DROWNING IN

Theoretically, government disaster relief programs—particularly the chief program run by the Small Business Administration (SBA)—should be efficient, consistent, and equitable. In reality, the SBA's response to the Gulf Coast hurricanes has been a disaster. Unfortunately, the reforms proposed by Congress might bring little or no improvement to the process.

Veronique de Rugy

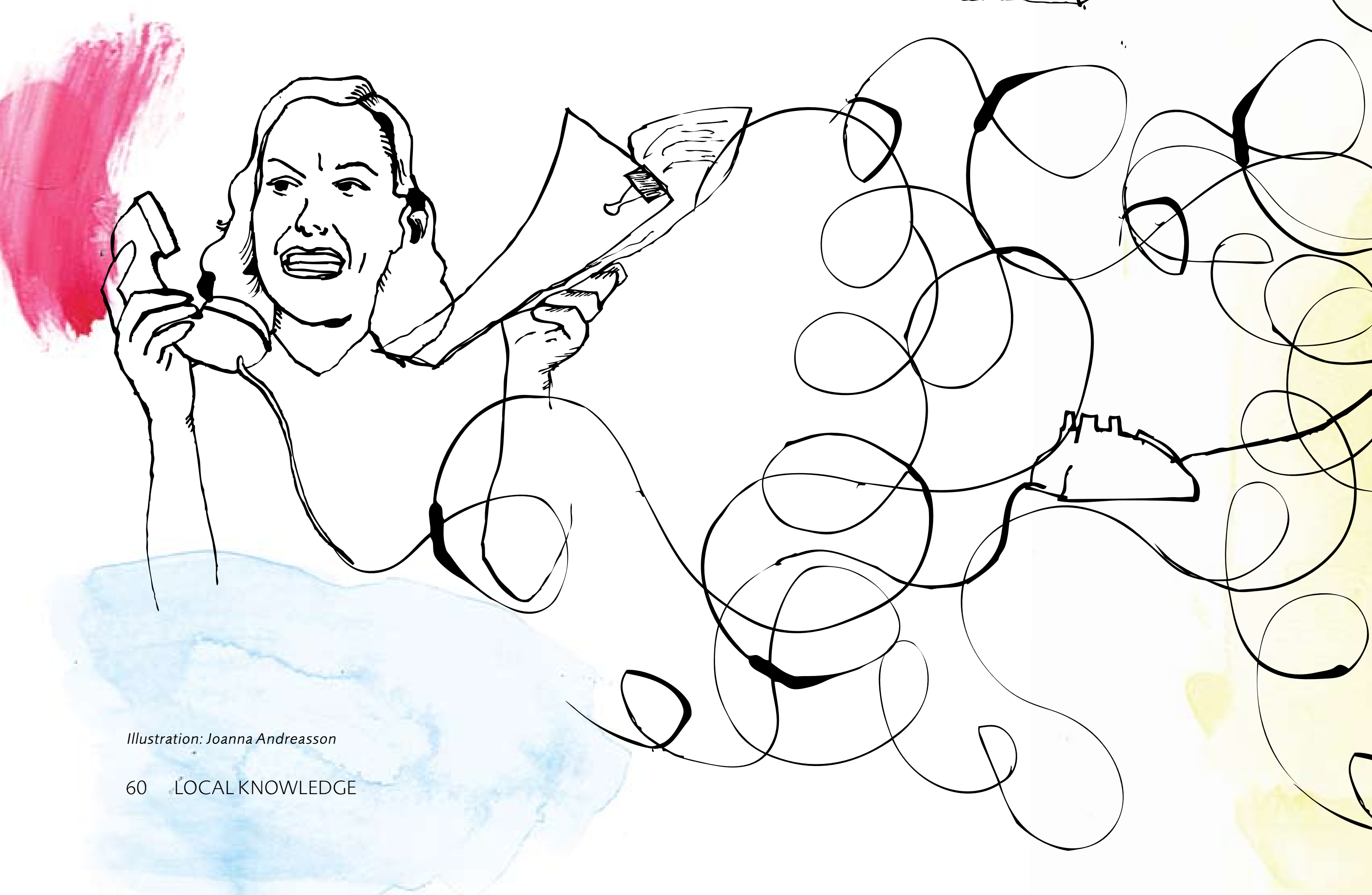


Illustration: Joanna Andreasson

BUREAUCRACY

"Working with the SBA (Small Business Administration) after a disaster is like having a second job. It takes a toll on your time, your resources, and your well-being,"[1] testified Donna Colosino, New Orleans resident and co-owner of Crescent Power Systems, to the House Committee on Small Business about the SBA's response to the 2005 Gulf Coast hurricanes. Her testimony is but one of many that tells the story of a natural disaster followed by a government-made disaster.

After the levees broke in New Orleans, there was nothing left of the Colosinos' electrical equipment business. Twelve feet of water flooded the building that housed their company in the Lakeview neighborhood of New Orleans and swept away everything they had worked to build.

"We lost everything. We lost our inventory. We lost all parts of our business, including all business documentation that we had for thirteen years," said Colosino.

Eager to restart their business, the couple quickly applied for a loan from the SBA. Rather than receiving the speedy help they needed to get back on their feet, though, the Colosinos found themselves awash in a sea of bureaucratic incompetence. Katrina had flooded them out, but the federal government was holding their heads underwater.

1. The House Committee on Small Business, *Statement of Donna Colosino, Co-owner, Crescent Power Systems*, 110th Cong., 1st sess., February 14, 2007, serial 110-03, 41.

The Rationale Behind SBA Disaster Loans

An important component of how quickly recovery can occur following a natural disaster is access to capital that enables those affected by a disaster to rebuild, relocate, and go back to their regular lives. Small businesses, for instance, are very sensitive to cash-flow interruption, so a lack of access to capital for their recovery can have serious consequences on their ability to survive.[2] In fact, it has been estimated that over 40 percent of businesses damaged during a disaster go out of business within two years.[3] Thus, the speed with which people can access capital will correlate to the speed of any recovery effort and affect its success.

Thus, the speed with which people can access capital will correlate to the speed of any recovery effort and affect its success.

Federal disaster assistance has a long history. According to the Congressional Research Service, Congress appropriated $2.5 million in 1906 to speed recovery from the San Francisco earthquake and subsequent fires.[4] Today, SBA disaster loans are the federal government's main disaster-relief program. As such, they are available not only to small businesses but also to individuals, businesses of all sizes, and nonprofits.

The common argument behind the federal provision of disaster loans is that after a disaster, small businesses and individuals have a very hard time getting banks to lend them capital to rebuild their houses or businesses because the disaster has destroyed or damaged most of the collateral's value. Moreover, even if banks agreed to lend money to disaster victims, the terms of those loans would likely be very disadvantageous to the borrowers, as banks would charge high interest rates and expensive fees to cover the higher risk of default. The failure of the capital market to provide disaster loans at low rates, taxpayers are told, is a market failure that requires the intervention of the federal government.

If banks did charge high interest rates and expensive fees to cover a high risk of default, that would not actually be a market failure. It would be the market responding to the perceived risk, but it is hard for people to accept that, in the eyes of banks, disaster victims are now high-risk borrowers. Furthermore, data confirm that commercial banks do not step up lending after disasters. However, it is possible that strong federal intervention over the years has effectively crowded out the private provision of disaster funds, fundamentally changing the nature of disaster relief.

Nonetheless, there are two factors that may make government intervention almost unavoidable. First, the disaster-relief system encourages individuals to stay, rebuild, and start over in the same area rather than to relocate. In economic speak, the American people seem to think that there is a positive externality for us all if New Orleans, for instance, recovers from a disaster rather than disappears. As a result, federal disaster loans are designed to go to individuals or firms who want to rebuild rather than relocate. Such restrictions on who has access to disaster loans or what borrowers can do with the money are likely to lead to serious distortions.

Many argue, however, that some public-policy objectives require the sacrifice of marketplace efficiency. It is an accepted feature of modern American government that some public interests or social policy gains can outweigh economic losses and hence are worth selected override of free-market values. A preference for rebuilding would certainly be one example since, as a nation, we are likely to incur higher costs—monetary and otherwise—by encouraging people to stay in a flood-prone area such as New Orleans rather than encouraging them to move to a lower-risk environment.

Second, the disaster-relief system is designed to return victims to their pre-disaster conditions even though most assets have been destroyed and accumulated capital is significantly reduced. Of course, the goal of rebuilding as things were before requires a large amount of capital. Yet, this is not

2. Rodney C. Runyan, "Small Business in the Face of Crisis: Identifying Barriers to Recovery from a Natural Disaster," *Journal of Contingencies and Crisis Management* 14, no. 1 (March 2006): 19.

3. U.S. House Small Business Committee, *Trends and Analysis of SBA Disaster Loan Program, 1992-2006* (March 2006), http://www.house.gov/smbiz/Reports/disasterloan2006.pdf.

4. N. Eric Weiss, *Changes to the SBA Disaster Loan Program: Proposed Legislation in the 110th Congress*, RL34058 (Washington, DC: Congressional Research Service, February 12, 2008), 1, http://assets.opencrs.com/rpts/RL34058_20080212.pdf.

Photo: Carrie Conko

a necessary requirement for recovery as many entrepreneurs can take advantage of the new conditions to start fresh with very little capital.[5]

These two constraints placed on our disaster-relief policy are possibly the largest obstacles in the private provision of disaster loans. Commercial banks, in theory, could provide the large amount of capital required to meet our policy objectives. However, banks want to lend only when loans have a high likelihood of repayment. Borrowers' ability to repay depends on the economic health of the local economy, but the economy has been devastated by the disaster itself. Lending money to any single borrower does not materially improve the economy, so one borrower would have a high likelihood of default, but if banks all agree to lend money widely, then the economy would likely improve overall. Homeowners who borrowed would be more likely to find jobs, and businesses that borrowed would be more likely to find consumers with funds to buy goods and services. In this environment, with all banks lending widely, the improved economic conditions would improve the odds of each loan being repaid. Thus, this is a problem of getting all banks to coordinate, to agree to work in concert to lend widely.

The coordination problem can be resolved if the federal government gives banks an incentive to lend money at a reduced interest rate to firms or individuals in a devastated area by guaranteeing part of a loan. Alternatively, the federal government can invest resources by lending money directly to firms and individuals to rebuild their homes and businesses.

And this is what the federal government does. Congress authorizes the SBA to provide low-interest loans to disaster victims contingent upon a disaster declaration from the president or the SBA administrator and a demonstrable ability to repay the loans. These loans are for the purposes of repairing or replacing real estate (up to $200,000), personal property (up to $40,000), or businesses and nonprofits, regardless of size (up to $1.5 million).[6] Loans can be for a period of up to thirty years.

Reduced interest rates to disaster victims amount to a federal grant to those receiving disaster loans. All disaster

5. See Frederic Sautet, "Ventures in Rebuilding: The Role of Entrepreneurship in the Post-Disaster Context" in this volume.
6. Weiss, "Changes to SBA Disaster Loan Program," 5.

loans carry a below-market interest rate, and borrowers who are unable to obtain credit on similar terms elsewhere pay a lower rate than borrowers who can obtain loans from other sources. For example, following Hurricane Katrina in 2005, SBA disaster loans to homeowners for home repair charged interest rates of 2.687 and 5.375 percent.[7] In comparison, the rates on a private sector, thirty-year fixed-rate mortgage in the fourth quarter of 2005 ranged from 5.77 to 6.33 percent. On an average SBA homeowner disaster loan of $45,000, this difference could save the borrower between $100 and $1,000 over the thirty-year life of the loan.[8] According to the SBA, more than 97 percent of the disaster loans made for the 2005 hurricanes were at the lower rate; very few loans were at the statutory maximum. In addition, the SBA has more relaxed underwriting standards than private-sector lenders, which allow it to lend money to riskier borrowers.

However, government intervention, even if potentially warranted, always introduces distortions. In fact, sometimes the cure can be worse than the disease. In the case of federal disaster relief, for instance, it appears that over the years, interest rate subsidies and liberal forgiveness provisions have contributed to increased federal relief costs for every major disaster.[9] The availability of low-interest loans or grants allows individuals to pay less than the cost associated with their risky activities (in this case, living in a flood-prone area below sea level). Since taxpayers bear the remainder of the cost, individuals make risky decisions based only on the portion of their potential losses that is unlikely to be covered by government relief. At this point, disaster relief becomes self-perpetuating since people never get the proper signals about their exposure to losses caused by natural disasters.

Without these signals, resources are repeatedly misallocated and individuals repeatedly put themselves in harm's way—especially if relief programs are designed to encourage people to stay rather than relocate. In addition, although disaster loans are not meant to replace disaster insurance, evidence shows that repeatedly shifting the costs of disaster relief to the federal government leads homeowners to consider disaster loans a substitute for flood insurance.[10]

Another argument for federal intervention in disaster relief is that many low-income individuals live in high-risk areas simply because they cannot afford to live elsewhere. Program advocates then argue that this fact alone commands government assistance in the wake of a disaster. However, it seems difficult to argue that government anti-poverty programs should be tied to disaster relief ones.

Private Sector Intervention

The economic justification for any government-lending or loan-guarantee program must rest on a well-established private-sector failure to allocate loans efficiently. Absent such a private-sector deficiency, government's activities would simply be a wasteful, politically motivated subsidy to this sector of the economy. In the case of disaster relief policy, the argument can be made that federal disaster loans provision might be necessary especially if the goal—right or wrong—is to encourage people to stay in disaster zones rather than to relocate. However, as mentioned earlier, it is very possible that the government's intervention itself or the constraints placed on the form the disaster relief should take are getting in the way of commercial banks providing disaster loans.

There are, in fact, many private sources that do provide quick access to capital following a disaster. These institutions already have mechanisms to deal with the problems caused by natural disasters—such as complete loss of property—and have proven remarkably effective in the aftermath of the 2005 hurricanes.

Credit cards were one avenue to capital for individuals and small businesses following Katrina.[11] Due to the extent of the damage, most people depleted their savings quickly. Many then turned to credit cards to close the gap because of the cards' ease of use, widespread acceptance, and immediate access to funds. In response to the heavy usage of credit cards following Katrina, many companies suspended minimum payments and late payment fees.[12] While credit cards are probably not a viable long-term solution since their inter-

7. Ibid., 2.

8. Ibid.

9. Michael Rettger and Richard Boisvert, "Flood Insurance or Disaster Loans: An Economic Evaluation," *American Journal of Agricultural Economics* 61, no. 3 (August 1979): 496-505; N. Eric Weiss, *Changes to the SBA Disaster Loan Program*, 5.

10. N. Eric Weiss, *Changes to the SBA Disaster Loan Program*, 1.

11. "Gulf Coast Small Business Owners Optimistic About Hurricane Recovery, Study Says." *The Times-Picayune*, August 29, 2007, http://blog.nola.com/tpmoney/2007/08/gulf_coast_small_business_owne.html.

12. Laura Bruce, "Hurricane Katrina Bill Payment Relief," *Bankrate.com*, September 5, 2005, http://www.bankrate.com/brm/news/pf/story1.asp.

est rates are generally high, this instant access to capital proved to be highly valuable to those displaced by Katrina.

Many micro-credit lending institutions also can provide access to capital in a quick and efficient manner. Prosper, an online peer-to-peer lending institution, makes it quick and easy to access loans. According to its website, Prosper is an online community where borrowers can request three-year, unsecured, fully amortized loans up to $25,000.[13] Lending institutions like Prosper help bridge a gap between charity and more traditional financial institutions. In this peer-to-peer setting, borrowers can pass unique information to lenders looking for an efficient and secure way to help.

There was also a large response from private nonprofit organizations, such as the Enterprise Corporation of the Delta Hope Community Credit Union (ECD/HOPE). These organizations used their knowledge and social networks to provide help quickly and efficiently to those most in need. After Katrina, ECD/HOPE lent roughly $2.3 million to some 4,000 victims.[14] Many of ECD/HOPE's borrowers had no or very low credit scores, demonstrating that some financial institutions are willing to lift their strict underwriting requirements in the wake of catastrophic circumstances. According to ECD/HOPE's 2008 impact report, 40 percent of Katrina victim borrowers had no credit scores and 12 percent scored below 500 on their credit reports.[15] Only 3 percent of borrowers had a credit score that commercial banks would consider acceptable.

Christine Cameron provides one example of an ECD/HOPE success story. After falling trees, torrential rain, and a mudslide from a nearby hill damaged her home, Cameron went to stay with her daughter in Jackson, Mississippi. There, she was introduced to ECD/HOPE.[16] As she waited for her insurance settlement and a check from FEMA, ECD/HOPE provided a loan to help her recovery begin.

"With my loan from HOPE, I was able to get the debris cleaned up and get my roof fixed," she says. "I was able to get the process started," which sometimes is all it takes to set a community on its way to recovery.[17]

While these are the observable paths to disaster recovery capital, there are potentially a large number of unobservable

13. Prosper Marketplace, Inc., *Prosper.com*, http://www.prosper.com.

14. Enterprise Corporation of the Delta Hope Community Credit Union, *ECD/HOPE Impact Report*, 2005, 17-19, http://www.ecd.org/Documents/2005ECD-HOPEImpactReport-HighResolution.pdf.

15. Ibid., 21.

16. Ibid.

17. Ibid.

or unreported channels to capital. It is not a far stretch to assume that countless family and friends provided help to those affected through direct transfers that were not reported or counted. These immeasurable connections are certainly a valuable post-disaster resource to many and should not be overlooked.

Keeping Disaster Victims' Heads under Water

American taxpayers probably expect the disaster programs they fund to be delivered in an efficient manner. Following Hurricane Katrina, private and nonprofit institutions provided capital quickly and efficiently. Very few of these institutions have or had developed a plan for responding to natural disasters. Yet, they provided capital quickly and efficiently because the key to their businesses' success is the ability to provide quick and easy credit on reasonable terms all of the time, not just in special cases.

By contrast, the SBA is in the business of responding to disasters and should have a plan for delivering disaster loans when needed. However, when the 2005 hurricanes hit the Gulf region, damaging communities throughout Mississippi, Louisiana, and Alabama, the SBA's response left thousands of businesses and homeowners stranded.

In July 2007, the Senate Small Business Committee held a hearing to evaluate the SBA's progress in responding to the 2005 Gulf Coast hurricanes.[18] It found that the SBA was not delivering disaster loans. Two years after Katrina destroyed New Orleans and devastated the Gulf region, the SBA still faced a huge backlog of loans, revealing its inability to process applications in a timely matter. Also, the SBA's loan-approval rate dropped from an average of 60 percent for previous hurricanes—including destructive Andrew in 1992—to 33 percent.[19] According to the House Committee on Small Business, the size of the disaster only partially explains the decline in loan approval during the 2005 hurricane season, as Congress immediately made large levels of funding available to respond to the disasters and large demographic and geographic similarities exist between the 2005 hurricanes and previous ones.

However, loan approvals are only one measure for

Photo: Joanna Andreasson

18. U.S. Senate Committee on Small Business and Entrepreneurship, *Oversight: Gulf Coast Disaster Loans and the Future of the Disaster Assistance Program*, 110th Cong., 1st sess., July 25, 2007, http://sbc.senate.gov/hearings/20070725.cfm.
19. *House Small Business Committee*, *Trends and Analysis*, 3.

determining the SBA's impact on recovery. Once it grants approval, the SBA must also close the loans. In most post-Katrina cases, it didn't.

Remember the Colosinos, whose electrical equipment business was destroyed by Katrina? The SBA finally approved them for a $250,000 loan in January 2006. After the long months of waiting for approval, the couple had to wait another four months to receive $10,000.[20] They never received another penny from the agency. With the partial disbursement of funds, the SBA could mark the loan as "completed," which it promptly did. Did the Colosinos want the remaining $240,000? SBA staffers told them that they would have to start the application process all over again.

"It was agonizing. It was—frustrating isn't the right word—it was horrific," confessed Donna. The horror only increased. A year later, the SBA announced that the $250,000 loan became due in full even though the Colosinos had received only $10,000.

The Colosinos telephoned the SBA repeatedly, re-sent all documentation and previous written exchanges, and received new documents to sign wherein nearly every detail was incorrect. Finally, the SBA asked them to provide receipts for about $250,000 in expenses in order to receive a loan that they should have received 18 months before. In other words, the SBA told the Colosinos they had to spend their loan before they could receive it.[21] In the end, the family had to sell their house and liquidate their savings in order to save their business.

According to the data, the Colosinos were not alone in their nightmare. Of the nearly 423,000 applications submitted, some 160,000 were approved, and yet two years after Katrina, the SBA had fully funded only 22 percent of these approved loans.[22] In other words, many people received only a small portion of the loan for which the SBA had approved them. Maybe worse, in some cases, the agency did not disburse any of the money. According to the SBA's own Inspector General (IG), at the end of 2006, the SBA had accumulated a backlog of more than 90,000 undisbursed loans.[23]

But things got worse. Faced with growing criticism, the SBA launched a "90-in-45" campaign meant to expedite disbursement of $6 billion in excess allocated funds to resolve the 90,000-loan backlog within 45 days.[24] But how sincere was this effort?

Before the Senate Committee on Small Business, former SBA loan officer Gale Martin testified, "I have brought with me the written testimony of eight other loan officers. We join together and we all agree that we were being forced by management to cancel, decline, and withdraw applications unnecessarily and unjustly in order to make the numbers look good to the public, the press, and Congress."[25]

Ms. Martin explained that it takes almost no time to decline, withdraw, or cancel a file, and there were many reasons to do so, especially after the SBA changed the criteria for declining or canceling a loan. So SBA loan officers under deadline did just that. They began to decline, withdraw, and cancel loans.

According to the SBA's IG office, as of January 25, 2008, the SBA had withdrawn 68,456 loan applications, many of them inappropriately.[26] The Inspector General (IG) notes, "We believe the lack of contact with applicants and hasty withdrawals occurred due to production goals, set forth in a directive issued by the Director of Disaster Loan Processing. In order to meet these goals, loan officers told us they were aware that some officers would withdraw incomplete applications as doing so was easier than getting them approved."[27]

At the end of her testimony, Martin said, "I could go on, and on, for hours here, but the truth is that only the wealthy moved through the system easily. People with credit issues, who owed the government even a little bit of money, who had lost their documents, or who just moved around, would probably not be given a loan, and if they were, they would have to fight to keep it."

20. The House Committee on Small Business, *Statement of Donna Colosino*.
21. Ibid., 43.
22. U.S. Small Business Administration, Office of the Inspector General, *Withdrawal of Disaster Loan Applications to Individuals and Businesses Impacted by the Gulf Coast Hurricanes*, oral testimony by Debra S. Ritt, 110th Cong., March 28, 2008, report 08-11, 2; U.S. Senate Committee on Small Business and Entrepreneurship, *Oversight: Gulf Coast Disaster Loans and the Future of the Disaster Assistance Program*, oral testimony by Gale B. Martin, 110th Cong., 1st sess., July 25, 2007, http://sbc.senate.gov/hearings/testimony/072507-Martin-testimony.pdf.
23. U.S. Small Business Administration, Office of the Inspector General, *Withdrawal of Disaster Loan Applications*, 2.
24. Ibid.
25. U.S. Senate Committee, *Oversight: Gulf Coast Disaster Loans*.
26. U.S. Small Business Administration, Office of the Inspector General, *Withdrawal of Disaster Loan Applications*, 2.
27. Ibid., 4.

The Recent Reforms: Progress or More of the Same?

During the July 2007 hearing before the Senate Committee on Small Business, the Government Accountability Office (GAO) released a report that questioned whether the SBA was prepared to handle another Katrina.[28] Congress must not think so, for it included a major overhaul of the SBA's disaster loan program in the recently passed Farm Bill. The new legislation allows private-sector lenders to make short-term "bridge loans" to businesses damaged by disasters. Businesses could use bridge loans while they await processing of their regular SBA disaster loans or insurance payments. In the event of a catastrophic disaster, lenders as well as the SBA could make disaster loans. All lenders could make disaster loans to small businesses, and preferred lenders in the SBA's 7(a) business loan program could make disaster loans to individuals.

The bill also authorizes the SBA to pay lenders to process disaster loans when applications overwhelm the agency, as was the case in 2005. The bill makes businesses anywhere in the U.S. eligible for disaster loans if they suffer economic injury as a direct result of the disaster, a measure similar to one enacted by Congress following the September 11, 2001, terrorist attacks. Finally, the legislation increases the maximum amount of a disaster loan from $1.5 million to $2 million and requires the SBA to create disaster response plans for various scenarios and conduct disaster simulation exercises every other year. While the bill provides some improvements over the current system—such as preventing disaster victims from receiving payments from multiple agencies—the bill also contains serious flaws.

First, the bill authorizes billions of dollars for use during a disaster, but the cost is not offset. Supporters of the bill claim that most of the bill's costs cannot be offset because no one can plan on spending disaster-related funds. But the truth is that the only thing getting in the way of offsetting the cost of disasters is Congress. Congress *chooses* not to plan better for disasters in the budget process. It might not know precisely when or where the next disaster will occur, but it knows that disasters will occur. Hence, Congress could and should carve out a disaster fund from the budget on the assumption that it will have to spend money on future disasters.

Second, supporters of the bill claim that the government should provide services to any and all businesses that are "adversely affected." While it may be true that disasters can affect large areas, this fact alone hardly justifies government intervention in the economy at nearly any time and in almost any way it wishes. Government can only reasonably provide assistance to those *immediately* affected by a disaster, not to those affected indirectly. It is impractical to deliver services to everyone who claims to have been affected because it is impossible to measure the indirect costs of disasters.

Moreover, the provision is based on the outdated economic notion that the government is able to provide a "stimulus" to the economy through increased federal spending. Such a notion fails to understand that government spending is not productive, but simply redistributive.

Third, Congress models the revised disaster loan program on the Supplemental Terrorist Activity Relief Program (STAR). Enacted following the 9/11 terrorist attacks, the STAR program was supposed to provide federal loans to businesses around the country who were affected by 9/11. Run by the SBA, the program was intended to provide an economic stimulus to the nation through government spending.

Modeling disaster loan programs after the STAR Program is irresponsible to say the least. A detailed report by the SBA's IG showed that both lenders and loan recipients abused the STAR program widely.[29] Testifying before the Committee on Homeland Security Subcommittee on Management, Integration, and Oversight, the IG reported, "Most lender files did not contain sufficient information to demonstrate that borrowers were adversely affected by the September 11th terrorist attacks and their aftermath. As a result, eligibility could not be determined for 85 percent of STAR loans reviewed."[30]

As it turned out, lenders wrongfully advertised the loans

28. U.S. Senate Committee on Small Business and Entrepreneurship, *Response to the Gulf Coast Hurricanes Highlights Needs for Enhanced Disaster Preparedness*, oral testimony by William Shear, 110th Cong., 1st sess., July 25, 2007, GAO07-1124T, http://sbc.senate.gov/hearings/testimony/072507-Shear-testimony.pdf.

29. Robert G. Seabrooks, U.S. Small Business Administration Office of Inspector General, *Audit of SBA's Administration of the Supplemental Terrorist Activity Relief Loan Program*, December 23, 2005, report 6-09, http://www.sba.gov/IG/6-09.pdf.

30. U.S. House Committee on Homeland Security, *Federal Assistance to New York: Lessons Learned in Fraud Detection, Prevention, and Control*, statement by Eric M. Thorson, 109th Cong., July 13, 2006, http://www.sba.gov/IG/WrittenStatement-7-13-06Hearingon9-11Response.pdf.

to customers as an opportunity to receive lower interest rates rather than as a loan program intended for 9/11 victims. According to the IG report, many recipients had no idea they were receiving 9/11 loans rather than regular SBA loans. For instance, in 2002, Nevada Construction Cleanup received a $1.53 million STAR loan through the Henderson, Nevada-based Silver State Bank to expand its business.[31] The 15-year-old company removes debris that subcontractors leave at job sites. But David Marino, the company's controller, told the *Las Vegas Review Journal* that he has no idea how Nevada Construction Cleanup landed on the list of terrorism-relief loan recipients.

Modeling disaster loan programs after the STAR Program is irresponsible to say the least. A detailed report by the SBA's Inspector General showed that both lenders and loan recipients abused the STAR program widely.

"This loan was way before 9/11," Marino said. Marino was unable to pinpoint a precise borrowing date, but he said Nevada Construction Cleanup had had its SBA loan for at least 4½ years. Terrorism recovery "wasn't even a thought in anybody's mind at that time," Marino said. According to the *Journal*, officials with the various banks that handled the loans told investigators they only qualified businesses for the anti-terror loans after SBA officials aggressively marketed the program to "mean that every small business could claim it was somehow impacted by the attacks, and therefore, eligible to receive a STAR loan."[32]

The SBA inspector general's report confirms this statement and blames top agency officials for the way the SBA promoted the program "by advising lenders that virtually any small business qualified and assuring them that SBA would not second guess their justifications."[33] The report cites other abuses of the STAR program. A Texas golf course owner received a $480,000 STAR loan under the justification that "people were more interested in staying home and watching the attack on television than playing golf."[34] That the course had a different owner when the attacks took place and the justification for loan guarantees did not apply to the new owner did not prevent the lender from disbursing the loan.[35] A Las Vegas tanning salon received a $583,500 loan on December 3, 2002.[36] A company representative told investigators the business was not harmed by the terrorist attacks, but investigators ignored the statement because "many of the customers who use tanning salons are performers in casinos and work in various capacities in the casino industry," and "Las Vegas tourism was hit hard by 9/11, and many casino workers lost their jobs or had their hours scaled back. . . . This is a large part of (the borrower's) customer base."[37] Better yet, according to the same report, "the lender's credit memorandum showed the borrower experienced a 51.6 percent sales growth for 2001 and an annualized 2002 sales growth of 31.6 percent."[38] In the end, the STAR program became just another way for lenders to make money by leveraging a government guarantee. It did not serve the people it was intended to help.[39]

The fourth major problem with the bill is that it does not lay down solid rules for what constitutes a disaster. This lack of clarity opens the door for massive increased federal intervention on behalf of businesses that are affected by snowfall or rising fuel prices.

Finally, the bill encourages private-sector lenders to

31. Samantha Young Stephens, "Loans Went Here, There: Audit Questions Post-9/11 Aid," *Las Vegas Review Journal* (December 30, 2005), http://www.reviewjournal.com/lvrj_home/2005/Dec-30-Fri-2005/news/5132430.html.
32. Ibid.
33. Seabrooks, *Audit of SBA's Administration of the STAR Loan Program*, 10.
34. Ibid., app. B, 1 and app. C, 4, sampled loan no. 19.
35. Ibid., app. C, 4.
36. Ibid., app. B, 2, sampled loan no. 50.
37. Ibid., app. C, 7, sampled loan no. 50.
38. Ibid.
39. See Veronique de Rugy, "Big Banks, Not Small Businesses, Benefit from the SBA," *Regulation Magazine*, Winter 2008, 10-11, http://www.mercatus.org/repository/docLib/200801251_regulation_magazine_-_winter_2007.pdf.

make short-term "bridge loans" to businesses damaged by disasters. While giving an incentive to the private sector to make disaster loans is a good idea, it has the potential to become nothing more than corporate welfare for banks and lenders.[40] The new program would rely heavily on the SBA's main small business lending program, the 7(a) program. 7(a) authorizes selected banks and preferred lenders to make loans to small businesses that cannot receive credit elsewhere. The government guarantees up to 85 percent of the loans, greatly reducing the risk to lenders. Similarly, under the new lending program, the government would guarantee up to 85 percent of any loans private banks would make to victims of a disaster.

The program's purpose is to give lenders an incentive to loan money to individuals on whom lenders would not ordinarily take a risk. Though the intentions of this new program are good, the chances are high that the program will ultimately serve big lenders rather than disaster victims. After all, the 7(a) program has become the benefactor of primarily large corporations and investors rather than of small businesses.[41]

Look at how the program works. First, lenders agree to make loans that they otherwise would not make, knowing that the taxpayer will pay the most of the cost of a default. Second, through the SBA's Secondary Market Program, lenders have another way to reduce their risk even further and also to increase their lending capability.[42] Lenders pool the guaranteed portions of SBA loans and then sell to investors trust certificates that represent claims to the cash flows. In other words, the guaranteed portions of the loans are turned into tradable securities, or "securitized." Ultimately, lenders and investors alike can make a steady and large income off of this investment because it is backed by taxpayer money. If the loan recipient defaults, the investor does not lose anything because the taxpayer foots the bill.

Perhaps that is why Bank of America is the single largest SBA loan provider in the country, with J.P. Morgan and Wells Fargo not far behind. After all, as David Bartram, president of the National Association of Government Guaranteed Lenders (banks that make SBA loans), said in a 2006 hearing on the SBA, lenders "can be as profitable in a 7(a) loan program as we are in our conventional lending if done correctly."[43]

The provisions in the Farm Bill open the disaster loan program to private lenders in a similar fashion. Not surprisingly, the lending industry supports the program: they are likely to gain from it financially. But if lenders are not scrupulous in how they make disaster loans, this program could cost taxpayers dearly. Sixteen to eighteen percent of all regular 7(a) small business loans default.[44] Further, despite a thirty-year maturity period, "an unpublished Small Business Administration report estimates that up to a quarter of Louisianans who took out SBA loans after Katrina may default on them within the next two years."[45] High default rates are expected when the government makes disaster-related loans, but if lenders do not guard taxpayer dollars, the problem could get out of control. For instance, as of 2007, guarantees on SBA loans represented some $83 billion in potential taxpayer liabilities, a risk that banks would otherwise assume.[46] Irresponsible lending practices increase the probability that this money will come to be due by taxpayers and that the federal government will end up owning many disaster victims' homes and businesses.

Conclusion

By all accounts, the 2005 hurricane season was the one of the worst the United States has ever seen. It devastated the Gulf Coast, and thousands of people lost all they had—their homes, their businesses, and even their lives. If this were

40. Veronique de Rugy, "Banking on the SBA," *Mercatus on Policy*, no. 2 (Arlington, VA: Mercatus Center, August 2007). http://www.mercatus.org/repository/docLib/20070924_onpolicyno2.pdf.

41. Ibid.

42. House Subcommittee on Government Programs and Oversight, Small Business Committee, *Secondary Market for Guaranteed Portions of 7(a) Loans*, testimony by Thomas McCool, 105th Cong., 2nd sess., September 23, 1998, GAO/T-GGD-98-184, 5, http://www.gao.gov/archive/1998/gg98184t.pdf.

43. Senate Committee on Homeland Security and Governmental Affairs, *The Effectiveness of the Small Business Administration*, oral testimony by David Bartram, 109th Cong., 2nd sess., April 6, 2006, 38.

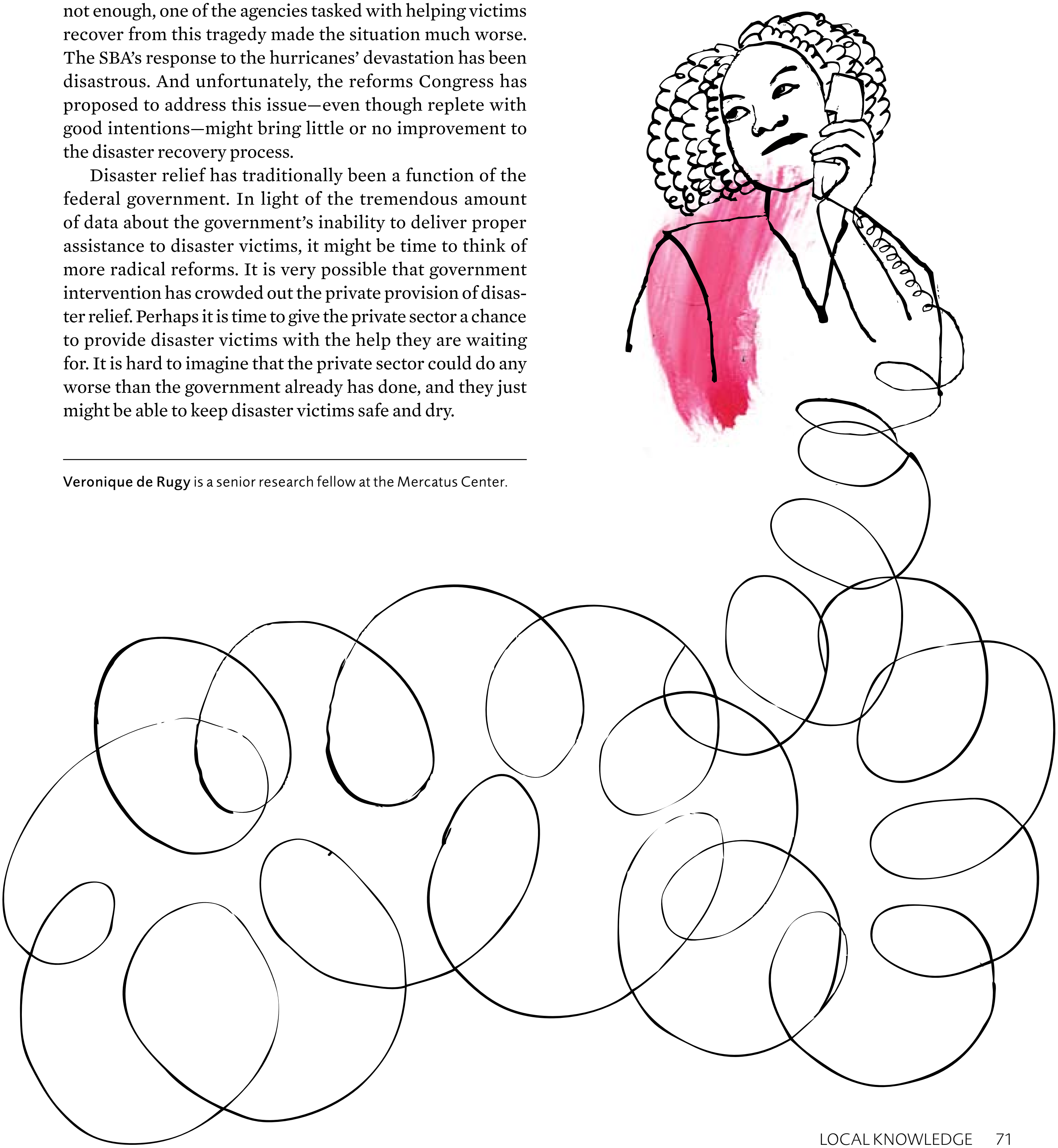
44. Veronique de Rugy, "A Guaranteed Success? Why the SBA should not Guarantee Loans," *Mercatus on Policy*, 1 (Arlington, VA: Mercatus Center, August 2007), http://www.mercatus.org/repository/docLib/20070924_onpolicyno1.pdf.

45. Daniel M. Rothschild, "The Myths of Hurricane Katrina," *Reason Online*, August 29, 2007 http://www.reason.com/news/show/122221.html.

46. Zachary Kalman and Douglas J. Elliott, *The Small Business Administration: A Primer* (Washington, DC: The Center on Federal Financial Institutions, 2006), 11.

not enough, one of the agencies tasked with helping victims recover from this tragedy made the situation much worse. The SBA's response to the hurricanes' devastation has been disastrous. And unfortunately, the reforms Congress has proposed to address this issue—even though replete with good intentions—might bring little or no improvement to the disaster recovery process.

Disaster relief has traditionally been a function of the federal government. In light of the tremendous amount of data about the government's inability to deliver proper assistance to disaster victims, it might be time to think of more radical reforms. It is very possible that government intervention has crowded out the private provision of disaster relief. Perhaps it is time to give the private sector a chance to provide disaster victims with the help they are waiting for. It is hard to imagine that the private sector could do any worse than the government already has done, and they just might be able to keep disaster victims safe and dry.



Veronique de Rugy is a senior research fellow at the Mercatus Center.