



Patrick J. [Signature]

REPORT TO THE CONGRESS

Administration Of The Disaster Loan Program In Connection With The 1964 Alaska Earthquake B-163451

Small Business Administration

*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

MAY 28, 1969



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B- 163451

To the President of the Senate and the
Speaker of the House of Representatives

This is our report on the administration by the Small Business Administration of the disaster loan program in connection with the 1964 Alaska earthquake. Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Bureau of the Budget, and the Administrator, Small Business Administration.

A handwritten signature in black ink, reading "James B. Stacks", is positioned above the title of the Comptroller General.

Comptroller General
of the United States

D I G E S T

WHY THE REVIEW WAS MADE

The Small Business Act authorizes the Small Business Administration (SBA) to make loans to anyone with a tangible property loss as a result of floods or other catastrophies and, in designated disaster areas, to small business concerns suffering substantial economic injury as a result of a disaster.

The March 1964 Alaska earthquake caused physical damage to public and private property estimated to be in excess of \$300 million. The need for urgency in repairing or replacing damaged or destroyed property was extremely important because of the short construction season and the need to encourage people not to leave Alaska. Because of the urgency and the magnitude both of the earthquake and the necessity to encourage the disaster victims to rebuild in Alaska, the SBA Administrator waived or revised many of SBA's rules and regulations published in the Code of Federal Regulations and in SBA's Disaster Loan Manual.

In view of this unusual situation, the General Accounting Office (GAO) reviewed SBA's policies and procedures followed in processing the Alaska earthquake disaster loans.

FINDINGS AND CONCLUSIONS

GAO found that SBA waived its long-established policy which generally precluded assistance to borrowers having the capabilities to finance the repair or replacement of their damaged property. As a result, loans were approved by SBA to borrowers who, GAO believes, could have furnished the financing needed to replace or repair their destroyed or damaged property. Although GAO does not question the legality of the loans made, GAO does believe that the blanket waiver of such long-standing loan policy, established in accordance with congressional intent, should not have been made in the absence of clarifying legislation. (See p. 10.)

GAO found a need for improved communication of changes in established rules and regulations. Regulations generally prohibiting loans for the expansion or enlargement (upgrading) of repaired or replacement property had been waived erroneously. Regulations generally prohibiting refinancing of existing loans were waived without adequate guidelines for

administering the new policy. GAO believes that the manner in which these regulations were waived resulted in the approval of loans for amounts in excess of those which should have been approved. (See p. 18.)

Some loans were approved even though SBA, in GAO's opinion, did not adequately review or document information necessary for determining the eligibility of the applicant, the reasonableness of the amount requested, or the allowability of the use of certain of the funds. (See p. 29.)

GAO found that, in a number of instances, the amount of a loan had been based on the cost of replacing property destroyed even though the borrower planned to relocate in another State where the cost of replacing the property would be substantially lower. (See p. 36.)

Examples of loans in support of GAO findings are presented throughout the report. GAO estimated that the unnecessary or questionable disbursements, assuming that the loans will be fully disbursed, would total about \$16 million and that, based on the difference between the interest rate charged to borrowers and the higher interest rate paid to the Treasury, additional cost to SBA would be about \$1.8 million.

RECOMMENDATIONS OR SUGGESTIONS

GAO proposed that:

- Rules and regulations published in the Code of Federal Regulations be waived or changed only through formally documented and distributed procedures, and, when waivers are made, adequate guidelines be issued for their implementation.
- Procedures be strengthened for determining eligibility and the amount of financial assistance that should be made to the disaster loan applicant.

AGENCY ACTIONS AND UNRESOLVED ISSUES

The Administrator stated that SBA had been aware of the specific weaknesses noted by GAO and was in general agreement with the matters pointed out in the report. He stated further that action had been taken to prevent recurrence of the weaknesses. The Administrator stated, however, that establishing or changing agency policy was within his legal authority.

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO believes that the matters discussed in this report will be of interest to congressional committees having legislative and oversight responsibility for programs administered by SBA.

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ABBREVIATIONS

GAO	General Accounting Office
SBA	Small Business Administration

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INTRODUCTION

The General Accounting Office has made a review of the administration of the disaster loan program in connection with the March 27, 1964, earthquake in Alaska, by the Small Business Administration. Our review, which was directed primarily toward examining into the administration by the Small Business Administration of its policies and procedures for reviewing and approving disaster loans in Alaska, did not include an overall evaluation of the program or an evaluation of the effectiveness of the program in promoting reconstruction and alleviating financial hardship in the area affected by the disaster.

THE 1964 ALASKA DISASTER

On March 27, 1964, south-central Alaska was hit by a violent earthquake. The earthquake came suddenly and without warning at 5:36 p.m., Alaska time, and lasted from 2 to 4 minutes. The upheaval and subsidence of land caused by the earthquake and the tidal wave triggered by the seismic disturbance combined to cause major damage over an area of about 50,000 square miles, containing 60 percent of Alaska's population and producing 55 percent of the State's revenues.

The earthquake resulted in one of the greatest disasters in the recorded history of the United States. Homes collapsed, highways split in two, bridges and radio towers crumbled, water mains burst, stores sank 20 to 30 feet into the ground. In Anchorage, much of the business district was destroyed and the valuable residential area of Turnagain was reduced to ruin. At Kodiak, the City's entire fishing fleet and most of its canneries were crushed. At Seward, docking facilities and piers disappeared. Similar damage occurred at Valdez, Whittier, Cordova, and Seldovia. Physical damage to public and private property was estimated at over \$300 million.

On March 28, 1964, the President of the United States declared a major disaster area in Alaska. Because Alaska had experienced property loss and damage of such staggering proportions in relation to its resources, and because existing machinery was insufficient for the task of rebuilding, the President established the Federal Reconstruction and

Development Planning Commission on April 2, 1964, by Executive Order 11150. The Executive Order provided that the Commission should develop coordinated plans for Federal programs which would contribute to reconstruction and to economic resources development in Alaska and should recommend appropriate action by the Federal Government to carry out such plans. The need for urgency in repairing or replacing damaged or destroyed property was extremely important because of the short construction season and the need to encourage people not to leave Alaska.

Much of the initial effort of the Commission was devoted to developing data to serve as a foundation for reconstruction planning and to drafting proposed legislation.

The Commission concluded that, in a State with a broader based economy, such a blow would have been awesome, but for Alaska, it was calamitous. The State's credit position and the need to maintain a flow of private capital were major concerns of the Commission following the earthquake. Of primary importance to the Commission, therefore, was a legislative program to provide additional Federal aid not possible under the then existing authorities. The Commission recommended and the Congress approved a number of amendments to the Alaska Omnibus Act. These amendments were designed to provide additional extraordinary help believed necessary. In addition, the Commission urged Federal agencies, which could render assistance, to provide financial support as quickly as possible and with maximum flexibility. The agencies responded by liberalizing normal disaster aid policies. One of the agencies rendering assistance was the Small Business Administration.

THE SMALL BUSINESS ADMINISTRATION

The Small Business Administration was created by the Small Business Act of 1953 (15 U.S.C. 631) as an independent agency operating under the general direction and supervision of the President. SBA is headed by an Administrator appointed by the President, by and with the advice and consent of the Senate.

SBA was established primarily to aid small business concerns. In addition, SBA administers a disaster loan program

authorized by section 7(b) of the act. Under this program, SBA is empowered to make such loans, either directly or in participation with lending institutions, as it may determine to be necessary or appropriate to individuals, to business concerns (regardless of size), and to various non-profit organizations, which have tangible property losses resulting from floods, or other catastrophies, and in designated disaster areas to small business concerns suffering substantial economic injury, resulting from the loss of revenue.

There is no statutory limit to the amount of a disaster loan. Subsequent to the earthquake in Alaska, the maximum term, including extensions and renewals, of disaster loans was increased, by an amendment to the act, from 20 years to 30. The act provides that the interest rate on SBA's share of a disaster loan shall not exceed 3 percent per annum and that SBA's share of a disaster loan made in participation with a lending institution shall not exceed 90 percent of the balance of the loan outstanding at the time of disbursement.

The policies governing the approval of applications for financial assistance by SBA were established by a Loan Policy Board composed of the Administrator of SBA, as chairman; the Secretary of the Treasury; and the Secretary of Commerce. The Board was abolished, effective July 27, 1965, and its functions were transferred to the SBA Administrator.

The rules and regulations relating to the disaster loan program, set forth in the Code of Federal Regulations, state that financial assistance will be made to relieve the distress and hardships attendant upon a disaster and that such financial assistance will be considered on an individual basis in the light of the circumstances of the applicant and of the particular disaster. In addition to presenting a general statement of policy, the rules and regulations set forth specific criteria with regard to the eligibility requirements for financial assistance, types of financial assistance available, purposes of the loan, when and how to apply for a loan, and the amount, interest rate, collateral, and repayment requirements of the loan.

When the Administrator declares an area eligible for assistance under SBA's disaster loan program, applications for assistance are filed with the regional, branch, or disaster field office, serving the area in which the applicant resides or maintains his principal place of business. SBA's Disaster Loan Manual provides that an SBA loan specialist be assigned to process the application for a loan and to report on proof of loss; purpose of loan; adequacy of collateral; and essential financial, management, and related information regarding the application. The manual also sets forth the criteria and the procedures to be followed by the loan specialist in carrying out the review of the application. On the basis of his review, the loan specialist outlines his reasons for recommending approval or declination of the application and any special terms and conditions under which he recommends approval. The disaster loans are approved or declined, depending on the amount of the application and other considerations, by field or Washington office personnel.

Under the SBA Disaster Participation Agreement Program, all banks in the disaster area are eligible to participate in the disaster loan program. SBA participates with such banks in disaster loans under an agreement whereby SBA purchases up to 90 percent of each loan disbursement. Prior to disbursement SBA reviews the loan application for conformance with SBA statutory, regulatory, and policy requirements.

Prior to July 1966, SBA's lending programs were financed from a single revolving fund established in the Treasury. Capital for the fund was provided primarily by appropriations, repayments of loans, and payments of interest. The act requires SBA to pay into miscellaneous receipts of the Treasury, following the close of each fiscal year, interest on the outstanding loan disbursements from the revolving fund at rates determined by the Secretary of the Treasury, taking into consideration the current average yield on outstanding interest-bearing marketable public debt obligations of the United States of comparable maturities as calculated for the month of June preceding such fiscal year. For disaster loan funds disbursed in fiscal years 1964-66, SBA was charged interest at rates ranging from 3.875 percent

to 4.125 percent. In July 1966, pursuant to an amendment to the Small Business Act, a separate revolving fund was established in the Treasury for disaster loans.

On March 28, 1964, the Administrator, SBA, declared those sections of Alaska which were affected by the earthquake, or tidal waves and fires resulting from the earthquake, a disaster area eligible for loans under the SBA disaster loan program. Because of the magnitude of the earthquake in Alaska and the urgency of the vast rebuilding program, the SBA Administrator waived or revised many of SBA's rules and regulations. In April and May 1964, SBA personnel, residents of the Alaska disaster area, and other interested persons were formally notified of certain of the revised policies; but formal notification was not made of other revisions. The waivers included in formal notifications generally eased the restrictions on eligibility, loan fund limitations, use of loan proceeds, and fees and interest rates that could be charged by banks. SBA officials advised us that rules and regulations had not been waived for any previous disasters. The findings in this report relate in part to the effect of the waivers and SBA's administration thereof.

The vast rebuilding program necessitated by the earthquake also had an effect on the availability of funds for SBA's other lending programs. The Administrator reported to the Congress in his 1964 annual report that the unprecedented demand for business loans and for loans to assist victims of the Alaska earthquake caused a heavy drain on the loan revolving fund. To conserve funds, SBA curtailed the business loan program, starting in November 1964, by limiting SBA direct loans to \$15,000 and SBA's share of immediate participation loans to \$50,000 compared to the statutory limitation on direct or participation loans of \$350,000.

In April 1965, in hearings before the Select Committee on Small Business, House of Representatives, the Administrator testified that funds had not been adequate to permit approval of all business loans which otherwise would have been approved. He informed the Committee that over \$17 million of business loans were ready for formal approval action as soon as funds became available. In October 1965,

SBA discontinued acceptance of applications for direct and immediate participation business loans. SBA, in May 1966, reopened the regular business loan program.

The principal officials of SBA responsible for the activities discussed in this report are listed in appendix II.

ADMINISTRATION OF THE DISASTER LOAN PROGRAM
IN CONNECTION WITH THE 1964 ALASKA EARTHQUAKE

On the basis of our review, we believe that certain aspects of SBA's disaster loan program in Alaska could have been administered in a more effective and efficient manner.

The Administrator issued oral instructions waiving the disaster loan policy which generally precluded assistance to borrowers who had the capabilities to finance the repair or replacement of their damaged or destroyed property. Loans were approved by SBA as a result of the blanket waiver in instances where, we believe, the borrowers could have furnished the financing needed to repair or replace their destroyed or damaged property. Although we do not question the legality of the loans made, we do believe that the blanket waiver of such long-standing loan policy, established in accordance with congressional intent, should not have been made in the absence of clarifying legislation.

In addition, our review showed that improved communication of policy changes, or waivers of policy, was needed in order that persons responsible for the review and approval of loan applications would be made fully aware of the policy in effect and the manner in which it was to be administered. We believe that the manner in which waivers of certain rules and regulations were communicated by SBA resulted in the approval of loans in amounts excess to those which should have been approved.

Our review showed a need to strengthen the review and approval procedures for determining the eligibility of applicants for disaster loans and the reasonableness of the amounts requested. We noted loan approvals for which, in our opinion, SBA had not adequately reviewed or documented information necessary for determining the eligibility of the applicant, the reasonableness of the loan amount requested, or the allowability of the use of certain of the funds.

We noted also the need for SBA to establish a policy with regard to the computation of the amount of financial

assistance available to persons who planned to relocate outside of the disaster area, where the cost of replacing destroyed property would be substantially different from the cost in the disaster area. During our review, we noted that, in a number of instances, the amount of the loan was based on the cost of replacing destroyed property in Alaska instead of the lower cost of replacing the property in the State to which the borrower planned to move. Prior to the completion of our field review, SBA had established such a policy and had issued implementing instructions.

We estimated that the unnecessary or questionable disbursement of Federal loan funds in connection with the above findings, assuming that the loans will be fully disbursed, would total about \$16 million. On the basis of the difference between the 3-percent interest rate charged borrowers on disaster loans and the higher rate of interest SBA was paying to the Treasury in the year of loan approval, we estimated that the additional cost to SBA over the term of the loans would be about \$1.8 million.

The Administrator, SBA, in a letter dated March 14, 1968 (see app. I), stated that SBA had been aware of the specific weaknesses noted in our review and was in general agreement with the matters pointed out in the report. He stated also that actions had been taken to prevent a recurrence of the weaknesses. The Administrator stated, however, that establishing or changing agency policy was within his legal authority.

QUESTIONABLE WAIVER OF DISASTER LOAN POLICY

The Administrator issued oral instructions waiving the basic and long-established disaster loan policy which generally precluded assistance to borrowers who had the capabilities to finance the repair or replacement of their damaged property. As a result of the blanket waiver, loans were approved by SBA when, in our opinion, the borrowers could have furnished the financing needed to replace or repair their destroyed or damaged property. Although we do not question the legality of the loans made, we do believe that the long-standing loan policy, established in accordance with congressional intent, should not have been waived in the absence of clarifying legislation.

SBA's basic disaster loan policy, formalized and published in the Code of Federal Regulations (13 CFR 120.4), provides that, if funds are otherwise available without undue hardship to a disaster victim, its principal owners, shareholders, or stockholders, SBA may require that such funds be expended prior to the expenditure of Federal funds. In addition, SBA's manual for guidance of its employees and officials in reviewing and approving disaster loans provides that, if funds may be available on reasonable terms from a financial institution or other sources, or from the applicant's own resources, without undue hardship, the disaster loan should not be made.

There is little doubt that the disaster loan program, with its long-term and low-interest-rate loans, was established by the Congress for the purpose of providing needed financial assistance to disaster victims. In introducing on the floor of the Senate the disaster loan legislation which SBA now administers, Senator Alben Barkley stated that:

"*** Many of those persons are unable to go to a bank and make what is called a bankable note by putting up the exact security which a bank requires. *** The object of this bill is to make it possible for such citizens, whose cases are equally meritorious with the cases of others, to obtain loans under such terms as they may be able to meet and based upon such terms as they may be able to give, if they can give any, all of it being left to the discretion and judgment of the proposed new organization."

* * * * *

"The bill now under consideration is intended to afford relief to a very large class of worthy persons who do not desire to ask for charity, but who cannot make loans at banks and give what would be called adequate security for such loans. ***"

It appears that SBA, in consistently opposing proposed disaster relief legislation that would have permitted

disaster loans without regard to whether or not the required financial assistance might be available from sources other than SBA, has recognized that the purpose of the program was to provide financial assistance to those for whom no other assistance was available. Before the Subcommittee on Flood Control, Committee on Public Works, House of Representatives, the Administrator, SBA, in commenting on Senate bill 1861 and related bills (89th Cong., 2d sess. 118), stated:

"However, if there is reason to believe an applicant can obtain funds at reasonable terms from private sources or has sufficient funds to help himself without undue hardship, the SBA processing office will look into the matter before approving the loan.

"This is done to make sure that the basic purpose of the disaster program is fulfilled--helping those disaster victims who cannot help themselves."

In a letter dated August 30, 1965, to the Chairman, Committee on Public Works, House of Representatives, commenting on proposed disaster relief legislation, the Administrator stated that:

"It is our understanding, however, that section 3(d) would prevent the Small Business Administration from requiring an individual borrower to demonstrate his inability to obtain private financing at reasonable cost. As we indicated in our testimony on S. 1861 before the Senate Public Works Committee, we have in the past refused to make loans where it has become apparent that private financing at reasonable cost has been available. We believe that our current authority which enables us to waive the required finding that private credit is not available at reasonable cost on a case-by-case basis is preferable to a blanket waiver of the type contained in this section."

In a letter dated July 25, 1967, to the Chairman, Committee on Public Works, United States Senate, the Administrator stated that:

"Existing SBA disaster loan criteria, therefore, give full recognition to the needs of disaster victims, while at the same time taking into account the fact that it would be inappropriate for the government to provide 3 percent disaster loans to persons or concerns not actually in need of such government assistance. We believe this principle is generally accepted as sound and as necessary to conserve the government's funds."

SBA has expressed the belief, in a memorandum prepared by its Office of General Counsel, dated April 13, 1965, that, in the absence of such a policy, it would not be exercising a discretionary function and would be acting only as a disbursing agent if it made loans to everyone who could show damage because of a disaster.

In our review of 196 loans, we found 25 loans totaling about \$7 million, of which \$6.8 million was SBA's share, where, in our opinion, the applicants could have furnished the financing needed to repair or replace the damaged property. Our review disclosed no documentation or justification for the waiver of SBA's long-established disaster loan policy.

The Anchorage Regional Director informed us, however, that the SBA Administrator had orally rescinded the limitations which excluded applicants of substantial means from being eligible for disaster loans. We estimated that, on the basis of the difference between the 3-percent interest rate charged borrowers on disaster loans and the higher rate of interest SBA was paying to the Treasury in the year in which the loan was approved, the additional interest cost to SBA over the terms of these 25 loans, assuming all of the loans are fully disbursed, will be about \$757,000.

Several examples of loans approved by SBA; where, we believe, the borrowers could have furnished the financing needed to replace their disaster-damaged property are as follows:

--In August 1965, the Anchorage Regional Director approved a 30-year loan of \$132,000, to replace a home and furniture destroyed in the disaster and to retire an existing \$26,800 mortgage on the destroyed property. The borrower had reported to SBA a net worth of about \$1.2 million, consisting mostly of marketable securities. The SBA loan specialist who reviewed the application made no special comment in his report regarding the borrower's ability to repair the damaged property by use of his own funds but did indicate that the borrower's financial condition and SBA's analysis of his financial condition indicated an exceptional repayment ability.

--In December 1965, a loan was approved by Washington officials for \$1 million, with a 7-year repayment period, to a corporation for replacement of a damaged building located in Anchorage, Alaska. In its application submitted to SBA in September 1965, the borrower reported that current assets of the corporation exceeded current liabilities by about \$6.1 million and included almost \$1.4 million in cash. In a commercial credit report to SBA, it was stated that commercial loans in the high-seven figures were available to the applicant.

The SBA loan specialist, when evaluating the application, reported the corporation's net worth and recommended approval of the loan on the basis that the corporation's ability to repay was well-substantiated.

The loan approval contained the following justification:

"Creditwise, there appears to be ample justification for approval of this loan. In some ways, it would appear this applicant could obtain all the necessary funds through private financing and use of its own assets. However, this is beside the point, as concerns the policy and history of SBA disaster assistance following the 1964 earthquake, ***"

--In August 1964, Washington headquarters approved a direct loan of \$157,000 to purchase land and to replace a residence and personal property which were destroyed during the disaster. The SBA loan specialist's report stated that the borrower's financial statements showed total assets of about \$377,500 and a net worth of approximately \$263,700 and that the assets were included at cost values (one investment conservatively worth \$650,000 was included at a value of about \$106,000). The loan specialist also noted that the borrower was financially able to provide additional funds if the cost of replacing the residence exceeded the loan amount. Prior to final approval of the loan application, a Washington loan officer commented:

"This is a case of helping those who can help themselves. Applicant appears to be well able to handle his loss. However, to single this one out of the many that have already received aid and were able to handle their losses would not, in my opinion, be justified in view of the liberal policy in this disaster."

In September 1965, the SBA Executive Administrator instructed SBA personnel that, because of limited available funds, they should approve only loans which were in the national interest and which would best implement the aims of the SBA program. He further informed them that this could be accomplished by close adherence to established policies and he suggested that:

"In addition, a closer look at the availability of financing from other sources is required. Screen prospective applicants more thoroughly to assure that needed credit is not otherwise available. Sources of credit should not be limited to commercial banks but should include personal assets of principals in the business, SBIC's ***."

Conclusions and agency comments

As a result of the blanket waiver of the long-standing loan policy, loans were approved by SBA when, in our opinion, the borrowers could have furnished the financing needed to replace or repair their destroyed or damaged property. Although we do not question the legality of the loans, we believe that the waiver of the policy, which was established in accordance with congressional intent, should not have been made in the absence of clarifying legislation. The approval of loans which were not in accordance with the formalized policy resulted in SBA's incurring additional costs because of the difference between the 3-percent interest rate on disaster loans and the interest rate charged by the Treasury.

The Administrator, in commenting on this matter by letter dated March 14, 1968, stated that SBA's policy has been one of providing financial assistance only to applicants who cannot reasonably provide such assistance from their own resources or from other sources. He stated that the only exception to this policy was in connection with the earthquake in Alaska where the Administrator believed a waiver of the policy was necessary and appropriate for the recovery of Alaska.

The Administrator stated that the legislative history of the disaster loan program made it clear that SBA was to exercise discretion in order to meet the need of the disaster situation and to carry out a liberal and sympathetic administration. He stated also that a review of the legislative history indicated nothing that would prevent the Administrator from changing SBA's stated policy if the occasion demanded a change.

We recognize and do not question the nature of the disaster loan program which requires that emergency assistance be extended to disaster victims in an expeditious manner, neither do we question the broad legal authority of the Administrator in carrying out the provisions of the Small Business Act. We do question, however, the discretionary authority of the Administrator to make a blanket waiver of the long-standing policy regarding the availability of

funds which was established in accordance with the intent of the Congress.

With regard to the Administrator's comment that the waiver was believed necessary and appropriate for the recovery of Alaska, it appeared that the existing policy was adequate to fulfill this purpose. In a letter to the Committee on Public Works, House of Representatives (see p. 12), the Administrator, SBA, expressed the belief that, in the case of need, it could on a case-by-case basis waive the disaster loan policy regarding availability of financing from other sources. On the basis of our review, it does not appear to us that the blanket waiver of the SBA policy, which eliminated from the loan review and approval procedure any consideration of the need of applicants for disaster loans, was necessary or appropriate for Alaska's recovery from the 1964 earthquake.

NEED FOR IMPROVED COMMUNICATION IN THE DISASTER LOAN PROGRAM

We believe that the manner in which waivers of certain rules and regulations were communicated by SBA resulted in the approval of loans in amounts excess to those which should have been approved. During our review we noted that the regulation generally prohibiting loans for the expansion or enlargement (upgrading) of repaired or replacement property had been waived erroneously and that the regulation generally prohibiting refinancing of existing liens had been waived without adequate guidelines for administration of the new policy.

In our opinion, the results of our review in Alaska demonstrated a need for SBA to improve the administration of its disaster loan program by ensuring that, when regulations are waived or changed, officials and employees responsible for carrying out the program are made fully aware of the policy in effect and the manner in which it should be administered.

Upgrading of replacement property

SBA's rules and regulations published in the Code of Federal Regulations state that the purpose of disaster loans is to restore a victim's home or business property as nearly as possible to predisaster condition, and that SBA's share of a loan should not exceed the actual physical loss resulting from the disaster. There is no restriction, however, on upgrading the replacement or repaired property if it is done with funds from sources other than SBA's disaster loan program.

In our review of 196 disaster loans, however, we noted that 38 included about \$3.3 million for upgrading the repaired or replacement property. Of the 38 loans, three, representing about \$85,000 for upgrading, were included in our finding concerning the capabilities of borrowers to repair or replace their damaged property without SBA assistance. (See p.10 and interest calculation on p. 13.) For the remaining 35 loans, we estimated that on the basis of the difference between the 3-percent interest rate charged borrowers on disaster loans and the higher rate of interest

SBA was paying to the Treasury in the year of loan approval, the additional cost to SBA over the term of the loans for the upgrading, assuming the loans will be fully disbursed, would be about \$493,000.

Our review of SBA's files disclosed no documentation that the policy restricting the amount of SBA's loans to the actual value of the physical losses sustained had been waived. An SBA official in Anchorage informed us, however, that, about May 1964, a Washington official had orally authorized the Anchorage office to allow a one third upgrading of facilities with proceeds from disaster loans in Alaska.

The Washington official who, according to the Anchorage official, had authorized the waiver stated that he did not recall waiving the policy generally prohibiting disaster loans for upgrading of property but that it was very likely the matter had been discussed during a visit by him to Alaska and a one third upgrading had been determined to be allowable. The Washington official, however, could not specifically recall the reasons for authorizing the waiver. He stated, however, that no written waiver of SBA's published rules and regulations had been issued for upgrading of property and that he was unable to recall why the reported waiver, if made, had not been formalized. The Washington official responsible for providing technical direction to the field offices for the administration of the disaster loan program told us that he was not aware of a waiver of the policy regarding upgrading of property but that he did not know what other SBA officials may have authorized.

An Anchorage official informed us that the authority to allow upgrading of property in Alaska by use of disaster loan funds was orally rescinded by a Washington official about 15 months after it had been informally authorized in May 1964. We were informed by the Anchorage official that the waiver was rescinded upon the realization by Washington officials that upgrading of property was contrary to SBA's disaster loan policies. However, as in the case of the implementation of the waiver, our review of SBA's files disclosed no documentation rescinding the waiver.

We believe that, if the Washington official who initiated the waiver of the policy had attempted to communicate the waiver in a formal manner, the erroneous waiver would have been disclosed and it would not have been implemented. We believe the implementation of the waiver by informal communication resulted in the approval of loans which erroneously included provision for upgrading of property. Two examples of disaster loans used for financing the replacement of borrowers' destroyed property with property significantly larger in size and value are as follows:

- The borrower owned a building in Anchorage, Alaska, which contained a total of 5,600 square feet and was purchased in 1915 at a cost of \$1,055, including moving costs of \$430. SBA records indicated that improvements costing about \$10,000 had been made to the building up to the time of the disaster. The borrower reported to SBA that the building was damaged beyond economical repair and applied for a \$250,000 loan which, together with \$25,000 of private funds, would be used to construct a 12,000-square-foot building.

SBA participated to the extent of 90 percent, or \$225,000, of the \$250,000 loan for the construction of the new building. We estimated that the borrower was allowed to use about \$112,920 of the total loan funds to more than double the size of its building.

- The borrower owned a building of 4,500 square feet, which he reported destroyed along with tools, stock, and furniture. SBA participated for \$186,000 in a \$248,000 loan. Of the total loan, \$177,000 was for the construction of a replacement building containing 10,500 square feet, or over two times the size of the one destroyed.

We estimate that, of the total loan of \$177,000 for the construction of a replacement building, about \$101,000 can be attributed to the cost of upgrading the size of the replacement building.

During the period when the Anchorage branch office was approving loans for upgrading of property, the SBA Seattle regional office, which had cognizance over the Anchorage branch, and an office in Washington, which performed a post-approval review of loans, informed Anchorage officials that upgrading of property was not allowable.

In July 1964, an official of the Washington office, in a letter to an SBA official in Anchorage, emphasized the purpose of the physical-loss disaster program--that is the restoration of the applicant to predisaster status and not the expansion of his property. In November 1964, an official of the SBA Seattle region stated in a letter to the Anchorage branch that, under no circumstances, was upgrading allowable and that only facilities equal in space and general construction to those damaged or lost could be provided with disaster loan funds.

We found, however, that Washington officials from the same organizational unit that sent the July 1964 letter to Anchorage were approving loans which included funds for upgrading the replacement property. The following case is an example of a loan approved by Washington officials where the size of the borrower's replacement building, land, and parking area exceeded that of his predisaster property.

--The borrower owned buildings containing 26,700 square feet of space, which had sustained damage of about \$1.25 million from the earthquake. SBA approved a \$1.9 million disaster loan which included about \$637,000 to construct a building containing 37,400 square feet of space to replace the damaged buildings; \$226,000 for the purchase of an estimated 200,000 square feet of land to replace building sites which had contained about 42,000 square feet; and about \$99,000 for the construction of an 83,000-square-foot, paved parking area to replace a 12,000-square-foot, rock-surfaced parking lot. The loan also included about \$938,000 for the replacement of inventory and equipment, the retirement of short-term notes, and the repair of damage.

On the basis of an architect's estimate of the cost to construct the replacement building, it appears

that the approved disaster loan included about (1) \$181,084 for increasing the size of the borrower's replacement building by about 40 percent, (2) \$177,800 for the purchase of land about five times the area of the borrower's land prior to the disaster, and (3) \$85,000 for a parking area about seven times larger than the borrower's predisaster parking lot. Subsequently, the loan was reduced to \$1,693,000 at the borrower's request.

The Administrator, SBA, in commenting on this matter by letter dated March 14, 1968, stated that, when an SBA Washington official had learned that loans were being approved for the upgrading of property, he checked with higher authority and rescinded the waiver. The Administrator indicated also that it had never been SBA's policy to permit upgrading of property under the disaster loan program relating to physical damage.

Refinancing of existing loans

SBA's basic policy, published in the Code of Federal Regulations, provides that disaster loan proceeds may be used to repay existing bank loans where (1) the bank participates in the disaster loan in an amount at least equal to the bank's loans being refinanced or (2) SBA determines that the bank loan was a temporary loan used to alleviate the disaster injury.

On April 16, 1964, the SBA Anchorage office was advised by Washington headquarters that the SBA Administrator had established for the Alaska disaster a revised policy providing that, in the absence of adequate cooperation on the part of existing lienholders, SBA would, on a case-by-case basis, consider paying off existing obligations with a portion of the SBA disaster loan proceeds. The nature of the existing obligations eligible for refinancing was not indicated in the directive to the field. Subsequent correspondence from Washington headquarters to the Anchorage office specified that the refinancing decision was to be based on the need of the applicant for assistance.

We found that existing liens of about \$3 million had been refinanced for 36 of the 196 loans we reviewed; although, in our opinion, the borrowers had the financial capabilities to meet repayment requirements of both the original loan and the additional loan to repair earthquake damages. Eleven of the 36 loans, representing about \$1.5 million of questionable refinancing, were included in our findings concerning the waiver of the disaster loan policy relating to the capabilities of borrowers to repair or replace their damaged property without SBA assistance (see p. 10 and interest calculation p. 13) and the eligibility of applicants and the reasonableness of loan amounts (see p. 29). For the remaining 25 loans, we estimated that, on the basis of the difference between the 3-percent interest rate charged borrowers on disaster loans and the higher rate of interest SBA paid the Treasury in the year of loan approval, the additional cost to SBA over the term of the loans for the questionable refinancing, assuming that the loans will be fully disbursed, would be about \$159,000.

On May 22, 1964, the Financial Assistance Division of SBA in Washington informed the Anchorage office that, for businesses with physical damage, SBA could consider lending funds for repayment of existing loans on property; other delinquent obligations; and, where necessary, current indebtedness. However, as in the instance of the prior directive of April 16, 1964, from Washington headquarters, no instructions were issued on the administration of the revised policy.

A Washington official responsible for coordinating the disaster loan program and for developing instructions and guidelines informed us that written guidelines to implement the above policy were not developed because it was not deemed necessary or feasible. He stated that approval of an SBA disaster loan to repay a borrower's existing lien was an area where individual judgment had to be exercised.

We believe that the absence of guidelines to the Anchorage office on carrying out the revised policy resulted in the approval of loans covering the repayment of existing loans when there was no demonstrated or apparent need for the refinancing. For example:

--In July 1964, SBA's Anchorage office approved a \$249,000 disaster loan, with monthly payments based on a 30-year repayment period, consisting of \$23,000 for the repair of earthquake damage to the borrower's residential and commercial property, and \$226,000 for the repayment of two existing loans--one of \$34,800 on the borrower's residence and the other of \$191,200 on the business property. The SBA loan was made in participation with a bank; SBA's share was 90 percent, or \$224,100. The borrower's predisaster monthly payments on the above loans were about \$1,743. The SBA-approved disaster loan for refinancing of the two existing loans and for the repair of the damage required monthly payments of about \$1,150, or a reduction of almost \$600 a month. The monthly repayment requirement on a loan of \$23,000 for the repair of the damage would have been about \$97 a month.

On the basis of our review of the borrower's financial data and discussions with the borrower, it appears that the borrower's ability to meet the original loan repayment requirements was about the same after the disaster as before. In view of the amount of damage sustained, we question the need to refinance existing loans to the extent of reducing the monthly repayment requirements below \$1,743.

Notwithstanding the lack of adequate guidance, the Anchorage office was questioned on several occasions by Washington officials about refinancing certain existing loans. In July 1964, the Anchorage office was advised by a Washington official that many cases had been noticed where the earthquake damage was relatively minor in comparison with the amount of the loan approved and that it was never intended that mortgage loans should be refinanced indiscriminately. The Washington official stated that existing loans should be refinanced in instances where the applicant's income was not sufficient to cover payments on the disaster loan and the existing first real estate mortgage.

In July 1964, another Washington official informed the Anchorage office that refinancing of existing liens was intended to be on a case-by-case basis as necessary, as when payment of the additional loans for disaster repairs would impose an undue hardship on the borrower. He stated also that it was intended that such refinancing should not reduce predisaster loan payments or provide a "windfall" for the borrower. In August 1964, Washington officials again advised the Anchorage office that, despite numerous previous discussions, there was still a lack of justification for the refinancing of existing debts in many of the loan approvals by the Anchorage office. An example of a loan subsequently approved by the SBA Anchorage office follows.

--In April 1965, SBA's Anchorage office approved a 20-year, \$170,000 loan to an individual for the repair of estimated damage of \$9,000 to an apartment building, and for the repayment of an existing loan of \$161,000. SBA participated in the loan for 80 percent, or \$136,000. The borrower's predisaster payments on the existing loan were about \$1,000 a month. A \$9,000, 20-year disaster loan, for building repairs only, would have required payments of

about \$55 a month, which, together with the payments required on the existing loans, would have required monthly payments of \$1,055, or only \$17 more than the payments required on the approved disaster loan. Our review disclosed no evidence of a need to refinance the existing loans in view of the relatively minor damage sustained.

Although it appears to us that the SBA Anchorage office interpretation of the revised policy regarding the refinancing of prior loans on a case-by-case basis was not the same as the SBA Washington interpretation; there were no guidelines issued by SBA Washington for the use of SBA personnel actively involved in the loan review and approval process.

The SBA Administrator, in commenting on this matter in his letter of March 14, 1968, stated that early visits to the disaster area and discussions with lending institutions and businessmen indicated that refinancing of existing loans in many situations was necessary if the banks and businesses were to survive. He stated also that the refinancing of the existing loans was in line with the instruction of April 16, 1964, which provided that, where there was an absence of adequate cooperation on the part of a lienholder, consideration would be given, on a case-by-case basis, to paying off existing loans with a portion of the disaster loan funds. He stated further that SBA was certain that there was not adequate cooperation on the part of the lienholders and that, unfortunately, the SBA loan specialists did not document their reports to reflect this lack of cooperation.

Although we recognize the reason and rationale of the administration in waiving, on a case-by-case basis, the general prohibition against the refinancing of existing liens, we believe that the absence of guidance to the SBA personnel responsible for reviewing and approving loans, setting forth the nature of existing obligations eligible for refinancing, resulted in the approval of loans which included provision for the repayment of existing loans. In each of the cases noted in our review, cooperation by the lienholder was not a pertinent issue because the loan recipient had adequate financial capability to meet the repayment requirements of both the original loan and the SBA

loan and, therefore, refinancing by the original lienholder was not necessary.

The Administrator stated also that the question of refinancing existing liens was under review by SBA. Subsequently, on March 19, 1968, a directive setting forth changes in the disaster loan policies and procedures was issued at the direction of the Administrator. The directive stated that no funds would be approved for refinancing existing liens on residences except to refinance a previous SBA disaster loan. The directive stated also that no funds would be approved for refinancing of existing debts for businesses except (1) debts owed SBA with an interest rate no higher than that on the new loan or (2) refinancing current liabilities payable under the economic injury program.

Agency comments and our conclusion

We believe that SBA's administration in Alaska of its rules and regulations relating to loans which include provisions for upgrading of replacement property and for refinancing of existing loans demonstrated a need for improved communication of revisions in policy and instructions and of the manner in which they were to be administered. We believe that the erroneous or inadequate communication of changes in regulations resulted in SBA's approving loans, at a 3-percent interest rate, which provided funds for purposes which were contrary to SBA's published rules and regulations or which apparently were not intended under the waiver. Because funds used by SBA to finance its lending program were borrowed at rates of over 4 percent in fiscal years 1965 and 1966, the excessive disbursement of Federal loan funds resulted in substantial interest costs to the Government over the term of the loans.

We proposed, therefore, that, to improve the administration of the disaster loan program, to avoid excessive interest costs to the Government, to ensure that only eligible applicants receive loans, and to provide for consistent treatment of disaster victims, SBA provide that its rules and regulations, published in the Code of Federal Regulations, be waived or changed only through formally documented and distributed procedures. We proposed also that,

when SBA might find it necessary to waive or otherwise change its established policy, adequate guidelines be issued for the use of personnel reviewing and approving loans so that the revised policy could be properly implemented.

The Administrator, SBA, in commenting on the matter in his letter of March 14, 1968, agreed with our proposals. He noted, however, that, due to the urgency of making disaster loans, SBA would expect to be able to operate under the rule changes while formal documentation was being implemented. With regard to the issuance of adequate guidelines, the Administrator referred to 11 new detailed directives which SBA had issued, setting forth the operation of the disaster loan program, and noted that SBA had conducted training courses and expected to continue its training activities. The Administrator stated further that SBA Washington office personnel responsible for the disaster loan program would monitor all large disasters and provide for an adequate review of processed cases for all disaster operations.

We plan, as part of our future audits of SBA activities, to examine into the effectiveness of the guidelines and review procedures relating to the disaster loan program.

NEED TO STRENGTHEN REVIEW AND APPROVAL PROCEDURES

Our review disclosed a need for SBA to strengthen its procedures for the review and approval of disaster loans. Of the 196 disaster loans reviewed, we noted 39 instances where, in our opinion, SBA had not adequately reviewed or documented information necessary for determination of eligibility of the applicant, the reasonableness of the loan amount requested, or the allowability of the use of certain of the funds.

Eligibility and reasonableness of loan amount

In many instances, the records indicated that SBA personnel reviewing loan applications had not obtained a complete description of the damage to property or reliable estimates of the cost to restore the property to its pre-disaster condition or to replace it. We believe that a more detailed review of several loan applications by SBA should have disclosed that, although damage had been sustained, the eligibility of the applicant or the amount of the loan was questionable.

We believe that the following two examples demonstrate the adverse effect that can result from the approval of disaster loans without the benefit of information necessary for determining eligibility for and limitation of assistance.

- SBA participated with a bank in a \$200,000 loan to a partnership for the construction of a new building to replace a building damaged by the earthquake. The loan was originally approved for \$100,000 on the basis of a reported income and damage loss and was later increased to \$200,000 to finance increased construction costs of the new building. SBA provided 90 percent of the loan, or \$180,000. At the time of the disaster, the partnership, a contracting firm, owned a one-story building constructed in 1962 for about \$80,000. In its application for the disaster loan, the borrower submitted, in support of the amount

of estimated loss, a letter from an architect, which stated in part that:

"Examination of your site and test drilling logs taken in close proximity to the site preclude any possibility of repairing your foundation and any additional building. *** We would recommend your making only necessary repairs at this time to existing building. Your plans for a second floor must be shelved.

"Your loss should be calculated as a loss of lot and building valuation loss. Our estimate of this would be approximately \$100,000. ***"

We were advised by the architect that the estimated loss was based on a combination of income and damage losses and that he had no idea what the dollar amount of damage was to the building.

At the time of our review, the damaged building had been repaired and was being utilized; but we were unable to obtain a statement of costs incurred to repair the building. We were informed by an official of the City of Anchorage that the only building permit for the building, other than for its actual construction, was issued in July 1965 for remodeling at an estimated cost of \$11,500.

The documentation in SBA's records supporting its reasons for approving a loan for \$200,000 was the above-mentioned letter from the architect to the borrower. We estimated that, based on the difference between the 3-percent interest rate charged the borrower and the 4.125-percent interest rate paid to the Treasury by SBA in the year the loan was approved, the additional cost to SBA over the term of the loan for its share of the unsupported amount of about \$188,500 will be about \$16,900.

--SBA approved two disaster loans totaling about \$3.3 million to a private utility company, which included about \$2.2 million to be used for expansion of facilities. The utility company, which provided

service to areas outside the City of Anchorage, reported physical damages of about \$103,000 and an economic injury loss of about \$108,000 as a result of the disaster.

In May 1964 the company requested a \$2 million disaster loan to provide about \$1,021,000 for facilities expansion, about \$768,000 for debt refinancing, and about \$211,000 for the repair of physical damage and for loss due to economic injury. The utility company indicated that an expansion of its facilities was necessary and justified on the basis of a need to establish new water facilities in outlying areas in order to provide adequate services to sites for construction of new homes and relocation of damaged homes.

An SBA loan specialist in Alaska reported that, of the borrower's estimated losses of \$211,000, only about \$96,000 for physical damages could be verified and recommended that a loan for that amount be approved. A Washington official, however, approved the loan for \$2 million as requested and reported that SBA officials, including the Administrator, agreed that the "application as presented is eligible" for a disaster loan. In May 1965 the borrower requested an additional disaster loan for about \$1.4 million to provide about \$1.3 million for completion of the facilities expansion and the remainder for repair of the physical damage. A \$1,255,000 loan was approved by Washington officials.

We estimated that, based on the difference between the 3-percent interest rate charged the utility company and the interest rates charged SBA by the Treasury in the years the two loans were approved, the cost to SBA over the term of the loans for the unsupported portion of about \$3,204,000 will be about \$359,900.

The Administrator, SBA, in commenting on the loans to the private utility company, stated that, because of the destruction of apartment buildings and homes, lots with sewer and water facilities were needed to meet the needs of displaced people. He stated also

that a portion of the second loan requested to increase the number of lots was refused by SBA because the company could not show that the additional lots were needed for displaced disaster victims. Therefore, SBA had limited the loan to the additional costs of providing for the number of lots originally approved.

Our review disclosed no evidence in support of the first or second loan as to the number, if any, of the disaster victims who planned to relocate or as to any other substantiation for the reasonableness of the amount of the two loans.

Bank charges

Our review showed that, contrary to SBA policy, loan funds were being applied to service fees charged the borrower by two participating banks and that the deductions for such charges were shown in a report which was part of the loan documentation available at the time of loan closing and disbursement. We estimated that about \$49,000 in disaster loan proceeds intended for the use of the disaster victims were improperly withheld by participating banks as a service fee for processing loans.

SBA's basic policy regarding bank service fees provided that no such fee would be charged by the participating banks to the borrower or to SBA on disaster loans. On May 19, 1964, SBA announced a waiver of the policy prohibiting banks from deducting a fee for servicing disaster loans from SBA's portion of loan repayments. The announcement provided for a fee of 0.25 percent per annum on the unpaid portion of SBA's share of the loan and was payable from the interest collected for the account of SBA.

Our review showed, however, that, in addition to charging to SBA an authorized fee for servicing disaster loans, two of the six Alaska participating banks were also deducting a fee from the borrowers' loan proceeds for processing their loans. The two banks participated with SBA in 149 loans in Alaska for about \$12 million.

We were informed by officials of the two participating banks that the fees being charged SBA borrowers were the usual fees charged on all real estate loans by the banks and that SBA was aware of the fee.

The two banks reported the deductions for service charges to the borrower on a locally devised SBA report entitled "Accounting for the Use of Loan Proceeds." Although the report was part of the loan documentation available at the time of loan closing and disbursement, we were informed by SBA officials in Seattle that they were unaware that participating banks had deducted a service fee from loan proceeds. An SBA official in Anchorage informed us that he was aware of only one isolated case where a bank had deducted a service fee. He informed us that, in that instance, SBA had objected and the bank had made arrangements to collect the fee from other sources.

Agency comments and
our conclusion

Although we recognize that the magnitude of destruction caused by the 1964 earthquake, and the nature of the disaster loan program require assistance in an expeditious manner, we believe that applications for loans should be adequately reviewed to help ensure that loans are approved only for eligible applicants and in amounts for which the applicants are eligible. The unnecessary disbursement of Federal loan funds to ineligible applicants or disbursements in excessive amounts result in additional cost to the Government because of the difference between the interest rates on funds obtained from the Treasury and the 3-percent rate charged by SBA on disaster loans.

We believe that the matters discussed above relating to eligibility of applicants and the use of loan proceeds to pay bank charges illustrate a need for SBA to more adequately review pertinent information relating to the disaster loss and information submitted by the applicant or participating bank in support of the amount requested for the repair or replacement of damaged or destroyed property. We believe also that, to ensure that disaster loans are made only to eligible disaster victims and in amounts required to restore the disaster victim's home or business as nearly as possible to predisaster condition, SBA should obtain from such applicants a complete description of the destroyed and proposed-replacement property. In addition, we believe that, because a disaster victim's eligibility for a loan and the limitations on the assistance available to such victims are based to a large extent upon their reported loss and intended use of loan funds, SBA should independently verify losses as reported by applicants for disaster loans and the reported expected use of loan funds.

To strengthen procedures for determining eligibility and limitations of assistance available to disaster loan applicants, we proposed that SBA require that an applicant for a loan or the participating bank submit a complete description of the destroyed or damaged property, and a detailed accounting of the use to be made of the loan funds. We proposed also that either an SBA official or the participating bank official, verify the loss as reported by an

applicant for a disaster loan and that the justification for the amount of the loan be fully documented.

The Administrator, SBA, in commenting on these matters by letter dated March 14, 1968, expressed general agreement with our views and stated that SBA had already strengthened its review and approval procedures by the issuance of detailed disaster loan directives. He stated also that SBA had under consideration a procedure for a Washington review of selected disaster loans to ensure that the instructions are adhered to. On March 19, 1968, a directive setting forth changes in the disaster loan policies and procedures was issued at the direction of the Administrator. The directive provides for Washington office review of all disaster business loans of \$50,000 or more and of every 25th loan.

The Administrator stated also that the present instructions required a complete description of the destroyed or damaged property and of the proposed replacement property and required a detailed accounting for the use of loan proceeds. He stated further that SBA's present instructions required a contractor's estimate of repair or replacement costs, an SBA appraiser's estimate for structural damage, and either the SBA appraiser's or loan specialist's estimate on personal property losses.

We believe that the actions taken by SBA, if properly implemented, will strengthen the review and approval procedures for disaster loans. We plan, as part of future audits of SBA activities, to examine into the effectiveness of the directives and the review procedures relating to the disaster loan program.

With regard to the bank charges, the Administrator, SBA, stated, and we concurred, that the SBA Anchorage office should have required the banks to remit these funds to the borrower.

POLICY CHANGED FOR MAKING LOANS TO PERSONS
RELOCATING OUTSIDE THE DISASTER AREA

We noted in a number of instances that the amount of a disaster loan was based on the cost of replacing destroyed property in Alaska instead of on the lower cost of replacing the property in the State to which the borrower planned to relocate. Prior to the completion of our review, SBA made appropriate changes in its policy.

The SBA rules and regulations published in the Code of Federal Regulations (13 CFR 123.4) states that the purpose of the disaster loan is to restore a borrower's home or business as nearly as possible to predisaster condition. SBA policy provides that restoration of damaged property need not be in the same location but that SBA's share of a loan should not exceed the estimated cost of restoring the destroyed property. We found in our review that, during the period from March 1964 until July 1966, there existed no guidelines stating the basis on which the amount of a loan should be computed when the borrower relocated outside the disaster area where the cost of construction was significantly different from the cost in the disaster area.

In reviewing 196 disaster loans, we noted that, for five loans to borrowers relocating in other States, SBA had approved amounts based on the replacement cost in Alaska. We estimated that, if the amount of the loans had been based on the estimated cost of replacing property, equal in size to that destroyed in the disaster area, in the State where it was to be constructed, the approved loans would have been reduced by about \$520,000. Our estimates of the cost of replacing the property were based on published cost differential data used in the construction industry.

Two of the five loans representing about \$45,000 of the \$520,000 were included in our finding concerning the waiver of the disaster loan policy relating to the capability of borrowers to finance the repair or replacement of their damaged property from other sources. (See p.10 and interest calculation on p. 13.) For the remaining three loans, we estimated that, on the basis of the difference between the 3-percent interest rate charged borrowers on disaster loans and the higher interest rate paid to the Treasury by SBA in

the years the loans were approved, the additional interest cost to SBA over the terms of the loans, assuming the loans will be fully disbursed, would be about \$62,000.

The following example demonstrates the effect of basing the amounts of the loans on the cost of construction in Alaska.

--An apartment building destroyed in the disaster was reported to have been 85 percent complete at the time of the disaster. The building, situated on about 27,700 square feet of land, was to have 70 units and to contain a total of about 76,300 square feet. SBA approved a disaster loan for \$1,937,215 which included \$650,000 for refinancing of prior liens. The balance of \$1,287,215 was to cover the tangible loss claimed--\$1,177,215 for construction and financing, and \$110,000 for land costs of the partially completed building.

The borrower used the loan funds and \$263,000 from other sources, to acquire two shopping centers in Oregon having about 116,900 square feet of building area and about 424,300 square feet of land area. The borrower thereby obtained about 40,600 square feet or 53 percent more building space and about 396,600 square feet or about 14 times more land area than before the disaster.

We estimated that, based on construction cost differential data provided by a valuation service company, suggested to us by an SBA appraiser, it would have cost about \$754,000 to construct, to the same stage of completion, a building in Oregon equal in size to the building destroyed in Alaska. However, the amount included in the approved loan for the purchase of the replacement buildings in Oregon was based upon a total cost of \$1,177,215, which the borrower had incurred in constructing the destroyed building in Alaska, or \$423,215 more than the cost in Oregon.

In July 1966 during our field review, the Administrator issued a revised disaster loan manual which, for the first

time, included guidelines for computing the amount of assistance SBA could provide to borrowers relocating outside the disaster area. These guidelines stated, in part, that:

"If the property cannot be restored to its approximate pre-disaster condition, the amount of the loan request should be the cost of replacing such property on its former site. However, if it appears advisable, the property may be rebuilt on a more acceptable site. *** However, the disaster program is not intended to provide expansion of the borrower's facilities. *** Careful attention should be paid to comparative replacement costs when borrower intends to relocate a considerable distance from the disaster area. In no instance should funds in excess of the amount to construct comparable space at the new location be authorized." (Underscoring supplied.)

Conclusion

We believe that the absence prior to July 1966 of specific policies and guidelines for establishing the basis on which loan amounts should have been computed when an applicant planned to use the funds to construct a property outside of Alaska, resulted in SBA's providing financial assistance to the applicant in excess of that required to restore his property as nearly as possible to its predisaster condition. Guidelines issued in July 1966, if properly implemented, should, in our opinion, result in lending practices consistent with the objectives of the disaster loan program.

SCOPE OF REVIEW

Our review was undertaken as part of our continuing evaluation of the programs of SBA. The review, which was directed primarily toward examining into the administration of SBA's policies and procedures for processing and approving disaster loans, did not include an examination into controls over loan disbursements or SBA loan-servicing activities.

Our review was made at SBA headquarters in Washington, D.C., and at its regional offices located at Anchorage, Alaska, and Seattle, Washington.

Our review included an examination of the basic law authorizing the program and pertinent legislative history so that we might ascertain the intended purposes and scope of the program. We also reviewed SBA's policies and procedures as published in the Code of Federal Regulations (13 CFR 120 and 13 CFR 123) and the policy waivers as adopted by SBA officials. In addition, we interviewed SBA officials, the former Executive Director, Federal Reconstruction and Development Planning Commission for Alaska, participating bank officials, and individual recipients of disaster loans. We also considered the work performed by SBA internal auditors at the Anchorage and Seattle offices for the years 1964-66.

SBA reported that, as of March 31, 1968, it had approved 1,294 direct loans and 342 loans in participation with private lending institutions to victims of the Alaska disaster. These loans totaled about \$99.5 million, of which SBA's share was about \$96 million. We made a detailed examination of 196 selected disaster loans totaling \$49 million. We reviewed all loans approved or participated in by SBA as of May 20, 1966, which were over \$350,000; and we selected other loans, giving consideration to the amount, the location of the borrower, and the type of loan.

APPENDIXES



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

MAR 14 1968

OFFICE OF THE ADMINISTRATOR

Mr. Henry Eschwege
Associate Director, Civil Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

This is in response to your letter of January 30, 1968, requesting our comments on the proposed report to the Congress titled "Administration of the Disaster Loan Program in connection with the 1964 Alaska Earthquake Small Business Administration."

We have reviewed the report and our comments are given below. However, prior to these comments we believe that some background concerning the Alaska earthquake should be considered.

As you are aware the earthquake and resulting tidal waves and fires in Alaska occurred on Good Friday, March 27, 1964. Also affected to some degree were the States of Washington, Oregon, California, and Hawaii. The earthquake damage, although centered around Alaska's largest city of Anchorage, was fairly widespread and affected many more smaller communities.

On April 2, 1964, the President issued Executive Order 11150. This Executive Order established a Cabinet-level commission known as the "Federal Reconstruction and Development Planning Commission for Alaska", with a Chairman and an Executive Director to be designated by the President. Senator Clinton P. Anderson and Dwight Ink were named by the President as Chairman and Executive Director, respectively.

This Executive Order directed the Commission and the Federal, State, and Local agencies to do everything within their authority for the reconstruction and economic and resources development of Alaska. (A copy of Executive Order 11150 is attached.)

Under Section 7(b) of the Small Business Act, as amended, we have the responsibility in a disaster situation to assist the private sector of the economy with loans as the Administration may consider necessary and appropriate.

Our Office of General Counsel has advised that, according to the legislative history of the Disaster Loan Program, Congress made it clear that the RFC and SBA was to exercise discretion, so as to meet the need of the disaster situation and to carry out a liberal and sympathetic administration. The question of these Alaska changes appears to be solely one of policy and the Administrator of the Small Business Administration alone is empowered to determine what policy changes are necessary and appropriate to meet a given situation.

Changes in policy were not limited to SBA alone in this disaster. The size and scope of this disaster required all Federal agencies who could, to assist to the extent feasible. Other Federal Departments were requested to utilize their authority to assist to the extent possible and make necessary adjustments to their operations. This was suggested by the Chairman of the Commission, Senator Anderson, to accomplish reconstruction of the area at the earliest possible date. The Omnibus Bill passed by the Congress was also an example of steps taken to get the job done.

The Congress and the State of Alaska each appropriated $5\frac{1}{2}$ million dollars to repay obligations of disaster victims whose homes had 60 percent or more destruction.

Many meetings were held with the Commission and the Executive Director of the Commission to accomplish the job in line with the President's directive. Many, if not all, of the policy changes made by SBA were fully discussed at these meetings and had the Commission's concurrence.

Our comments on each recommendation are:

Recommendation on page 16 states:

"To better administer the disaster loan program to conserve Federal loan funds, and to help assure that financial assistance is being provided only to applicants who cannot reasonably obtain financing from other sources, we recommend that SBA not waive policies which are based on the interpretation of the intent of the Congress."

Section 7(b) of the Small Business Act, as amended, provides that "the Administration is empowered to make such loans as the Administration may determine to be necessary and appropriate..."

Our Office of General Counsel has indicated that there is nothing in the legislative history to estop the Administrator from changing his stated policy if the occasion demands a change.

The changes which were made in the policy for disaster loans in Alaska were considered by the Administrator necessary and appropriate and had, in most cases, the approval of the Federal Reconstruction and Development Planning Commission for Alaska.

Recommendation on page 30 states:

"Therefore, in an effort to improve the administration of the disaster loan program, to avoid excessive interest costs to the Government, to assure that only eligible applicants receive loans, and to provide for consistent treatment of disaster victims, we recommend that SBA provide that rules and regulations published in the Code of Federal Regulations be waived or changed only through formally documented and distributed procedures. We recommend also, that when SBA finds it necessary to waive or otherwise change its established policy, that adequate guidelines be issued for the use of personnel reviewing and approving loans so that the revised policy can be properly implemented."

We agree with the recommendation that "Federal Regulations be waived or changed only through formally documented and distributed procedures." However, due to the urgency of making disaster loans, we would expect to be able to operate under the rule changes while the formal documents are being implemented.

We also, agree with the recommendation concerning the issuance of adequate guidelines. In fact during the past year and one half, we have issued 11 new detailed directives spelling out our operations. We have also had training courses and expect to continue our training. In addition, the Washington Office personnel responsible for the disaster program will monitor all large disasters and provide for an adequate review of processed cases for all disaster operations.

Recommendation on page 41 states:

"We recommend in order to strengthen procedures for determining eligibility and limitations of assistance available to disaster loan applicants, that SBA, require from the applicant or participating bank, a complete description of the destroyed or damaged property, proposed replacement property and a detailed accounting for the use of the loan funds. We recommend also that an official from either SBA or the participating bank, verify the loss as reported in support of the disaster loan application and that the justification for the amount of the loan be fully documented and supported."

With regard to the first part of recommendation concerning requiring description of property, our present instructions require this recommended procedure. The monitoring of the disaster operation by the Washington Office of Disaster Loans will assure that our instructions are adhered to.

Concerning the second part of the recommendation SBA's present instructions provide that structural damage be verified by an SBA appraiser and personal property can be verified by a loan specialist. We will make it clear in our instruction that this procedure is also applicable under our participating programs, as we consider it absolutely necessary that all damages be verified.

The following are additional comments with regard to certain subsections of the report:

1. Questionable Waiver of Disaster Loan Policy

"The following cases are examples of loans approved by SBA where, we believe, the borrowers could have furnished all or part of the financing needed to replace their disaster damaged property." (page 13)

SBA's present policy is, and has been, to provide financial assistance only to applicants who cannot reasonably provide same from their own resources or other sources. The only exception to this policy was the earthquake disaster when the Administrator felt a waiver was necessary for the recovery of Alaska.

2. "Need for improved communications in the Disaster Loan Program

a. Upgrading of replacement property" (page 17)

The SBA Displaced Business Loan Program is the only disaster program which provides for limited upgrading. Our Anchorage Branch Office states that someone in an official position authorized upgrading in this physical disaster.

When the Director, Office of Disaster Loans, learned of this authority, he checked with higher authority and rescinded this provision.

It has never been, nor is it now, our policy to permit upgrading in any disaster program other than the DBL program.

3. Refinancing of existing loans

"SBA's basic policy published in the Code of Federal Regulations provides that disaster loan proceeds may be used to repay existing bank loans where (1) the bank participates in the disaster loan in an amount of at least equal to its loans to be refinanced, or (2) SBA determines that the bank loan was a temporary loan used to alleviate the disaster injury." (page 23)

Early visits to the disaster area and discussions with the lending institutions and businessmen brought forth the fact that refinancing in many situations was necessary if the banks and businesses were to survive. Accordingly, the Administrator approved refinancing for the first time in any disaster. This information was given to the disaster area in a teletype dated April 15, 1964, as follows: "Where there is absence of adequate cooperation on the part of the existing lienholder, consideration will be given on a case-by-case basis to pay off the existing lien with a portion of the SBA disaster loan, provided there is a reasonable showing by the loan applicant of ability to repay such increased loan for the combined purposes."

APPENDIX I

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From our discussions with the lending institutions we knew that they would insist on the repayment. We are, therefore, certain that there was not adequate cooperation on the part of the lienholders and that refinancing was in line with the Administrator's instructions. Unfortunately, our loan specialists did not document their reports to reflect this.

Refinancing to any degree and under any circumstances is presently under review with the exception of short-term debt payment which has always been permitted under our Economic Injury Disaster Loans.

When the refinancing decision is made definite, instructions and guidelines will be issued by the Washington Office and the program monitored by Washington personnel.

[See GAO note.]

GAO note: Comments pertaining to draft report material not included in final report have been omitted.

[See GAO note]

5. Need to strengthen review and approval procedures

"Our review disclosed a need for SBA to strengthen its procedures in the review and approval of disaster loans." (page 31)

We have already strengthened our review and approval procedures for disaster loans by issuance of eleven detailed disaster loan directives which we previously cited.

SBA is also presently reviewing certain disaster cases in disasters now in operation. In addition, we have under consideration a procedure to review all disaster processed cases over a certain dollar amount and every 25th or 50th disaster loan processed. This program should be fully operative before the beginning of the last quarter of fiscal year 1968.

6. Eligibility and reasonableness of loan amount

"...SBA personnel reviewing loan applications did not obtain complete description of the property lost or reliable estimates showing costs to repair or replace the property to its predisaster condition." (page 32)

Our present detailed directives correct this situation. The directives provide for a contractor's estimates of repair or replacement costs, with SBA appraiser's estimates for structural damage and either SBA appraiser's or loan specialist's estimates on personal property.

Further, the Central Office monitoring of the program and review of certain cases will correct any prior deficiencies.

GAO note: Comments pertaining to draft report material not included in final report have been omitted.

Concerning the loan to the private utility, the Administrator of SBA decided that due to the destruction of apartment buildings and homes, lots with sewer and water were needed to meet the needs of the displaced people.

The original loan provided for this approach.

The request for a second loan to increase the number of lots was refused because the utility company could not produce evidence that the additional lots were needed for displaced disaster victims. The second loan was, therefore, limited to the additional costs (original estimates too low) to provide for the original number of lots approved.

7. Bank charges

"SBA personnel, in reviewing documentation submitted by participating banks, did not note that contrary to SBA policy, loan funds were being applied to service fees charged to the borrower by the bank." (page 37)

Our Anchorage Office should have required the banks to remit these funds to the borrower.

8. Policy for making loans to persons relocating outside the disaster area -- established

"Our review disclosed a need for SBA to establish policies and guidelines regarding the extent of assistance available to disaster victims using disaster loan funds to locate outside the disaster area." (page 42)

In July 1966, we issued in our new directives adequate instructions and guidelines to correct this situation. The Central Office will have this under complete control as the handling of the approved loans will be under a different regional office from the approving office, and the transfer will be directed by the Central Office.

We have been aware of the specific weaknesses mentioned in the report and we are in general agreement with the matters pointed out. In our opinion, the actions already taken will prevent a recurrence of the weakness outlined in the report.

We appreciate the opportunity to comment on the proposed report and will furnish any additional information you may desire.

Sincerely yours,

A handwritten signature in black ink, reading "R.C. Moot". The signature is written in a cursive, slightly stylized font. The "R" is large and loops around the "C". The "Moot" is written in a more fluid, connected style.

Robert C. Moot
Administrator

Attachment

Executive Order 11150

**ESTABLISHING THE FEDERAL RECONSTRUCTION AND DEVELOPMENT
PLANNING COMMISSION FOR ALASKA**

WHEREAS the people of the State of Alaska have experienced death, injury and property loss and damage of staggering proportions as a result of the earthquake of March 27, 1964; and

WHEREAS the President, acting pursuant to authority granted in the Act of September 30, 1950, as amended (42 U.S.C. 1855-1855g), has declared a major disaster in those areas of Alaska adversely affected by the earthquake beginning on March 27, 1964; and

WHEREAS the Federal Government and the State of Alaska desire to cooperate in the prompt reconstruction of the damaged Alaska communities; and

WHEREAS the Federal and State Governments have a common interest in assuring the most effective use of Federal and State programs and funds in advancing reconstruction and the long-range development of the State; and

WHEREAS such effective use is dependent upon coordination of Federal and State programs, including emergency reconstruction activities, which affect general economic development of the State and the long-range conservation and use of natural resources; and

WHEREAS the Governor of Alaska has declared his intention to establish a State commission for reconstruction and development planning:

NOW, THEREFORE, by virtue of the authority vested in me as President of the United States, it is ordered as follows:

SECTION 1. *Establishment of Commission.* (a) There is hereby established the Federal Reconstruction and Development Planning Commission for Alaska (hereinafter referred to as the Commission).

(b) The Commission shall be composed of a Chairman, who shall be designated by the President, the Secretary of Defense, the Secretary of the Interior, the Secretary of Agriculture, the Secretary of Commerce, the Secretary of Labor, the Secretary of Health, Education, and Welfare, the Administrator of the Federal Aviation Agency, the Housing and Home Finance Administrator, the Administrator of the Small Business Administration, the Chairman of the Federal Power Commission, and, so long as the President's declaration of a major disaster is in effect, the Director of the Office of Emergency Planning. Each agency head may designate an alternate to represent him at meetings of the Commission which he is unable to attend.

(c) The Chairman may request the head of any Federal executive department or agency who is not a member of the Commission under the provisions of subsection (b); above, to participate in meetings of the Commission concerned with matters of substantial interest to such department or agency head.

(d) The President shall designate an Executive Director of the Commission, whose compensation shall be fixed in accordance with the standards and procedures of the Classification Act of 1949, as amended.

SEC. 2. *Functions of the Commission.* (a) The Commission shall develop coordinated plans for Federal programs which contribute to reconstruction and to economic and resources development in Alaska and shall recommend appropriate action by the Federal Government to carry out such plans.

(b) When the Governor of Alaska has designated representatives of the State of Alaska for purposes related to this order, the Commission shall cooperate with such representatives in accomplishing the following:

(1) Making or arranging for surveys and studies to provide data for the development of plans and programs for reconstruction and for economic and resources development in Alaska.

(2) Preparing coordinated plans for reconstruction and economic and resources development in Alaska deemed appropriate to carry out existing statutory responsibilities of Federal, State, and local agencies. Such plans shall be designed to promote optimum benefits from the expenditure of Federal, State, and local funds for consistent objectives and purposes.

(3) Preparing recommendations to the President and to the Governor of Alaska with respect to both short-range and long-range programs and projects to be carried out by Federal, State, or local agencies, including recommendations for such additional Federal or State legislation as may be deemed necessary and appropriate to meet reconstruction and development needs.

SEC. 3. *Commission procedures.* (a) The Commission shall meet at the call of the Chairman.

(b) The Commission may prescribe such regulations as it deems necessary for the conduct of its affairs, and may establish such field committees in Alaska as may be appropriate.

(c) Personnel assigned to the Commission shall be directed and supervised by the Executive Director of the Commission. Activities of the staff shall be carried out, under the general direction and supervision of the Chairman, in accordance with such policies and programs as may be approved by the Commission.

(d) The Chairman of the Commission shall report to the President from time to time on progress and accomplishments.

SEC. 4. *Agency cooperation.* (a) Each Federal agency represented on the Commission shall, consonant with law, cooperate with the Commission to expedite and facilitate its work. Each such agency shall, as may be necessary, furnish assistance to the Commission in accordance with the provisions of section 214 of the Act of May 3, 1945 (59 Stat. 134; 31 U.S.C. 691).

(b) Other Federal agencies shall, to the extent permitted by law, furnish the Commission such information or advice bearing upon the work of the Commission as the Chairman may from time to time request.

SEC. 5. *Construction.* Nothing in this order shall be construed as subjecting any Federal agency or officer, or any function vested by law in, or assigned pursuant to law to, any Federal agency or officer, to the authority of the Commission or of any other agency or officer, or as abrogating any such function in any manner.

LYNDON B. JOHNSON

Approved:

THE WHITE HOUSE,
April 2, 1964.

PRINCIPAL OFFICIALS OF
THE SMALL BUSINESS ADMINISTRATION
RESPONSIBLE FOR THE ADMINISTRATION
OF THE ACTIVITIES DISCUSSED
IN THIS REPORT

		<u>Tenure of office</u>	
		<u>From</u>	<u>To</u>
ADMINISTRATOR:			
Hilary J. Sandoval, Jr.	Mar. 1969	Present	
Howard J. Samuels	Aug. 1968	Feb. 1969	
Robert C. Moot	Aug. 1967	July 1968	
Bernard L. Boutin	May 1966	July 1967	
Vacancy (note a)	Sept. 1965	May 1966	
Eugene P. Foley	Aug. 1963	Sept. 1965	
ASSOCIATE ADMINISTRATOR FOR FI-			
NANCIAL ASSISTANCE (note b):			
Logan B. Hendricks (note c)	Nov. 1963	Present	

^a During this period, Mr. Ross D. Davis, Executive Administrator, assumed the duties of the SBA Administrator.

^b The title of this position was known as Deputy Administrator for Financial Assistance prior to January 1967.

^c Acting Deputy Administrator for Financial Assistance from November 1963 to August 1964.