STATEMENT OF

HANNIBAL “MIKE” WARE
ACTING INSPECTOR GENERAL
U.S. SMALL BUSINESS ADMINISTRATION

BEFORE THE

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

APRIL 26, 2017

INTRODUCTION

Chairman Chabot, Ranking Member Velázquez, and distinguished members of the Committee, thank you for the opportunity to discuss our oversight of the U.S. Small Business Administration's (SBA's) Disaster Assistance Program. Disaster assistance has been part of SBA since its inception in 1953. Through its Office of Disaster Assistance (ODA), SBA provides long-term, low-interest financial assistance to businesses of all sizes, private non-profit organizations, homeowners, and renters following a disaster. Each year, SBA approves hundreds of millions of dollars in disaster assistance loans. SBA's FY 2016 year-end disaster financial assistance portfolio balance was $6.2 billion. It is the mission of the Office of Inspector General (OIG) to provide independent, objective oversight to improve the integrity, accountability, and performance of the SBA and its programs, to include the Disaster Assistance Program, for the benefit of the American people.

OIG's ROLE

OIG was established within SBA by statute to promote economy, efficiency, and effectiveness and to deter and detect waste, fraud, abuse, and mismanagement in the Agency's programs and operations. During fiscal year (FY) 2016, OIG achieved nearly $145 million in monetary recoveries and savings—an almost seven-fold return on investment relative to our FY 2016 operating budget—and made 81 recommendations for improving SBA's operations and reducing fraud and unnecessary losses in the Agency's programs.

Among its duties and responsibilities, OIG is responsible for conducting reviews and investigations of the Disaster Assistance Program. Importantly, as Acting Inspector General (IG), I am charged with keeping the Administrator and Congress fully and currently informed about problems and deficiencies in SBA. Our work in the disaster assistance area is performed in an independent manner to ensure the objectivity of our work. It is our statutory guarantee of independence that makes our work and insight into SBA's programs unique.

OIG audits are conducted in accordance with Federal audit standards established by the Comptroller General, and other reviews generally are conducted in accordance with standards established by the Council of the Inspectors General for Integrity and Efficiency (CIGIE). In addition, we coordinate with the Government Accountability Office to avoid duplicating Federal audits. We also establish criteria to ensure that the non-Federal auditors that OIG uses (typically, certified public accountant firms) comply with Federal audit standards.

OIG investigations are conducted in accordance with the CIGIE Quality Standards for Investigations and Federal law. In conducting investigations, whenever the IG has reason to believe that Federal criminal law has been violated, the IG must promptly report that evidence directly to the Department of Justice, without prior clearance by Agency officials outside OIG.

MANAGEMENT CHALLENGES FACING DISASTER ASSISTANCE PROGRAM

OIG has identified the competing priorities of delivering timely assistance and the need of reducing improper payments as a top management challenge for SBA. Prior audits performed by OIG have found that SBA had not taken sufficient steps to prepare for large-scale disasters, such as properly preparing and training a new workforce for high application volumes.   As a result, the program often has been unable to provide timely assistance in the aftermath of major disasters. Unfortunately, the need to disburse such loans quickly poses many challenges, many of which are evidenced through improper payments. Additionally, the need to provide disaster assistance quickly can increase opportunities for dishonest applicants to commit fraud.

SBA's improper payment rate for disaster direct loan disbursements has continued to decrease, although its efforts prior to 2012 were not sufficient due to the absence of an effective corrective action plan. Specifically, SBA missed its target goals of reducing improper payments in the Disaster Assistance Program during these years. Target goals were 16.7 percent for FY 2010, 20.0 percent for FY 2011, and 17.0 percent for FY 2012. Instead, SBA reported rates of 34.2 percent, 28.4 percent, and 17.9 percent, respectively for FY 2010 through 2012   The high rates and the absence of an effective corrective plan made clear that this is a top management challenge and would continue to be so for the foreseeable future.

By addressing OIG-identified concerns and prioritizing internal controls, SBA has been able to significantly reduce improper payments, though the challenge persists. In FY 2016, SBA reported an improper payment rate of 5.32 percent, which is lower than the reported rate of 8.13 percent in FY 2015 and 12 percent reported in FY 2014. However, it remains a concern since the reported rate is above the threshold for significant improper payments, as defined by the Improper Payments Elimination and Recovery Act (IPERA) of 2010.

We also remain concerned that SBA does not limit the proportion of a borrower's gross income that may be relied on to service debt, potentially leaving borrowers with insufficient income to cover living expenses and taxes. In addition, SBA did not effectively implement statutory provisions intended to assist in disbursing funds quickly and effectively.

The Recovery Improvements for Small Entities (RISE) After Disaster Act of 2015 extended the period for Hurricane Sandy survivors to apply for disaster assistance, increasing the difficulty of loan eligibility determinations due to the lapse in time since the disaster occurred in October 2012. The Act also allowed express loans in disaster areas and required a report on the 2008 Private Disaster Loan Program. Historically, SBA has faced challenges standing up private lender disaster programs and has been unable to implement statutory private sector disaster loan programs in the past.

RISKS TO SBA DISASTER ASSISTANCE PROGRAM

SBA provides low-interest disaster loans to businesses of all sizes, private non-profit organizations, homeowners, and renters. SBA disaster loans can be used to repair or replace the following items damaged or destroyed in a declared disaster: real estate, personal property, machinery and equipment, and inventory and business assets. The program includes four categories of loans for disaster-related losses: home disaster loans, business disaster loans, economic injury disaster loans (EIDL), and military reservist economic injury loans (MREIDL).

Disaster Loans Vulnerable to Fraud

Unfortunately, the need to disburse such loans quickly poses many complications and may create opportunities for dishonest applicants to commit fraud. OIG audits have identified that SBA's disaster loans have been vulnerable to fraud and losses in the past because (1) loan transactions are often expedited in order to provide quick relief to disaster survivors, (2) lending personnel hired in connection with a disaster declaration may lack sufficient training or experience, and (3) the volume of loan applications may overwhelm SBA's resources and its ability to exercise careful oversight of lending transactions.

Most of the Hurricane Sandy loan fraud allegations investigated by OIG include false eligibility declarations, misuse of proceeds, and submission of false invoices or other false statements. For example, fraud can occur when a property owner attempts to represent their secondary residence, such as a vacation home, as their primary residence. OIG has worked closely with state and Federal agencies to address residence eligibility fraud and has observed that SBA appears to have been more effective in detecting fraudulent and ineligible disaster assistance applications for secondary residences than in previous disaster responses.

Systemic improvements are key to reducing fraud and delivering efficient services. In recent years, OIG audits and investigations have identified specific instances of fraud as well as necessary systemic improvements to reduce fraud and provide effective and efficient loan delivery and protect taxpayer dollars. For example, a 2010 report, *SBA's Role in Addressing Duplication of Benefits Between SBA Disaster Loans and Community Development Block Grants*, (Report 10-13), found that SBA took the lead in working with States to identify and recover duplicate benefits. Although SBA did so because it thought it was acting in the best interest of the Government to reduce duplicate benefits, SBA incorrectly placed HUD CDBGs ahead of SBA assistance in the delivery sequence, thereby making them the primary assistance provider. This essentially resulted in $925.6 million in CDBG funding being used before SBA loan funds, contrary to the delivery sequence. Specifically, $643.8 million of CDBG funds were sent to SBA to pay down fully disbursed SBA loans, and SBA canceled $281.8 million of undisbursed SBA disaster loans. The report's five recommendations were primarily geared toward having SBA, in coordination with HUD and FEMA, develop agreements and roles consistent with sequence of delivery outlined in 44CFR 206.191.

In 2014, we initiated a similar review to determine SBA's posture in minimizing duplicate benefits as it pertained assistance provided in response to Hurricane Sandy. We determined that SBA's internal controls to prevent duplication of benefits were adequately designed and generally working as intended.

SBA's role to prevent duplication of benefits with HUD's CDBG Program is to provide timely, accurate, and complete loan information to HUD grantees that administer the grants for HUD. To accomplish this, we found SBA (1) signed a memorandum of understanding with each grantee that specified the information to be shared between the grantee and SBA; (2) obtained the grantee's action plans approved by HUD; and (3) provided program guidance to case managers and loan modification officers for each individual program offered by the grantees. We also found a few instances where SBA did not timely annotate in the loan file that a grant had been awarded. However, no benefits were duplicated since the disaster survivor had not requested a loan, loan reinstatement, reconsideration or reacceptance, or increase of a loan from SBA after they were awarded CDBG fund. It is clear that system improvements can dramatically reduce risks to the taxpayer.

Improper Payment Rate Remains Above IPERA Significance Threshold

The Disaster Assistance Program is deemed susceptible to significant improper payments. Office of Management and Budget Circular M-15-02 defines significant improper payments as "gross annual improper payments (i.e., the total amount of overpayments and underpayments) in the program exceeding (1) both 1.5 percent of program outlays and $10,000,000 of all program or activity payments made during the fiscal year reported or (2) $100,000,000 (regardless of the improper payment percentage of total program outlays)." In FY 2015, the Disaster Assistance Program's improper payment rate was 8.13 percent ($24.6 million), and for FY 2016, SBA reported an improper payment rate of 5.32 percent ($18.4 million). As such, the Disaster Assistance Program continues to be a program that is susceptible to significant improper payments. Of note, the improper payment rate achieved by SBA in FY 2016 was lower than the agency's 7.3 percent reduction target and below the 10 percent improper payment rate necessary to comply with IPERA requirements.

SBA's corrective action plan for the Disaster Direct Loan Program has been effective in reducing the improper payment rate. Specifically, SBA conducted training for the disbursement staff at the PDC regarding acceptable documentation for the various types of insurance coverage. Additionally, SBA continues to perform independent reviews on all disbursements equal to or greater than $100,000 to identify and prevent improper payments prior to loan disbursement. SBA also continues to conduct multilayered reviews of loan approvals and disbursements on a random basis, by teams within the two major departments of the PDC, to identify and reduce improper payments.

SBA also includes improper payment reduction as a rating factor in the annual performance evaluations of all loan processing staff, including loan officers, attorneys, and PDC management officials. Finally, ODA's Management and Quality Control teams continue to hold biweekly meetings to discuss ongoing improper payment issues and develop strategies on how to resolve the issues and prevent future improper payments.

Maximum Allowable Fixed Debt May be Exceeded, Limiting Borrower's Ability to Repay Disaster Loans

SBA provides eligible disaster survivors with the maximum available financial assistance on attractive terms. On occasion, in order to facilitate widespread program delivery of disaster home loan benefits, SBA exceeds its normal home loan debt-to-income lending parameters, potentially straining and/or limiting the borrowers' ability to repay the disaster loans. SBA's Disaster Assistance home loan rules do not specify an upper limit to the proportion of a borrower's gross income that may be relied upon to service debt. Allocating too much of the borrower's income for debt servicing could result in the borrower having insufficient income to repay the loan, resulting in defaulted loans and additional financial distress to disaster survivors.

In the past, the maximum allowable fixed debt, the proportion of a borrower's income that can be safely allocated for home loan debt repayment was generally capped at 40 percent; higher income proportions allocated for debt repayment were considered unaffordable. The revised Disaster Assistance standard operating procedure (SOP) issued in 2015 implemented a tiered approach to the maximum income allocation for home loan debt service ranging from 36 percent for incomes below $25,000 to 50 percent for incomes of above $60,000. These limits may be exceeded with supervisory approval, but the SOP does not establish an upper threshold for the supervisor to consider relative to income allocated for home loan debt service under this provision. While SBA's Disaster Assistance SOP does provide a formula for determining the minimal amount of income reserved for living expenses and taxes when evaluating disaster business loan guarantors' repayment ability, the disaster home loan program rules do not include a similar required reserve of income to meet necessary living expenses.

An August 2016 report on early-defaulted Hurricane Sandy loans (Report 16-18) found that loans to borrowers who did not otherwise have repayment ability were approved by allocating high proportions of borrower income to service debt. Home loans with higher than normal debt service ratios given to borrowers with low incomes and poor credit histories appeared especially vulnerable to default. SBA should determine when the borrower's proposed debt service ratio creates an unacceptable financial burden to the disaster survivor and should train its loan officers to safeguard loan affordability.

Statutory Provisions Intended to Quickly Disburse Disaster Funds Not Implemented

In the wake of disasters like Hurricane Sandy, congressional representatives expressed concern that SBA did not effectively develop and utilize programmatic innovations intended to assist in disbursing funds quickly and effectively. For instance, SBA did not implement statutory provisions of the Immediate Disaster Assistance Program (IDAP), Economic Injury Disaster Assistance Program (EDAP), and the Private Disaster Assistance Programs (PDAP), collectively known as the "Guaranteed Disaster Assistance Programs" mandated by Congress in 2008. These provisions were enacted with the expectation that they would allow SBA to provide expedited disaster loans in partnership with private sector lenders. These provisions remain unimplemented.

In July 2016, SBA prepared a memorandum to notify Congress of the work that management performed to address these provisions. Ultimately, SBA stated that it sought advance public comment on proposed rulemaking for these loan programs and received limited public responses, the majority of which were opposed to implementing the three loan programs. The objections were based on the cost of program participation under the current pricing structure and the lender's lack of infrastructure to deliver loans that meet SBA standards (such as evaluating eligibility and duplication of benefits); loan terms that include longer maturities than conventional lending practices; the high cost of providing these loans; inadequate collateral security; and their lack of expertise in the home loan sector. Lenders were also concerned that loan guarantees would be denied due to improper eligibility determinations.

Recovery Improvements for Small Entities After Disaster Act Introduces New Risks

The RISE After Disaster Act, enacted November 25, 2015, introduced new initiatives that may pose additional risks and difficulties for SBA's loan programs. First, the Act directed SBA to make disaster loans available to Hurricane Sandy survivors for a 1-year period following its enactment—over 3 years after the disaster. Because of the significant time elapsed, SBA may have difficulty verifying whether physical losses and economic injury were attributable to Hurricane Sandy, potentially resulting in ineligible recipients receiving loans. We are currently performing an audit of eligibility controls for applications approved during the extended eligibility period of the Act. Second, the Act introduced the Express Recovery Opportunity Loan Program, which provides loans up to $150,000 to disaster survivors from private lenders. Given that SBA has not yet implemented the Guaranteed Disaster Assistance Programs authorized in 2008, SBA is likely to experience difficulties implementing this program as well.

RECENT AND ONGOING OIG OVERSIGHT

In October 2012, Hurricane Sandy struck the northeastern United States with its aftermath being rated as the second costliest storm in U.S. history. OIG was appropriated $5 million in supplemental funds to provide oversight over the SBA's disaster response to Hurricane Sandy. The funds are intended to supplement our oversight capacity to address Hurricane Sandy disaster assistance and potentially other major disasters for a period of at least 4 to 6 years. This funding level is based on experience with major disasters in the past such as the Gulf Coast hurricanes in 2005. Availability of funds for this timeframe is particularly important because experience has shown that fraudulent loans are not immediately identified, have a deferment period for repayment, and take years to default. Additionally, there is a 5-year statute of limitations (from the date of the last false statement) to prove a false statement to the SBA. With the passage of RISE, the potential for Sandy related criminal and civil investigations will continue until at least 2022. To date, we have issued nine reports and have an additional ongoing review pertaining to our oversight efforts of SBA's Hurricane Sandy disaster assistance.

OIG criminal investigators aggressively investigate fraud allegations pertaining to Hurricane Sandy and other disaster assistance. In doing so, we have partnered on many occasions with our colleagues in OIGs of the Department of Homeland Security and the Department of Housing and Urban Development, as well as other federal, state, and local counterparts. Fraud allegations and schemes frequently involve unauthorized use of loan proceeds, overstatement of financial losses, material false statements in the application process, false or counterfeit supporting documentation, and false assertions regarding primary residency in affected areas at the times of disasters. To date, our office has initiated 72 investigations involving allegations of fraud pertaining to Hurricane Sandy. As of April 6, 2017, OIG had 33 open cases involving disaster loans with potential dollar losses of nearly $13.5 million.

In response to the potential for fraud following Hurricanes Katrina, Wilma, and Rita, the OIG joined other law enforcement organizations in establishing the National Center for Disaster Fraud. From FY 2006 through FY 2016, the OIG, in conjunction with other law enforcement agencies, produced 86 arrests, 97 indictments/informations, and 96 convictions related to wrongdoing in SBA's Disaster Loan Program for these three hurricanes. Investigations for these disasters to date have resulted in over $7.9 million in court-ordered restitution and related recoveries, as well as the denial of nearly $4.5 million in loans to potentially fraudulent borrowers.

OIG reviews will continue to focus on loan eligibility, origination, disbursement, repayment, servicing, and liquidation activities related to disaster loans. OIG criminal investigators also continue to aggressively investigate fraud allegations pertaining to disaster assistance.

CONCLUSION

The Disaster Assistance Program is a vital component to the nation's response plan for homeowners and business owners in the wake of significant disasters. As such, it is critical that the program is operated in the most effective and efficient manner. Having implemented corrective actions for dozens of OIG recommendations since Hurricane Katrina, it is evident ODA is better positioned to provide assistance to disaster victims, though every disaster tests SBA's ability to deliver anew. Each disaster has unique circumstances and poses unforeseen challenges that SBA personnel must adapt to and overcome to be successful. The need to disburse loans quickly, and in some instances in large volumes, poses many complications and may create opportunities for dishonest applicants to commit fraud and SBA personnel to make errors in the lending process.

Having effective internal controls, robust technology design and resources, and training programs are keys to mitigating risks to the taxpayer. OIG has and will continue to play an important role in identifying risks and making recommendations for corrective action in these regards. Our focus is to keep SBA leadership, our congressional stakeholders, and the public currently and fully informed about the problems and deficiencies in the program as identified through our work. We value our relationship with the Committee and the Congress at large, and we look forward to working together to address identified risks and the most pressing management challenges facing the Disaster Assistance Program.