrite by the secondary markets and their regulators. Lenders and other financial institutions utilize aggregate, as well as loan-level data on a routine basis to assess whether underwriting standards are yielding the default, prepayment, and charge-off rates they predicted as well as to monitor the credit quality of their respective portfolios and identify their greatest risk exposure. Without such analyses, banks and other financial institutions would compromise their profitability and risk ratings.

While SBA does not share the profit motive of private lenders, in its role as a steward of taxpayer funds, SBA's Office of Lender Oversight (OLO) monitors on a quarterly basis the portfolios of the Section 7(a) and 504 loans that lenders originate with an SBA guarantee. OLO's loan and lender monitoring activities include maintaining a database of information about SBA's loans and lenders which is used to monitor lender and portfolio performance. Analytical data generated from the loan monitoring system significantly enhances OLO's ability to measure and evaluate the guarantee risk within SBA's small business guaranteed loan portfolio."⁹² OLO ranks lenders according to the risks each lender's loan portfolio presents to SBA.

Currently, estimating the annual credit subsidy rate and re-estimating rates for prior-year cohorts is the only formal feedback mechanism SBA uses to indicate how well its underwriting criteria help to predict and control the risk of default on disaster loans.⁹³

SBA should be held more directly accountable for the underwriting standards and decisions it makes in order to better manage both the current and future credit risks it assumes. To improve accountability, SBA must follow sound commercial and government practice and define, monitor, and manage its portfolio.

Define Risk

SBA should consult with the appropriate congressional committees and with OMB to obtain a mandate to define the level of risk that it will seek to assume within its mission as a government agency serving disaster victims.⁹⁴ Then it can set and revise, on the basis of experience, the underwriting standards that are appropriate to meet that target for business and home loans. To adjust its underwriting criteria to meet a targeted default or charge-off rate, SBA will need to capture and monitor historical disaster loan characteristics (income, credit score, type of employment, type of disaster, etc.) and performance data (prepayment, delinquency, and default rates).

⁹² U.S. Small Business Administration, "National 7a Lender Guide," Chapter 7, Lender Oversight, <http://www.sba.gov/7alenders/chapter7.pdf>.

⁹³ Source: Interview with SBA officials.

⁹⁴ The Panel understands, but has not been able to document, that an SBA Administrator some years ago sought to obtain such guidance from the Congress, but without success. However, that occurred before the advent of the Credit Reform Act of 1990 and the need for federal credit programs to link their program costs more closely to management actions that can keep those costs within budgeted resources.

Monitor Risk

SBA should set procedures to actively monitor the disaster loan portfolio on a quarterly basis. In doing so, SBA should utilize the in-house expertise of OLO. Capturing and monitoring loan level data will enable SBA to assess whether there are predictive variables to indicate how borrowers will perform post-disaster which could help lead to the eventual development of an automated underwriting system customized for disaster loan borrowers.

Manage Risk

Monitoring risk indicators on a routine basis will enable SBA to better manage the risk it assumes on the front-end by reacting to observed trends and incorporating changes in, for example, underwriting standards, processing procedures, creating new loan products, or involving private sector participation in disaster lending. By examining risk indicators such as charge-off rates as a percentage of delinquencies and defaults, SBA would be equipped with the knowledge to implement early and aggressive servicing interventions on the back-end including utilizing a menu of loss mitigation options. The Panel recommends that:

Under guidance from the Congress and in consultation with OMB, SBA specify the general level of risk it will assume, monitor its risk on a quarterly basis, and manage risk by revising underwriting standards and servicing actions in response to observed trends.

CHAPTER IV STRUCTURAL CHANGES

The *Analytical Perspectives* volume of the President's FY 2004 Budget examined the federal role in the credit markets. The discussion began by identifying the instances in which intervention was justified:

The roles of federal credit and insurance programs can be broadly classified into two categories: helping disadvantaged groups and correcting market failures. Subsidized federal credit programs redistribute resources from the general taxpayer to disadvantaged regions or segments of the population. Since disadvantaged groups can be assisted through other means, such as direct subsidies, the value of a credit or insurance program critically depends on the extent to which it corrects market failures.⁹⁵

Two of the credit tools used by the federal government to correct market failures are direct loans and loan guarantees. Both instruments are able to reach underserved groups by providing longer maturities and lower interest rates, making loans more affordable to borrowers. In the case of direct loans, the government borrows funds from the U.S. Treasury to make loans directly to borrowers. The transactions involve no banks or other financial institutions, agents, or other intermediaries. Federal employees process, close, disburse, and service loans. In the case of loan guarantees, loans are originated, processed, closed and disbursed by private lenders, but the government issues lender guarantees to protect them against default losses on the guaranteed portion the loan.

Historically the Disaster Assistance Program has been structured to provide disaster loan borrowers the most affordable and flexible terms available (i.e., long maturities, repayment deferrals, and lower interest rates), which the government is able to deliver given its lower cost of funds. In addition, some predict that lenders would not participate or serve similar borrowers to those served by today's disaster loan program without a 100 percent guarantee, which defeats the objective of risk-sharing, a key design in loan guarantee programs. Because SBA was overwhelmed with the volume of loan applications following the Gulf Coast hurricanes, the agency is considering ways to capitalize on private-lender involvement, as well as possible structural changes to the program.

UTILIZING PRIVATE LENDERS

Benefits of Private Lender Involvement

During catastrophes, SBA needs the private sector's capabilities, that is, access to people who are familiar with the mechanics of lending and experienced in applying underwriting standards to individual loan applications. By utilizing private lenders, ODA could experience several

⁹⁵ *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004*, p. 189.

potential gains in the speed and quality with which the program delivers disaster lending decisions. Lenders should be willing to process loan applications for a fee. This is a cost that SBA should be willing to pay during catastrophic events, since it is getting a vital service in return. Some of the potential gains from using private sector lenders are outlined below. However, not unexpectedly, additional costs will likely be incurred to make the program attractive to lenders.⁹⁶

Existing Network of Participating Lenders

From an administrative perspective, SBA must set up shop for each newly declared disaster. The office deploys staff to the field, hires and trains Loan Officers to process loans and attorneys for closing and disbursements, and augments servicing staff when loan volumes grow larger than expected. Operating costs expand and contract according to disaster loan volume.

Under the Section 7(a) loan guarantee program, SBA already has an established framework and operating infrastructure to address small businesses' capital needs through approved lenders nationwide. SBA delegates loan approval, closing, and most servicing and liquidation authority and responsibility to over 500 Preferred Lender Program (PLP) lenders and over 1,800 *SBAExpress* lenders. In addition, SBA also originates loans through lenders in the Certified Lender Program. Certified lenders have demonstrated a proficiency in processing and servicing SBA-guaranteed loans and must meet certain portfolio performance standards. Performance of all lenders is monitored through SBA's Office of Lender Oversight whose mission is to maximize the efficiency of SBA's lending programs by effectively managing program credit risk, monitoring lender performance, and enforcing lending program requirements.

Local Expertise

Responding to a disaster is inherently a local operation. Local banks and other financial institutions have existing customer relationships, are members of the community, and are already present at the time of a disaster. Using a network of pre-approved SBA disaster lenders would reduce the need to send staff to the region to find space, bring in equipment, and rapidly hire and train staff. Because lenders originate loans virtually every day, training of lenders could be limited to specific eligibility requirements and other rules of the program and could be done at the time of certification before a disaster strikes.

Automated Underwriting

Most private lenders use sophisticated automated underwriting tools to estimate an applicant's credit risk and deliver a preliminary answer to the prospective borrower in a matter of minutes. Automated underwriting is continually advancing by considering data beyond credit scores and income, and includes modeling patterns of repayment and how individuals behave with cash. Innovative developments in automated underwriting are able to capture and assess the credit quality of individuals who operate outside conventional financial institutions (i.e., who may not

⁹⁶ It has been SBA's experience that the Congress tends to reject considerations of assessing loan fees on borrowers who apply for or take out disaster home loans. Thus, if SBA were to pay lenders such fees, the budgeted costs of the program would increase.

have bank accounts or a history of borrowing and repaying extensions of credit) and consequently, do not have credit scores, by examining other types of payments such as rent and utilities.

Challenges to Involving Lender Participation

There are several hurdles to surmount in involving lenders in the disaster loan program. First, lenders could face similar challenges to SBA concerning capacity and preparedness. When local offices and staff are incapacitated by a disaster, lenders might not be able to shift staff from different locations without compromising operations in those areas. Lenders may also shy away from sharing bad publicity with SBA caused by rejecting disaster victims' loan applications. Finally, disaster loans would not be as attractive to lenders as other financial products since they would not be able to sell them for a profit on the secondary market as they do with SBA Section 7(a) loans.

One way for SBA to meet these challenges is to approach local and regional banks and other financial institutions for involvement in disaster lending during a catastrophic event. Their livelihoods depend on the immediate and long-term rebirth of the communities in which they are located. Many are staffed and managed by people who were born and raised in the area making their commitment to the area's resurgence a personal as well as professional goal. Financial institutions also have established relationships within the community that can be leveraged to provide additional services to SBA and the disaster victims it serves.

Another approach might be to have local lenders use DCMS or an SBA-approved web-based automated underwriting system calibrated to disaster program requirements. Not only would this strategy reduce the cost and complexity of entry to lender participation; it would also partially insulate the lenders from the blame caused by rejecting disaster loan applications since the decision to approve or decline the borrower would be based on SBA lending criteria.

POTENTIAL STRUCTURAL CHANGES

The objective of involving private sector banks and other financial institutions in the disaster loan program is to greatly increase SBA's ability to process loan applications during catastrophic disasters without reducing homeowners' and businesses' access to disaster assistance; increasing credit losses, due to lax underwriting; and increasing operating expenses to unacceptable levels.

Contractors Process and Close Direct Loans

SBA has already taken steps to involve the private sector in the next large-scale disaster by awarding three contracts to process and close disaster loans. The contractors, which are loan service providers, will make approve or decline recommendations based on the program's financial underwriting criteria and the statutory character requirements. Loan files will be sent back to the loan processing and disbursement center for final decision. The contractors will also close loans on-site within the defined disaster area.

So that they will be prepared for the 2007 hurricane season, contractors are expected to have completed a minimum number of loan files by June 1, 2007. While they will only be utilized for overflow after a catastrophic event, contractors will be provided with a sufficient number of files annually to ensure that they are current on SBA processing and closing procedures. Workload will be divided equally between the contractors unless performance dictates otherwise.⁹⁷

Unfortunately, SBA may not be able to take full advantage of the potential productivity gains available from these contracts by sending and receiving files through the mail instead of allowing contractors direct access through DCMS.

Banks and Other Financial Institutions Could Process, Close and Disburse Direct Loans

Lenders could process, close and disburse direct loans while SBA provides the capital to fund the loan. To achieve the efficiencies offered by this scenario, SBA could provide underwriting guidelines to the lenders using their expertise in making the final approve or decline decisions, as they did in the Gulf Opportunity (GO) Loan pilot program. Doing so may be more costly than hiring additional Processing and Disbursement Center staff. However, in cases when there are PDC staff shortages and high turnover rates following catastrophic disasters, using bank or other financial institution employees to process, close and disburse disaster loans could provide much needed staff to augment the PDC labor pool. Most importantly, it could also greatly speed up loans to disaster victims. Such a program could also provide business to local banks or financial institutions that may be struggling to remain open due to a shrinking customer base following a catastrophic disaster.

Encouraging lender participation will be a challenge, given that SBA did not receive any proposals in response to its request for proposals on private sector loan processing and closing of disaster loans. Lenders would require origination and closing fees which would be paid by SBA.⁹⁸

In this scenario, disaster loans that are originated by banks or other financial institutions would be SBA direct loans. SBA could institute a pilot program that would pay participating banks or other financial institutions a flat-fee to handle each disaster loan file. When deciding which files should be sent to the participating financial entities, PDC staff could apply the requirements of SBA's expedited processing pilot program, and send only those files that qualify for the no credit elsewhere rate and have credit scores at or above 620. Participating banks and financial institutions could be given access to DCMS in order to maintain their file loads and obtain FIT loss verification inspection results.

The risk is that without a financial stake in the loan, the lender might set the underwriting bar too low. Currently, mortgage bankers who originate and sell loans do not have a financial stake in the loans, but they know that if too many of their loans default, Fannie Mae and Freddie Mac will not buy their mortgages on the secondary market or will apply other serious sanctions. Thus,

⁹⁷Source: Interview with an SBA official.

⁹⁸ Again, it should be noted that the Congress tends to reject considerations of assessing loan fees on borrowers who apply for or take out disaster home loans, which means that these costs would need to be borne by the Disaster Assistance Program.

SBA needs to identify a means of holding private-sector lenders accountable for applying SBA's underwriting criteria. In cases where a lender is an SBA Preferred Lender, poor underwriting could mean the cancellation of its preferred lender status. If the lender is not a preferred lender, SBA would need to find another sanction for failure to follow its underwriting criteria. To the extent that SBA adopts automated underwriting, the discretion of banks to decide which loans to close would be limited and program costs would be controllable to a greater extent.

The procedure could potentially work like this:

- SBA provides participating lenders with underwriting criteria.
- SBA sends these lenders loan applications from the strongest borrowers who do not have credit elsewhere.
- Lenders underwrite the loans using SBA standards or the DCMS processing system.
- SBA spot-checks individual lenders' compliance with underwriting guidelines.
- Lenders arrange for loss verification using SBA's Field Inspection Team.
- Lenders prepare documents in accordance with SBA requirements.
- When loan approval is complete and loan closing documents prepared, the lender notifies SBA and disburses the initial loan payment, and potentially the payment of subsequent loan disbursements.

The Panel recommends that:

In an effort to expand staff capacity and serve disaster loan borrowers expeditiously following a catastrophic event, SBA should pilot a disaster assistance program utilizing banks and other financial institutions to process, close and disburse direct loans.

SBA should conduct the pilot on a regional basis to establish procedures and identify areas of operational weakness, potential fraud, and greatest risk before implementing any full-fledged program to augment the origination of direct disaster loans by SBA officials, as at present, during a presidentially declared catastrophic disaster.

Other Options

SBA might also be able to serve more borrowers in a catastrophic event by adding a disaster loan guarantee program in order to enlist private banks and other financial institutions to make disaster loans during a catastrophic event. While the Panel is not making a recommendation that SBA adopt any of the following options, the agency may wish to consider these options.

Standard Loan Guarantee

Congress could restructure the Disaster Assistance Program as a loan guarantee similar to SBA's Section 7(a) program, which guarantees up to 85 percent of the principal balance and interest on the loan. A guarantee program, however, would be challenged to compete with the direct loan program because the cost of funds to borrowers is significantly below market rates for the vast majority of disaster loan recipients. Were the direct loan program replaced by a guarantee program, SBA would need to write-down the interest rate in order to serve the same or similar borrowers as it has during past disasters. A loan guarantee with market interest rates would likely only serve borrowers with the strongest credit quality.

Loan Guarantee With Interest Rate Guarantee

There are two major drawbacks to structuring the disaster loan program as a loan guarantee with an interest rate buy-down. First, it is costly to buy-down the interest rate over the life of the loan. In FY 2008, the disaster loan program is already estimated to subsidize borrower interest rates one percentage point under the government's cost of funds.⁹⁹ A loan guarantee program might require the agency to subsidize the interest rate by three points in a year. With a subsidy of this magnitude and a catastrophic disaster loan volume of \$10.6 billion,¹⁰⁰ SBA would pay over \$2.7 billion in interest rate payments over the life of the loans.¹⁰¹ While there would be some efficiency gains using private lenders, the gains would not be large enough to offset the additional cost of the interest rate buy-down, making this option more expensive than the current program. Current administrative expenses range between \$120 and \$150 million, amounting to between 5 and 12 percent of total loan volume. These costs would not be completely eliminated since SBA would continue to pay for loss verification, as well as oversight of the performance of loans and lenders.

To reduce the interest rate guarantee costs, Congress could restructure the program as a loan guarantee with a fixed percentage point interest rate buy down, giving SBA the right to purchase those loans from lenders after one or two years from the closing date. SBA would utilize the expertise and additional capacity of participating private lenders, but pay only the interest rate costs for 12 to 24 months.

The second drawback is that the proposal could have the unintended effect of supplanting regular SBA 7(a) loans that require no federal subsidy. Consequently, SBA could end up subsidizing loans that otherwise would have been made at no cost to the government.

Net Earnings Clause

Another method of making loan payments affordable to borrowers would be to introduce a net earnings clause, which would initially lower loan payments and require businesses to pay back a

⁹⁹ In the *FY 2008 Federal Credit Supplement* the average interest rate for Disaster Loan program borrowers is estimated to be 3.94 percent, which is almost one point less than the comparable U.S. Treasury rate.

¹⁰⁰ ODA approved \$10.6 billion in loans to victims of the Gulf Coast hurricanes.

¹⁰¹ The cost of the interest rate buy-down was estimated by applying the three-point interest subsidy of the credit subsidy rate to a catastrophic loan volume of \$10.6 billion.

percentage of their earnings after meeting certain performance requirements, beginning 5 years after receiving a business disaster loan.

Currently, SBA requires loans for \$1 million or more to include a net earnings clause entitling ODA to an annual payment of between 5 and 10 percent of the borrowers' net earnings.¹⁰² Each net earnings clause is written to the needs of the individual borrower. SBA can insert the clause in smaller loans, but the current practice limits its use to loans above \$750,000, since the administrative costs to implement the clause are high. Annual net earnings payments are calculated manually based on the business borrowers' IRS tax returns. The Office of Capital Access, as part of its servicing function, records and communicates the earnings payment due from the borrower.

Table 4-1. Guaranteed Loans

Options	Pros	Cons
Standard Loan Guarantee	<ul style="list-style-type: none"> Utilize existing SBA 7(a) program and network of participating lenders 	<ul style="list-style-type: none"> Without lower interest rates, the program would not serve the same disaster victims
Loan Guarantee with Interest Rate Guarantee	<ul style="list-style-type: none"> Able to serve the same disaster victims as the direct loan program 	<ul style="list-style-type: none"> Expensive to buy down the interest rate over the life of the loan Potentially supplanting regular 7(a) loans
Loan Guarantee with Net Earnings Clause	<ul style="list-style-type: none"> Make loan payment affordable to the borrower 	<ul style="list-style-type: none"> Applies only to business loans Expensive to administer

Risk of Using a Loan Guarantee

A loan guarantee would not come without risks. The following factors should be carefully considered before using a loan guarantee in the context of a disaster recovery program.

Selection Bias

A partial guarantee does not cover the full risk that a lender must assume. The objective of a partial guarantee is to share risk with lenders, so that they will make sound and responsible lending decisions. As a result, lenders are inclined to serve only those applicants with the best credit quality, leaving out others who would be served if the program were structured as a direct loan. Lenders may also favor current customers over borrowers unknown to them, while a federally operated direct lending program is indifferent to personal relationships.

¹⁰² Small Business Administration, *Disaster Assistance Program Standard Operating Procedures 50-30(5)* Chapter 5, Section 58, p. 105.

Leaving the lenders with a meaningful share of the risk would provide them with the incentive to practice sound underwriting. Again, to the extent that SBA develops and applies an effective automated underwriting system, this could reduce the extent that the program is subject to adverse selection or other gambits by lenders as they originate loans.

Unscrupulous Underwriting

Guaranteeing the interest rate paid by the borrower is one way of expanding the reach of a disaster loan guarantee program. To make it affordable from a federal budgeting perspective, however, SBA would likely need to institute a buy-back option allowing the agency to purchase the loan from a lender after 12 to 24 months, thereby reducing the period during which deeper interest rate subsidies are provided. However, if lenders underwrite loans knowing they can be sold later at par, unscrupulous lenders could underwrite borrowers who do not meet the income or credit criteria and ensure that their loans remain performing long enough for SBA to buy them back.

To mitigate this risk, SBA could screen loans for underwriting standards and program compliance before purchasing the loan. It could also deny the claim on a defaulted loan that was not underwritten according to SBA requirements. Again, automated underwriting, which can be used to shift loan decisions to SBA from the originating lender, can mitigate this problem.

Fraud

As more third parties are brought into a transaction, the harder it becomes to control for fraud. Under a federally operated direct loan program, there is only one lender—the government—which hires and trains Loan Officers. There are numerous safeguards built in to protect the government from fraudulent applicants. Under a loan guarantee program, however, not only does the government need to control for fraudulent applicants; it also needs to monitor the various private lenders and brokers involved in the program to avoid straw borrower or broker kick-back schemes or falsified credit elsewhere tests.

One way to counter the risk of fraud is to use SBA's network of certified PLP lenders. To participate in the PLP program, lenders are reviewed and certified for participation, and their SBA guaranteed loan portfolios are monitored on a regular basis. Since default rates are rolled into their status review, they will be held accountable for unusually high defaults. If fraud is discovered, they could be terminated from the program, fined, or both. SBA could also select the lender that a borrower would be required to use, in order to prevent potential scandal.

Caution is Warranted

While creation of some form of guaranteed loan program offers some potential advantages by allowing commercial lenders to help deliver disaster loans to their localities, any such change should be considered only with caution. A pilot program is essential to assure that guaranteed loans can be offered effectively and within acceptable risk tolerances. This conclusion may change if SBA adopts an effective and reliable automated underwriting system. While participation of commercial lenders as processors of disaster loans does not involve the same

magnitude of potential risk as a guaranteed disaster loan program, SBA would be wise to pilot this as well, before deciding whether to take it to larger scale.

INDIVIDUALS INTERVIEWED OR CONSULTED

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U.S. SMALL BUSINESS ADMINISTRATION

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We would like to thank the 40 homeowners and renters, and 40 business owners and non-profits, in New Orleans, Louisiana, and Biloxi, Mississippi who took the time to speak with us about their experiences with the SBA's Disaster Assistance Program. We wish you well in your rebuilding efforts.

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