



OFFICE OF
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July 16, 2007

Honorable Antonio R. Villaraigosa, Mayor
Honorable Rockard J. Delgadillo, City Attorney
Honorable Members of the City Council
c/o City Clerk's Office

**SUBJECT: AUDIT OF THE HOUSING DEPARTMENT'S LOAN
PORTFOLIO MANAGEMENT**

I am releasing the enclosed report entitled "Audit of the Housing Department's Loan Portfolio Management." A copy of this report was provided to the Los Angeles Housing Department.

If you have any questions or comments, please contact Farid Saffar, Director of Auditing at (213) 978-7392.

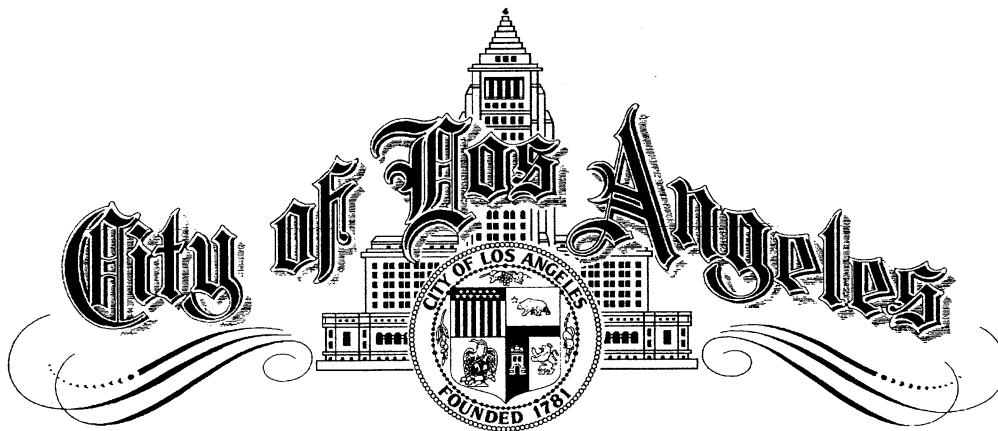
Sincerely,

A handwritten signature in black ink that reads "Laura N. Chick". The signature is written in a cursive, flowing style.

LAURA N. CHICK
City Controller

Enclosure





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July 16, 2007

Ms. Mercedes M. Marquez, General Manager
Los Angeles Housing Department
1200 W. 7th St., 9th Floor
Los Angeles, CA 90017

Dear Ms. Marquez:

Enclosed is a report entitled "Audit of the Housing Department's Loan Portfolio Management." A draft of this report was provided to you on May 25, 2007. Comments provided by your Department at the June 7, 2007 meeting were evaluated and considered prior to finalizing this report.

Please review the final report and advise the Controller's Office by August 16, 2007 on actions taken to implement the recommendations. If you have any questions or comments, please contact me at (213) 978-7392.

Sincerely,

FARID SAFFAR, CPA
Director of Auditing

Enclosure

cc: Robin Kramer, Chief of Staff, Office of the Mayor
Jimmy Blackman, Deputy Chief of Staff, Office of the Mayor
Helmi Hisserich, Deputy Mayor, Office of the Mayor
Karen L. Sisson, City Administrative Officer
Frank T. Martinez, City Clerk
Gerry F. Miller, Chief Legislative Analyst
Rev. William S. Epps, President, Affordable Housing Commission
Independent City Auditors





City of Los Angeles Office of the Controller

Audit of the Housing Department's Loan Portfolio Management

July 16, 2007

Laura N. Chick
City Controller

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AUDIT OF THE HOUSING DEPARTMENT'S LOAN PORTFOLIO MANAGEMENT

EXECUTIVE SUMMARY

The Office of the Controller's Auditing Division has completed an audit of the Los Angeles Housing Department's (LAHD or the Department) loan portfolio management. The objectives of this audit were to: (1) evaluate the LAHD's loan monitoring efforts and practices to determine whether adequate controls are in place to properly account for, monitor, record, and report its loan portfolio; (2) determine whether the collection and monitoring of loans comply with LAHD's and the City's policies and procedures, and applicable laws and regulations; (3) evaluate whether there is adequate litigation support to pursue delinquent borrowers, and; (4) evaluate LAHD's process for writing-off uncollectible amounts for reasonableness and for compliance with applicable laws and regulations.

Background

The Los Angeles Housing Department's mission is to provide safe and livable neighborhoods through the promotion, development, and preservation of decent and affordable housing for Los Angeles residents. To fulfill its housing development goals, the LAHD awards loans to qualified borrowers through its various loan programs funded by federal Community Development Block Grant (CDBG) funds and Home Investment Partnerships (HOME) funds, city-and state-issued Mortgage Revenue Bonds, various state grant programs, the City General Fund, redevelopment tax increment funds, and Department of Water and Power funds. As of June 30, 2006, LAHD had awarded approximately \$836 million in loans to over 4,500 borrowers since 1970.

The LAHD, through its Asset/Portfolio Management Division, services loans, monitors loan performance, and manages loan collections. Currently, the LAHD manages 4,450 loans with a total portfolio balance of over \$735 million. LAHD generates income from loan payments and loan pay-offs. Program income generated from loan repayments (including interest and related fees) was approximately \$44 million for Fiscal Year (FY) 2005-06 and \$40 million for FY 2004-05. Program income derived from repayments of CDBG loans is used to fund housing, economic development, social service, public facilities, and related administrative costs, while program income derived from repayments of HOME loans must be used exclusively to fund housing.

Scope

The audit was performed in accordance with General Accepted Government Auditing Standards and covered the period from July 1, 2004 to December 31, 2006. Fieldwork was conducted between October 2006 and February 2007. The scope of this audit did not include loan origination and occupancy monitoring.

Summary of Audit Results

The Department's role, as the City's Housing Agency, to provide affordable housing is very crucial. LAHD must recognize that proper oversight and monitoring of its loan portfolio is critical to ensure that repayments are maximized to help further the Department's goal of increasing affordable housing for the neediest residents of the City. The Department has fiduciary responsibilities and obligations to establish adequate controls to ensure repayment of loans awarded.

Overall, our audit found that LAHD needs to significantly improve its management controls to better manage its loan portfolio. The Department: 1) lacks reliable and useful financial information systems to evaluate, measure, and report its loan performance and to make sound decisions; 2) does not ensure borrowers comply with significant provisions of the loan covenants; and 3) does not have adequate oversight over its delinquent loans.

It should be noted that current management has recognized the need for improvement and has established some procedures that would help address some of the deficiencies identified in this report. For example, as a result of its new outreach efforts which started in 2005, the Department has attracted additional non-profit and for-profit affordable housing developers to the City. Relative to the residual receipt loans, in order to tighten controls over expenses, the Department capped the management fees that borrowers are allowed to deduct from income at \$10,000 per year. The management also recently approved an additional position for the Asset/Portfolio Management Division to monitor borrowers' compliance with key non-monetary loan provisions. Additional efforts need to be taken to strengthen controls over the management of the loan portfolio. Some of the key findings are as follows:

Key Findings

- **The Department's current loan portfolio has a high concentration of risk associated with a relatively few borrowers.**

Most financial and lending institutions have policies, whether formal or informal, relative to the institution's exposure to single borrowing entities or industries. These policies establish a criteria or methodology for analyzing and monitoring the concentration of risks to minimize the institution's exposure to the unexpected failure of a single borrower, or a significant downturn in a particular industry.

LAHD does not have any formal or informal policy for reviewing and analyzing the concentration of its loan risks. Our analyses of LAHD's portfolio as of June 30, 2006, showed a high concentration of loan risk among a few borrowers. Of the \$323 million awarded to 74 developers (and their affiliates), 30 borrowers received multiple loans totaling approximately \$240 million, 74% of the total funds awarded. The outstanding balance of \$203 million from these borrowers represents 28% of the \$735 million portfolio loan receivable balance. The fact that twenty of these borrowers are in default and the laxness of the Department's monitoring efforts (as discussed throughout this report) greatly increases the risks in LAHD's loan portfolio.

By concentrating its risk in a few borrowers, the Department's losses are likely to be greater if these borrowers defaulted. In fact, we found that one developer was awarded 23 different loans in 1994 as part of neighborhood preservation projects. The Department lost approximately \$3.6 million when this borrower defaulted. LAHD's losses could have been minimized if the loans were awarded to more borrowers. It should be noted that, over the last five years, the Department has added new developers through its outreach efforts. We encourage LAHD to continue its efforts to increase the pool of qualified developers. A wider pool of developers to work with, combined with stringent underwriting criteria, should help minimize the Department's losses from unexpected failure of any single borrower or entity.

- **LAHD awarded new loans to borrowers who were already in default on their other loan agreements with the Department or the City's Community Redevelopment Agency.**

In January 2003, the Council approved a "cross default" monitoring policy to protect the City from uncooperative borrowers. The policy, which was proposed by LAHD as part of its "new business" practice, authorized LAHD's General Manager to preclude borrowers and their related entities from accessing LAHD's lending or bond programs, if the borrower is non-compliant with existing loan obligations (either monetary or non-monetary) with LAHD.

LAHD does not follow this policy. Our review of the delinquent accounts disclosed that some borrowers who were in default either monetarily or non-monetarily received new loans from LAHD. Between 2000 and December 2006, we noted six borrowers who were already in default that were awarded new loans totaling approximately \$16 million. Another borrower, also already in default with the City's Community Redevelopment Agency, was awarded \$2 million in new loans in November 2006. This indicates that City agencies do not currently share default information. City agencies should share default information to preclude borrowers already in default on their existing obligations from accessing further assistance from the City until the default is cured.

- **LAHD did not enforce its loan default and collection procedures and did not adequately pursue delinquent borrowers.**

Effective loan monitoring procedures should include timely enforcement and follow-up of loans in default to ensure collections. The older the accounts stay in default the harder they are to collect. As of June 30, 2006, the Department's records show that there were 558 loans (316 monetary and 242 non-monetary) in default amounting to \$28 million that were delinquent for over 30 days. LAHD's monitoring guidelines dictate that the first late notice letter be mailed to delinquent borrowers within 15 days of delinquency. The Department indicated that the delinquent letters are automatically generated from its Loan Tracking System (LTS) at the intervals stipulated. For 80% (8 of 10) of delinquent loans tested, we noted that delinquent letters were sent more than two years after the borrowers had defaulted. These eight loans are worth about \$10 million. The Department indicated that the errors were due to systems limitations.

In addition, the Department was unable to provide evidence that it adequately followed up with the City Attorney's Office and other involved parties on loans in probate, bankruptcy, litigation, foreclosures and loan work-out arrangements (e.g., restructures, amendments) to afford a relevant and timely disposition of these problematic loans. Although, these loans were referred to the City Attorney for collection efforts, we saw no evidence that the Department continued to monitor to ensure timely disposition of these loans. At the time of our fieldwork, LAHD had 101 loans worth approximately \$34 million in these categories. Some of these loans had been in their status for two to six years. The Department indicated that, subsequent to our fieldwork, it has resolved 59 of these loans.

- **LAHD has a backlog of over 700 financial statements submitted by residual receipt borrowers that it needs to review. The backlog could be costing the Department millions in residual receipt income that could be used to help further its mission and goals.**

The loan agreements require residual receipt borrowers to submit annual financial statements to LAHD. The financial statements must be prepared by a Certified Public Accountant in accordance with Generally Accepted Accounting Principles. LAHD reviews the financial statements submitted by borrowers and prepares residual receipt analyses to determine if any residual payment is due from the borrowers.

Over the last two years, LAHD staff reviewed 245 financial statements, which generated over \$1.7 million in residual receipt income billed to the borrowers, an average of \$6,939 per financial statement reviewed. As of the time of our fieldwork, the Department had a backlog of over 700 financial statements that needed to be reviewed. There were an additional 200 annual financial statements that were due for submission by the residual receipt borrowers that had not been submitted.

Based on the Department's residual income over the last two years, the backlog translates to an estimated potential income of over \$6 million.

- **The Department has a total of \$5.7 million in loans that cannot be identified to specific borrowers.**

The Department indicated that the loan files were either lost or misplaced during the Department's transition from the Community Development Department over fifteen years ago. The amount has remained a reconciling item since then and is reflected in the gross receivable amount reported in the City's Comprehensive Annual Financial Report (CAFR).

Since the Department has no identifying information to post the loans, the LTS does not have any loan receivable relating to these loans. Staff sets-up a receivable only if a payment is received or when the borrower requests a payoff. Through these means, LAHD has recorded 10 loans for about \$3 million since 2001. However, there is no assurance that all payments of this type are posted to the LTS. LAHD needs to research and resolve the issues relating to these loans. If it is unable to resolve the discrepancy, the Department should seek Council approval to write-off the amount. If the amounts are written-off, the Department should maintain the funding source records, so that it can post all subsequent collections, if any, accurately.

The details of these and other findings are discussed in the findings and recommendations section of this report.

Review of Report

A draft report was provided to LAHD management on May 25, 2007. We discussed the contents of the report with Department management on June 7, 2007. The Department concurred with the findings and recommendations. We considered the Department's comments before finalizing this report. As previously indicated, management has recognized the need for improvement and has indicated its commitment to address the report's findings and recommendations. We would like to thank LAHD management and staff for their cooperation and assistance during the audit.

TABLE of RECOMMENDATIONS

RECOMMENDATIONS	PAGE REFERENCE
Section I. Concentration of Loan Risks and Write-offs	15
<p style="text-align: center;">LAHD management should:</p> <ol style="list-style-type: none"> 1. Continue its outreach efforts to increase the pool of qualified developers by developing formal outreach program. Efforts should include developing current less experienced developers as well as attracting new developers to apply for projects in Los Angeles. 2. Develop a policy to periodically analyze and monitor the concentration of its loan portfolio to minimize exposure from the unexpected failure of any single borrower or entity. 3. Continue to ensure that an equity or profit sharing clause is included in all its homebuyers' agreements where it provides funding for the homebuyer to acquire the property. 	
Section II. Monitoring of Delinquent Loans	21
<p style="text-align: center;">LAHD management should:</p> <ol style="list-style-type: none"> 4. Preclude borrowers who are in default from receiving new loans, as directed by the Council. Policies should include verifying borrowers' default history before a commitment letter is issued and also before final approval/disbursements. 5. Share default information with the Community Development Department, the Community 	

RECOMMENDATIONS	PAGE REFERENCE
<p>Redevelopment Agency and other pertinent agencies to ensure that borrowers who are non-compliant with any of their existing loan obligations do not receive new loans.</p> <ol style="list-style-type: none"> 6. Ensure that its new Housing Information System (HIMS) has a functionality or mechanism to automatically generate delinquent letters on loans in default. 7. In consultation with the City Attorney, identify and assess the probability of collecting amounts owed on loans that have been in probate, litigation, or bankruptcy for more than five years. 8. Recommend for write-off any amounts found in recommendation #7 to be uncollectible. 9. Identify borrowers who may have defaulted on their property taxes, ensure these borrowers are up to date on their taxes and/or take appropriate actions to protect the City's interests in case of a tax sale. 10. Complete the database to monitor insurance policies. The database should include a mechanism to alert staff when an insurance policy on a property is about to expire. 11. Periodically monitor the borrowers' legal entity status to ensure any changes do not affect the Department's ability to protect its investments. 12. Ensure that Portfolio Management Division's Director reviews and approves all subordinated loans. 	

RECOMMENDATIONS	PAGE REFERENCE
Section III. Monitoring of Annual Reports and Financial Statements	26
<p>LAHD management should:</p> <ol style="list-style-type: none"> 13. Develop a mechanism to identify and prioritize financial statements with residual receipts for review. Consider adding temporary resources to eliminate the backlog. 14. Consider implementing a rotation review cycle of the financial statements. The Department should work with the City Attorney’s office to modify the language in its agreements to allow for the flexibility to review the financial statements within the rotation cycle it adopts. 15. Seek assistance from the City Attorney to modify future, and, if possible, the existing agreements to incorporate the additional information to afford a detailed review of the financial statements. 16. Develop a mechanism to monitor its service paybacks and forgivable loans to ensure agreed upon social services, a condition for receiving forgivable loans, are being provided. 17. Revise its methodology for estimating the allowance for uncollectible loan receivable to reflect its current collection data. 	

RECOMMENDATIONS	PAGE REFERENCE
Section IV. The Loan Tracking System (LTS)	32
<p>LAHD management should:</p> <ol style="list-style-type: none"> 18. Ensure that its new Housing Information Management System has the capability to compound, accrue and accurately report interest for all its loan types and to generate pertinent loan reports. 19. Research and resolve issues relating to the \$5.7 million in loans that cannot be identified to specific borrowers. If unable to resolve, seek Council approval to write-off the amount so it can remove the amount from its books. 20. Require its Accounting Division to verify that all loans, once funded, are properly coded in the loan tracking and monitoring system. 	

BACKGROUND AND METHODOLOGY

Background

History and Mission

The Los Angeles Housing Department (LAHD or the Department) was established to provide for coordination, management, direction and operation of programs previously assigned to the Housing and Rent Stabilization Divisions of the Community Development Department and to provide for planning, coordination, direction and management of all other housing and rent control matters.

The Department's mission is to provide safe and livable neighborhoods through the promotion, development and preservation of decent and affordable housing. LAHD also performs routine periodic inspections of all rental housing except single-family homes, and possesses the police powers to enforce the City's rental housing laws.

Programs, Activities and Funding

LAHD has three program areas- Housing Development, Rent Stabilization and Code Enforcement. For fiscal year 2006-07, these programs are funded by Community Development Block Grant (CDBG) funds, Home Investment Partnership funds (HOME), the City General Fund, Community Redevelopment Agency funds (CRA), Department of Water and Power funds (DWP), HUD grants, the Municipal Housing Finance Fund, Housing Opportunities for Persons with Aids (HOPWA) funds, and State Proposition 46 grants (e.g., Workforce Housing, Cal-Home, Building Equity & Growth in Neighborhoods and EAGR grants). The LAHD has an adopted Fiscal Year (FY) 2006-07 budget of \$45 million and the Department employs over 400 employees.

The Housing Development program provides, manages, and monitors loans to property owners to increase and improve affordable housing, through home buyer, rehabilitation, and new construction programs.

The Rent Stabilization program administers the Rent Stabilization Ordinance, collects annual registration fees from landlords, approves rent adjustments, operates the rent stabilization telephone hot line and investigates complaints of ordinance violations.

The Code Enforcement program provides routine periodic inspections of all multifamily rental properties in the City for basic code enforcement and habitability and responds to tenant complaints of potential code violations.

Overview of the Asset/Portfolio Management Division

The Asset/Portfolio Management Division (PMD) services all loans, monitors loan performance, and manages loan collections. As of June 30, 2006, PMD manages 4,450 loans with a total loan portfolio balance of over \$735 million. It generates income annually from both monthly loan payments and loan pay-offs. Program income generated from loan repayments was approximately \$40 million in FY 2004-05 and \$44 million in FY 2005-06.

The Housing Department has a diverse portfolio ranging from single-family mortgages to residual receipts loans for major low to moderate-income housing projects. Generally, loans and other types of financial assistance are grouped into different categories by loan types as follows:

Type 1 - Deferred Loans

Deferred loans are those for which no payments are required until the property is sold or transferred. For example, soft second loans to first-time homebuyers are often deferred (i.e., no payments are required until the home is sold or transferred). This allows more of the homebuyer's monthly cash flow to be directed to first mortgage payments, making the home more affordable to families. In essence, because no payment is required on LAHD's loan, the homebuyer is able to qualify for a larger home loan.

Type 2 - Principal Only Loans

Principal only loans are generally offered at zero percent interest, but monthly principal payments are required to amortize (pay down) the loan balance over the life of the loan. These loans are generally offered for single-family rehabilitation where the low-income owners could not afford interest payments.

Type 3 - Principal and Interest Loans

Principal and interest loans are structured like traditional mortgages with all accrued interest and a portion of the principal paid every month. These loans typically amortize (are paid down) in full over the life of the loan. This type of loan structure is typically used for second mortgage loans provided through the rehabilitation programs.

Type 5 - Service Payback Loans

Service payback loans involve advancing funds, typically to a social service agency, in the form of a loan. The loan is "repaid" through the provision of services, at an agreed-upon rate or to an agreed-upon number of clients, over a period of time. The social service agencies provide an annual accounting of the services provided in return for which the Department writes-down a portion of the

loan balance. LAHD inherited these loans from the Community Development Department (CDD) and it no longer originates these types of loans.

Type 6- Forgivable Loans

Forgivable loans are structured such that funds are advanced for a particular purpose. If the borrower fulfills the purpose, then the loan is written-down until it is completely written-off. If the borrower is unable to fulfill the purpose, then the funds must be repaid. LAHD also inherited these loans from the CDD and no longer originates these types of loans.

Type 7- Construction Bridge Loans

Construction bridge loans are loans that are outstanding while a project is under construction. These loans are typically offered for Affordable Housing Trust Fund projects. Maturities are typically two years or less. They are often converted upon project completion to residual receipts loans.

Type 8- Residual Receipts Loans

Residual receipts loans are loans that are offered for large rental projects. They do not require fixed payment amounts. Payments are required only to the extent the project generates excess cash flow. Residual receipts loans are typically offered by municipalities for affordable housing developments since the cash flow generated by low rent payments is generally not sufficient to support large mortgage payments. Because they are usually for large scale projects, the dollar value of these loans account for high percentage of the Department's loan portfolio. As of June 30, 2006, residual receipt loans comprised approximately 57% of the \$728 million total portfolio balance.

Type 9- Renewable Deferred Loans

Renewable deferred loans are short-term loans that have no payments due until the maturity date of the loan. These loans can be extended, at the Department's option, if the borrower meets specified terms.

Type 10- Term Loans

Term loans have no payments due until a set maturity date. All principal and accrued interest is due and payable on the maturity date.

Type 11- Equity Share

Equity share loans include LAHD receiving a portion of any appreciation upon sale of the property. The Department's current management started the current equity share loan programs in April 2005.

The following table shows the types of loans, aggregate amount of each type and percentage of portfolio.

TABLE 1
COMPOSITION OF LOANS IN THE LAHD'S LOAN PORTFOLIO
As of June 30, 2006.

Loan Type	Loan Description	Number of Loans	Dollar Value of Loans	%(Number of loans)	%(Dollar Value)
1	Deferred Loan	1,796	\$51,721,481	40%	7%
2	Principal Payments Only	896	114,625,896	20%	16%
3	Principal and Interest	214	17,592,430	5%	2%
5	Service Payback	20	9,280,304	0%	1%
6	Forgivable Loans	148	940,063	3%	0%
7	Construction Bridge	7	6,544,769	0%	1%
8	Residual Receipts	289	417,259,288	6%	57%
9	Renewable Deferred	110	16,093,946	2%	2%
10	Term Loan	748	85,172,728	17%	12%
11	Equity Share	222	9,686,174	5%	1%
Total		4,450 loans	\$728,917,079 ¹		

Source: The Department's Loan Tracking System (LTS)

Objectives, Scope and Methodology

The main objectives of this audit were to evaluate the LAHD's loan monitoring efforts and to determine whether the monitoring and collection of loans comply with applicable laws and regulations. The specific objectives included the following:

- Evaluate the LAHD's loan monitoring efforts and practices to determine whether adequate controls are in place to properly account for, monitor, record, and report its loan portfolio.

¹ This total does not include the \$5.7 million in loans that are not reflected in the Loan Tracking System. See page 33 for a discussion of this reconciling item.

- Determine whether the collection and monitoring of loans comply with LAHD's and the City's policies and procedures, and applicable laws and regulations.
- Evaluate whether there is adequate litigation support to pursue delinquent borrowers.
- Evaluate LAHD's process for writing-off uncollectible amounts for reasonableness and for compliance with applicable laws and regulations.

The scope of this audit included LAHD's loan monitoring efforts for the period July 1, 2004 to December 31, 2006. Our scope did not include loan origination or occupancy monitoring. To meet our audit objectives, we performed the following procedures:

- Interviewed LAHD staff involved in loan monitoring and loan collection.
- Reviewed the PMD's loan monitoring guidelines.
- Reviewed a sample of borrowers' financial statements and residual receipt analyses performed by the Department staff for accuracy, timeliness and proper disposition in accordance with the Department's guidelines.
- Reviewed LAHD's management reports related to loans to evaluate the effectiveness of loan monitoring efforts including collections.
- Reviewed sample loan agreements to identify key compliance terms in the agreement.
- Tested sample loan files for evidence of compliance by the borrowers with the key terms of the loan agreement.
- Analyzed other loan related reports and documents to determine LAHD's compliance with its policies and procedures, and applicable laws and regulations.

The remainder of this report details our findings, comments and recommendations.

AUDIT FINDINGS AND RECOMMENDATIONS

Section I. Concentration of Loan Risks and Write-offs

Concentration of Loan Risks

Concentrations of credit exposure can pose risks to the financial health of any lending institution in the form of unexpected losses. While risk concentrations can occur almost anywhere within a financial institution's loan portfolio, monitoring and limiting such concentrations should be an integral part of an effective credit risk management program.

Most financial and lending institutions have policies, whether formal or informal, relative to the institution's exposure to single borrowing entities or industries. These policies establish a criteria or methodology for analyzing and monitoring the concentration associated with single or few borrowers to minimize the institution's exposure to the unexpected failure of any single borrower, or a significant downturn in a particular industry.

Finding #1: LAHD does not have a formal policy to evaluate the concentration of risks in its loan portfolio. The Department's current loan portfolio has a high concentration of risk associated with relatively few borrowers.

LAHD does not have a formal or informal policy for reviewing and analyzing the concentration of its loan risks. In order to understand LAHD's concentration of credit exposure, we obtained a database of all loans in the Department's Loan Tracking System (LTS) for analyses. The purpose of the analyses was to determine whether the portfolio was properly diversified among borrowers to minimize risks in case of unexpected losses.

Our analyses showed that, as of June 30, 2006, of the approximately \$836 million awarded since inception, thirty borrowers were awarded multiple loans totaling approximately \$240 million. The balance owed by these borrowers was \$203 million, approximately 28% of the Department's \$735 million June 30, 2006 gross loan receivable balance. These thirty borrowers with multiple loans are identified as developers in the Department's LTS. The LTS database identified an additional 44 borrowers (and affiliates) as developers, for a total of 74 developers. The amount awarded to the 74 developers/borrowers and their affiliates was \$323 million. Table 2 below shows the loan amounts for the thirty borrowers in relation to all developers as well as the total portfolio.

TABLE 2
CONCENTRATION OF RISK IN DEVELOPER BORROWERS WITH MULTIPLE LOANS
 (Total Portfolio)

Description	Number of Borrowers	As of June 30, 2006
Loans awarded to borrowers (and affiliates) identified as developers.	74	\$323 million
Loans awarded to top 30 (and affiliates) borrowers with multiple loans.	30	\$240 million
Loan receivable balance for the 30 developers/borrowers.	30	\$203 million
Balance owed by the 30 developer/borrowers as a percentage of total loan portfolio balance.		28%
Amounts awarded to the 30 borrowers with multiple loans as a percentage of all developers (since inception).		74%

Source: The Department's Loan Tracking System (LTS)

The fact that some of these borrowers are in default on their obligations along with the inadequacy of the Department's loan monitoring procedures (as discussed throughout this report) increases the risk in the Department's loan portfolio. By concentrating its risk in a few borrowers, the Department's losses are likely to be greater if these borrowers defaulted. In fact, the Department lost \$3.6 million awarded to one borrower in 1994 for 23 neighborhood preservation projects when the borrower defaulted. If the loans had been awarded to multiple borrowers, the Department could have minimized its losses.

During our discussions with the Department, management indicated that, over the last five years, it has implemented programs and outreach efforts to increase participation of non-profit and for-profit developers. At the request of the Department, we extracted data for the last five years for comparison with the total portfolio. The table below shows the results.

TABLE 3
CONCENTRATION OF RISK IN DEVELOPER BORROWERS WITH MULTIPLE LOANS
 (Loan Awards Made From July 2002 – June 2006)

Description	Number of Borrowers	July 2002 to June 2006
Loans awarded to borrowers identified as developers (July 2002-06).	71	\$197 million
Loans awarded to borrowers/developers with multiple loans (July 2002-06).	20	\$97 million
Amounts awarded to developers/borrowers with multiple loans as a percentage of awards to all developers (July 2002-06).		49%

Source: The Department's Loan Tracking System (LTS)

As indicated in Table 3, 49% of loan awards made to developers between July 2002 and June 2006 is concentrated in 20 borrowers. While the data still suggest a high concentration of risk in a few borrowers, it shows an improvement over the 74% in the total portfolio (in Table 2). We noted several loans were awarded to new developers. This suggests that the Department's outreach efforts to increase the number of developers may be working.

We recognize the Department's intent to utilize only highly experienced developers with excellent track records in its affordable housing developments. We also agree with the Department that it is unacceptable to utilize developers who lack the financial and managerial capacity to complete developments, just to attempt to diversify. Therefore, we believe the Department should continue its efforts to increase its pool of qualified developers, by attracting new developers through formal outreach programs and by developing its current inexperienced developers. A wider pool of qualified developers combined with stringent selection and underwriting criteria would help minimize the exposure to losses due to unexpected failure of any single borrower.

Recommendations:

LAHD management should:

- 1. Continue its outreach efforts to increase the pool of qualified developers by developing formal outreach programs. Efforts should include developing current less experienced developers as well as attracting new developers to apply for projects in Los Angeles.**
- 2. Develop a policy to periodically analyze and monitor the concentration of its loan portfolio to minimize exposure from the unexpected failure of any single borrower or entity.**

Write-Offs

The LAHD Hearing Committee has the authority to approve the write-off of loan amounts determined to be uncollectible due to third party foreclosures, bankruptcies, short pay settlements, and housing development loans in excess of current market property values.

We reviewed the loan amounts written-off within the last two fiscal years to determine whether the amounts were properly approved and that the Department had exhausted reasonable collection efforts. For the two years, LAHD wrote-off a total of approximately \$1.5 million in loans. Of this amount, \$1.4 million was owed by a single borrower/developer, Tupper Tobias, LLC, as a result of the housing development loans in excess of sales proceeds. However, we questioned how the sale prices for the homes were determined as discussed below.

Finding #2: It is questionable whether LAHD exercised proper discretion in determining the price of the homes in the Tupper Tobias single-family home project.

In June 1998, the City Council approved a loan for the Tupper Tobias Village development project located at Tobias Avenue in Panorama City. LAHD awarded approximately \$2.8 million to the developer, Tupper Tobias, LLC, for land acquisition, predevelopment and development of 14 single family homes to be sold to low income homebuyers. The project also included a child care facility. The proceeds from the home sales were to be used to pay-off the loan. The homes were supposed to be completed and sold in 2001. Based on the development costs and the anticipated value of the homes, the sale price was initially set at \$148,000 per unit.

However, the developer ran into financial difficulties and was unable to complete all the homes as originally anticipated. In 2001, the Department sought Council approval to increase the loan amount by \$400,000 in order to enable the developer to complete the project. The Department also obtained Council approval to increase the selling price to the appraised/fair market value of \$182,000 per unit, as determined by an independent

appraisal. In its communication to the Council, the Department indicated that the increase in the selling price to the fair market value was essential to maintain the market value of the housing stock in the neighborhood and that it believed that a below market price could economically undermine the market value of the homes in the surrounding community.

The developer, despite receiving the additional funding, was still unable to complete the sale of all these homes until 2005. LAHD's and the County Assessor's records show that only one home was sold in 2001 as originally anticipated. The remaining homes were sold between 2003 and 2005. The table below shows when each home was sold and for how much.

**TABLE 4
TUPPER TOBIAS SINGLE-FAMILY HOME PROJECT
SALES HISTORY**

Unit	Date First Sold	Original Sales Price	Subsequently Sold? Date Sold	Subsequent Sales Price
1	11/07/01	\$169,000	Yes- sold 05/05/05 & 11/02/06	\$479,900 & \$610,006
2	02/06/04	\$ 210,002	No	N/A
3	09/10/03	\$ 182,000	Yes- sold 04/06/04 & 05/01/06	\$348,000 & \$490,004
4	08/11/05	\$ 182,001	No	N/A
5	09/08/05	\$ 182,000	No	N/A
6	08/24/05	\$ 182,001	No	N/A
7	10/14/05	\$ 195,001	No	N/A
8	09/08/05	\$ 182,001	No	N/A
9	11/25/03	\$ 182,001	No	N/A
10	08/24/05	\$ 182,000	No	N/A
11	04/19/04	\$ 182,001	No	N/A
12	08/17/05	\$ 182,001	No	N/A
13	10/05/05	\$ 182,000	No	N/A
14	07/29/05	\$ 210,002	No	N/A

Source: County Assessor's Records

As indicated in the table, nine out of the 14 homes were sold in 2005. The homes were sold for the 2001 appraised values. Based on the updated independent appraisals conducted for LAHD in 2005, each unit was valued at \$430,000. As indicated below, one of the earlier buyers resold in 2005 for \$479,900, which was 184% more than the original sales price of \$169,000.

Because the developer incurred more construction costs than was initially estimated, the proceeds generated from the homes were not enough to cover the increase in development costs. As a result, the Department wrote-off the difference of approximately \$1.4 million. Although the Department is authorized to write-off

development costs in excess of sales prices, we believe if the Department had adjusted the sale price closer to the market value, the shortfall could have been avoided and the write-off would have been unnecessary.

Furthermore, while LAHD provided soft second and third loans to help most of the homebuyers acquire these properties, it did not benefit from the appreciation in property values because the loan agreements did not include an equity sharing clause. The County Assessor's records show that two of the original buyers resold their properties for a substantial profit.

One homebuyer, who purchased one of the homes in 2003 for \$182,000 sold the home within six months for \$348,000 and realized a profit of \$166,000. Another buyer who purchased a home in 2001 for \$169,000 sold in 2005 for \$479,900, a profit of \$310,900. The Department should have shared in the equity of homes it helped purchase. For example, in these two cases, if the Department had included a 20% equity sharing clause in its agreements, it could have generated additional revenue of \$95,380 {(\$166,000 plus \$310,900) multiplied by 20%}.

The Department indicated that it could not adjust the sale price because the homebuyers had already signed their purchase agreements and were therefore locked into the price in 2001. However, we reviewed the agreements provided and noted that only three were actually signed in 2001. Seven were signed in 2002 and three were signed in 2003. LAHD was not able to provide the purchase agreement for the remaining one home.

With respect to equity sharing, the Department's current management implemented an equity sharing program in April 2005 and now includes sharing clauses in all its assisted homebuyer programs. LAHD generated approximately \$600,000 in equity sharing from ten homebuyers who sold their properties since 2005.

Recommendation:

- 3. LAHD management should continue to ensure that an equity or profit sharing clause is included in all its homebuyers' agreements where LAHD provides funding for the homebuyer to acquire the property.**

Section II. Monitoring of Delinquent Loans

As of June 30, 2006, the Department's records showed that there were 558 loans (316 monetary and 242 non-monetary) in default amounting to \$28 million that were delinquent for over 30 days.

Finding #3: LAHD awarded approximately \$16 million in loans to borrowers who were already in default on their other loan agreements with the Department, in violation of its "new business" practice. Another borrower, already in default with the City's Community Redevelopment Agency was awarded \$2 million in new loans.

Effective loan portfolio management should include monitoring delinquent loans to ensure that borrowers who are in monetary and/or non-monetary defaults do not receive new loans until the defaults from prior loans have been cured.

In January 2003, the Council approved a "cross default" monitoring policy to protect the City from uncooperative borrowers. The policy, which was proposed by LAHD as part of its "new business" practice, authorized LAHD's General Manager to preclude borrowers and their related entities from accessing LAHD's lending or bond programs, if the borrower is non-compliant with existing loan obligations (either monetary or non-monetary) with LAHD.

The Council also requested that the Community Redevelopment Agency (CRA), the Housing Authority, and other pertinent agencies report back on the inclusion of the "cross default" policy to their respective lending and bond programs. The primary purpose of the "cross default" policy is to reduce the loan delinquency rate. The policy was intended to have these agencies detect borrowers who are in default on any of their obligations with the City and prevent them from receiving additional financial assistance until the default is cured.

Our review of the delinquent accounts disclosed that some borrowers who were in default either monetarily or non-monetarily received new loans from LAHD. Between 2000 and December 2006, we noted six borrowers who were already in default were awarded new loans totaling approximately \$16 million. Of this amount, \$8 million was awarded in 2006, which was in violation of its default policy. Another borrower, also already in default with the CRA, was awarded \$2 million in new loans in November 2006. This indicates that these agencies do not currently share default information.

The Department indicated that the breakdown occurred between the dates it issued the commitment letters and the dates the loans were funded. The Department maintained that it has a process in place to ensure that the commitment letters are not issued to defaulted borrowers. However, once the commitment letter is in place, staff does not always check the default listings before the loan is disbursed.

We requested the commitment letters for the loans in question. LAHD was able to provide commitment letters for four of the six loans. We checked the dates on the letters against the Department's delinquent listings to determine whether these borrowers were already in default on the dates the Department issued the commitment letters. The comparison showed that these borrowers were already in monetary and/or non-monetary default with their existing loans when the commitment letters were issued.

Even if the borrowers were not in default before the commitments, since the lag in time between the commitments and final disbursements could be as long as a few years, the Department should have rechecked the borrowers' default history before final disbursements to ensure that the borrowers were still in good standing. Most lending institutions perform this procedure as a standard practice. By awarding new loans to delinquent borrowers, the Department may be sending a message that enforcing its loan terms to protect public funds is not a priority since defaulted borrowers who received new loans are more likely to default again.

Recommendations:

LAHD management should:

- 4. Preclude borrowers who are in default from receiving new loans, as directed by the Council. Policies should include verifying borrowers' default history before a commitment letter is issued and also before final approval/disbursement.**
- 5. Share default information with the Community Development Department, the Community Redevelopment Agency and other pertinent agencies to ensure that borrowers who are non-compliant with any of their existing loan obligations do not receive new loans.**

Finding #4: LAHD did not enforce its loan default and collection procedures and did not adequately pursue delinquent borrowers.

Of the 558 loans in default as of June 30, 2006, 23 loans, totaling approximately \$3.5 million were delinquent for more than 10 years. The Department has initiated foreclosures on collateral properties for only four of the 23 loans. Effective loan monitoring procedures should include timely enforcement and follow-up of loans in default to ensure collections. The older the accounts stay in default the harder they are to collect.

LAHD's monitoring guidelines dictate that delinquent letters be mailed to borrowers who are in breach of their agreement to pay. The policies require that the first late notice letter be mailed to the borrower within 15 days of delinquency.

We selected 10 delinquent loans to determine whether LAHD had initiated appropriate and timely collection efforts in accordance with its policy. For 80% (8 of 10) of delinquent loans tested, we noted that delinquent letters were sent more than two years after the borrowers had defaulted. These eight loans are worth about \$10 million. The Department indicated that the delinquent letters are automatically generated from its Loan Tracking System. The Department determined that the delays in sending out delinquent letters were due to systems limitations.

Furthermore, the Department could not provide evidence that LAHD adequately followed up on loans in probate, bankruptcy, litigation, foreclosures and loan work-out arrangements (e.g., restructures, amendments) to afford a relevant and timely disposition of these problematic loans. Although, these loans were referred to the City Attorney for collection efforts, we saw no evidence that the Department continued to monitor to ensure timely disposition of these loans. LAHD currently has 101 loans worth approximately \$34 million in these categories. Some of these loans have been in their current status for two to six years. Past delays in enforcement may reduce the Department's ability to collect these funds. Subsequent to our fieldwork, the Department indicated that, in conjunction with the City Attorney's Office, it has resolved 59 of the 101 loans in these categories.

Recommendations:

LAHD management should:

- 6. Ensure that its new Housing Information System (HIMS) has a functionality or mechanism to automatically generate delinquent letters on loans in default.**
- 7. In consultation with the City Attorney, identify and assess the probability of collecting amounts owed on loans that have been in probate, litigation, or bankruptcy for more than five years.**
- 8. Recommend for write-off any amounts found in recommendation #7 to be uncollectible.**

Finding #5: LAHD does not have mechanisms to monitor compliance with the insurance requirements, payment of taxes and changes in legal entity statuses.

We reviewed a sample of loan files to determine whether the Department has mechanisms in place to adequately monitor key loan non-monetary covenants such as insurance, tax delinquencies and legal entity statuses. The Department's monitoring of these key covenants is inadequate. We noted the following:

Insurance Policy

LAHD's loan approval and funding is subject to evidence of insurance (as determined by its loan origination staff) sufficient to protect the City's interest in collateral property. Each borrower is required to list the City of Los Angeles Housing Department as the Loss Payee on the insurance policy. As the Loss Payee, the Department is expected to be notified by the insurance company if the borrower fails to renew an expired policy. LAHD guidelines require the PMD to ensure borrowers continue to maintain adequate insurance coverage for the properties that secure their loans. We found that PMD does not monitor to ensure that borrowers continue to maintain adequate insurance coverage. Seventy-one of the 77 (92%) samples tested did not have proof of a current insurance policy on file.

Tax Lien

Delinquent property taxes become liens against real property with priority over trust deed (loan) liens. If these taxes are of a significant amount, the City's loan could be in jeopardy. LAHD requires that the PMD, on an annual basis, compare loan data with the County's assessor's data to identify accounts with delinquent property taxes. The policies further require that borrowers with delinquent taxes be considered in breach of their loan agreement and be given 30 days to cure the breach or pay the loan. We did not see any evidence that these monitoring policies are being followed. We performed a comparison of loan data to the assessor's property tax data for 74 borrowers. Of the 74 borrowers, 10 (14%) had defaulted on their property taxes and may be at risk for a tax sale.

Legal Entity Status

LAHD does not monitor the legal entity status of its borrowers to determine if these statuses have changed. We verified statuses of a sample of the Department's borrowers by checking the Secretary of State's records. Two of the samples tested showed that the borrowers/entities were either dissolved, canceled or had merged with another entity. The Department's records did not reflect these changes.

Because the loans are secured by the real estate properties, inadequate or lack of insurance coverage could hamper the City's ability to recover its investments in the event of fire or natural disasters. The properties with tax liens may be at risk of future loss due to a tax sale. In addition, without knowing about legal entity changes, it may be difficult to enforce loan provisions.

According to the PMD, the Department has not been monitoring taxes, insurance and changes in legal entity status because of staffing shortages. In October 2006, the PMD added one staff to monitor the insurance, property taxes and changes in legal entity status. Currently, the PMD is working with LAHD's Systems group to develop a

database of properties that will assist the Department in monitoring borrowers' compliance with the annual insurance requirements and the requirement that they be current on their property taxes.

Recommendations:

LAHD management should:

- 9. Identify borrowers who may have defaulted on their property taxes, ensure these borrowers are up-to-date on their taxes and/or take appropriate actions to protect the City's interests in case of a tax sale.**
- 10. Complete the database to monitor insurance policies. The database should include a mechanism to alert staff when an insurance policy on a property is about to expire.**
- 11. Periodically monitor the borrowers' legal entity status to ensure any changes do not affect the Department's ability to protect its investments.**

Finding #6: Subordinated loan files tested did not contain evidence of authorization by the Portfolio Management Division, as required.

Any amendments, assumptions, or subordinations should always be in the public's best interest and follow LAHD's policies. For fiscal year ending June 30, 2006, there were 63 loans amounting to approximately \$18 million that were subordinated by LAHD. Subordination is an agreement which allows the borrower to obtain a new loan with a trust deed position that is superior to the City's position.

We reviewed five loans that were recently subordinated to determine whether the Department complied with its existing policies and whether the subordinations were in the City's best interest. For the most part, staff followed the Department's existing policy. However, we noted a lack of proper authorizations by the Director of PMD. The Department's guidelines state that each subordination agreement will be reviewed and approved by the Director of PMD. Two of the five subordinated loans tested did not contain evidence of appropriate authorizations from the PMD's Director, as required. Although another senior manager signed one of the subordination agreements, since the PMD Director is responsible for loan management and is likely to be more familiar with the status of each loan, the PMD Director should have also reviewed and signed the agreement, as required by the Department's policy.

Recommendation:

- 12. LAHD management should ensure that Portfolio Management Division's Director reviews and approves all subordinated loans.**

Section III. Monitoring of Annual Reports and Financial Statements

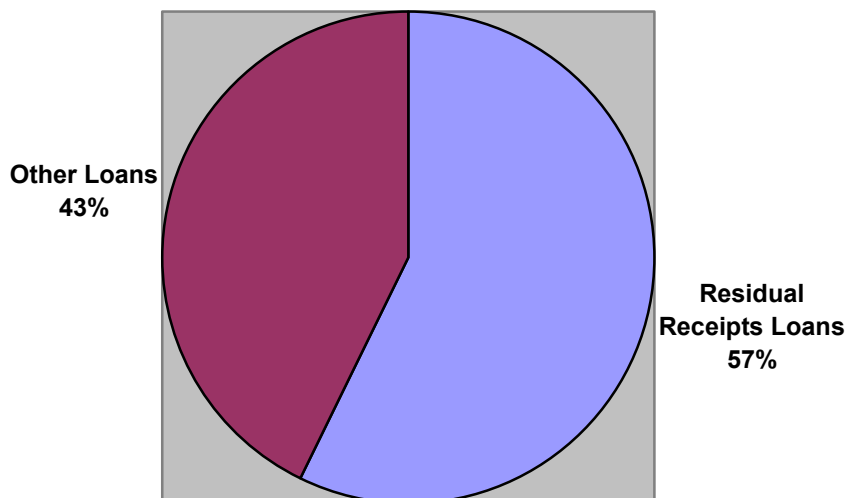
Residual Receipt Loans

To further the development of affordable housing units in the City, the Los Angeles Housing Department (LAHD), like the Community Redevelopment Agency, uses residual receipt loans for the development of affordable housing. The loans are made to eligible borrowers to develop housing units for moderate and low income families.

Residual receipts loans have repayment terms which provide for the payment of principal and interest from the project's cash flow. The promissory note details when and under what circumstances repayment will be due. LAHD shares in the residual income of the mortgaged property after allowable operating expenses are paid. These loans accrue interest and any residual income paid to LAHD goes first to pay current interest and then accrued interest and principal.

Generally, the borrower will not be in breach of the promise to pay if the project does not generate sufficient cash. The residual receipt loans comprise the bulk of the Department's loan portfolio, in terms of dollar amount. As of June 30, 2006, LAHD had 289 residual receipt loans worth approximately \$417 million, which comprised 57% of the Department's total loan portfolio of \$728 million.

**VALUATION OF RESIDUAL RECEIPT LOANS
AS A % OF LAHD'S TOTAL LOAN PORTFOLIO
As of June 30, 2006**



Source: The Department's Loan Tracking System (LTS)

Finding #7: LAHD has a backlog of over 700 financial statements submitted by residual receipt borrowers that it needs to review. The backlog could be costing the Department millions in residual receipt income that could be used to further its mission.

The loan agreement requires residual receipt borrowers to submit annual financial statements to LAHD. The financial statements must be prepared by a Certified Public Accountant in accordance with Generally Accepted Accounting Principles. LAHD reviews the financial statements submitted by borrowers and prepares residual receipt analyses to determine if any residual payment is due from the borrowers. Based on its computation, if it determined that any residual payment is due, LAHD bills the borrower for the amount. Loan documents include language in the “Repayment of Loan” paragraph that requires LAHD to review and approve financial statements and complete its residual receipt analyses within 60 days.

Over the last two years, LAHD staff reviewed 245 financial statements, which generated over \$1.7 million in residual receipt income billed to the borrowers, an average of \$6,939 per financial statement reviewed. Also, for the last two years it collected \$2.2 million of billed residual receipts. As of the time of our fieldwork, the Department had a backlog of over 700 financial statements that needed to be reviewed. There were an additional 200 annual financial statements that were due for submission by the residual receipt borrowers that had not been submitted. However, we noted that LAHD has sent letters out to request these statements.

Since the repayment of residual receipt loans is dependent on the results of operations as stated in the financial statements, the timeliness and accuracy of review of those statements are crucial to maximizing income that can be used to further the Department’s goals and mission. To put this in perspective, based on the Department’s residual income over the last two years, the backlog translates to potential income of over \$6 million.²

Recommendations:

LAHD management should:

- 13. Develop a mechanism to identify and prioritize financial statements with residual receipts for review. Consider adding temporary resources to eliminate the backlog.**
- 14. Consider implementing a rotation review cycle of the financial statements. The Department should work with the City Attorney to modify the language in its agreements to allow for the flexibility to review the financial statements within the rotation cycle it adopts.**

² Since LAHD generated an average of \$6,939 per financial statement from reviewing 245 financial statements over the last two years, we multiplied \$6,939 by 900 to arrive at the estimated potential income of approximately \$6 million. It should be noted that about a third of the financial statements reviewed do not result in residual income.

Finding #8: LAHD may be able to enhance residual receipt collections by performing more detailed analyses of the financial statements reviewed.

The Portfolio Management Division dedicated four staff to review the financial statements submitted by residual receipt borrowers. Of the 245 analyses completed by LAHD staff over the last two years, we reviewed a sample of 30 to determine whether the residual receipt computations were performed accurately and whether any residual receipts billed were collected. We noted that, for the most part, the staff follows the Department's guidelines and methodology for computing the residual receipt analyses. We did not find any mathematical errors in their computations. We also noted that all amounts due were billed promptly. The Department billed \$1.7 million in residual receipts over the last two years on its \$417 million residual receipt loan portfolio.

We believe LAHD can increase its collections by performing a more in-depth review of the borrowers' financial statements to address the deficiencies in their review process as noted below.

- Financial statements submitted by some borrowers lacked the necessary and sufficient information to afford a detailed review to calculate residual receipts due. Information such as interest income earned on operating and replacement reserves, additions and withdrawals in the operating and replacement reserves, and capitalized portions of any replacement reserve withdrawals were not provided. Generally, current agreements do not require borrowers to provide this type of information.
- There was no indication that staff reviews related party transactions to ensure the validity of the recorded transactions that may adversely reduce potential residual receipts. This is partly because the details of these related party transactions are not always provided by the borrowers because they are currently not required to.
- Withdrawal of funds from operating or replacement reserves should be taken into consideration when calculating the residual receipts due unless the amounts are used to fund capitalized assets, in which case they should not be allowed in the calculation of residual receipts due. Since, these amounts were already deducted from gross income when they were deposited into the reserves, the amounts should not be deducted again as expenses. Of the 30 residual receipts that we reviewed, nine had withdrawals totaling \$380,000 that could have been allowed in the calculation and added back to income. The Department could have potentially increased its residual receipts by approximately \$190,000.³
- The operating and replacement reserves allowed in the calculation of residual receipts due should be the actual amount funded per borrowers' financial

³ This calculation assumes that LAHD receives 50% of the residual income generated by each borrower's operation as stated in their loan agreements with the Department.

statements up to the accumulated annual amounts required as stated in the loan agreements. Typically, most borrowers deposit amounts lower than required into these reserves. Currently, in its calculation of residual receipts, LAHD gives borrowers credit for the amount they are required to deposit instead of the actual amounts deposited (which are often lower). LAHD indicated that borrowers are usually requested to deposit the difference. For example, one borrower who was required to deposit \$1,000 in its operating reserve account only deposited \$500. The Department deducted \$1,000 instead of \$500, thereby, decreasing the residual receipts due to the Department.

By incorporating these items into its review, LAHD is likely to increase its residual receipt income. However, before it can make the changes, the Department will need to properly notify residual receipt borrowers.

Recommendation:

15. LAHD management should seek assistance from the City Attorney to modify future and, if possible, the existing agreements to incorporate additional information to afford a detailed review of the financial statements.

Service Payback and Forgivable Loans

Finding #9: LAHD's monitoring of service payback and forgivable loans is inadequate.

LAHD inherited service payback and forgivable loans from the Community Development Department. While the Department indicated it no longer originates these types of loans, LAHD has approximately \$10 million in service payback and forgivable loans in its portfolio that it needs to continue to monitor. The service payback and forgivable loan agreements require borrowers to show proof of compliance with the specific conditions of the loans in order to get the amounts awarded forgiven. The primary condition that must be satisfied is the submission of an annual report. The annual report typically includes documentation such as the level of service provided during the previous year to support the borrower's compliance with the loan conditions and provides the basis for LAHD to forgive portions of the loan. If a borrower fails to submit an annual report, the loan goes into default and the Department should initiate collection efforts.

We sampled seven forgivable loans worth approximately \$2.8 million to determine whether LAHD monitors the receipt of annual reports and whether the Department processes the annual forgiveness amount accurately, timely and consistently in accordance with its policies. We found that LAHD does not monitor the submission of the required annual reports and does not initiate collection efforts for non-compliance. For six of the seven loans that we reviewed, the borrowers did not submit annual

reports to LAHD to demonstrate that the services were provided. Hence, the Department did not forgive any portions of these loans.

For example, the loan terms for one borrower provided that upon compliance with the service delivery requirement, the \$1.5 million loan would be reduced at the rate of \$150,000 per year or \$12,500 per month for a period of 10 years from 2003 to 2013. Assuming that the borrower complied with all loan provisions, by the end of FY 2005-06, the receivable should have been reduced by \$450,000 (i.e., \$150,000 for each of the fiscal years 2003-04, 2004-05 and 2005-06).

For this borrower, the Department's receivable records still reflect the original \$1.5 million because no amount has been forgiven. This was primarily because the borrower did not submit any annual reports to the Department. However, since the borrower did not submit any annual reports to demonstrate compliance, the loan should have gone into default and the Department should have initiated collection efforts or required that the borrower demonstrate compliance with the terms of the loan agreement. LAHD staff attributed the inadequate monitoring to personnel constraints.

Without the annual verification and proper monitoring, the Department is not only unable to reduce the receivable in its books accordingly, more importantly, it is also unable to determine whether a borrower is providing the required social services to justify the forgivable loan awarded.

Recommendation:

16. LAHD management should develop a mechanism to monitor its service paybacks and forgivable loans to ensure agreed upon social services, a condition for receiving forgivable loans, are being provided.

Finding #10: LAHD's methodology for estimating allowance for doubtful accounts is outdated.

At the end of each fiscal year, departments report their accounts receivable amounts and data to the Controller's Office for the preparation of the year-end Comprehensive Annual Financial Report (CAFR). Since the accuracy of the loan receivable amount depends on how much can be collected, reasonable efforts should be made to accurately estimate the uncollectible amount.

LAHD reported \$169 million in loan receivables (net of \$566 million allowance for uncollectible loans) for FY 2005-06. The Department determined these amounts based on a methodology it developed in 1998. Although, for the most part, the methodology appears reasonable, the allowance factors were derived using collection data for 1993 and 1994 as a baseline. Collection data from over 12 years ago may not reflect the most current collection data or loan programs administered by the Department.

Recommendation:

- 17. LAHD management should revise its methodology for estimating the allowance for uncollectible loan receivable amounts to reflect its current collection data.**

Section IV. The Loan Tracking System (LTS)

Finding #11: LAHD's loan receivable balances and other information in the Loan Tracking System are incomplete and inaccurate.

Keeping complete and accurate loan information helps management make informed decisions on the Department's loan receivable portfolio balances. LAHD uses the Loan Tracking System, developed in the 1980's under the Community Development Department, to track its loan activities. The technology is not compatible and cannot be fully integrated with other systems used by LAHD to generate pertinent reports. We noted the following issues relating to the LTS:

- LTS does not have the capability to compound, accrue and accurately report on interest for certain loan types. Therefore, LAHD does not use LTS to compound interest automatically for some loan types and their interest must be computed manually.
- In some cases, loan amounts (i.e., principal loan amounts including accrued interest) in the LTS differ from that in the loan agreements according to the confirmation replies received from the borrowers.
- Reports generated from the LTS are incomplete. For example, LTS cannot generate a report to show how much revenue (in principal, interest, and fees) LAHD can expect to collect over a certain period of time. We asked for a listing of all loans that were assumed (assumptions) within the past one year, the Department indicated that LTS was not able to generate the listing.

The lack of an effective system hampers the Department's ability to monitor its loans efficiently. LAHD indicated that it anticipates completing its replacement system, the Housing Information System (HIMS), by the end of 2007.

Recommendation:

- 18. LAHD management should ensure that its new Housing Information Management System has the capability to compound, accrue and accurately report interest for all its loan types and to generate pertinent loan reports.**

Finding #12: The Department has a total of \$5.7 million in loans that cannot be identified to specific borrowers. In addition, some awarded amounts are not reflected in the Department's LTS due to improper coding.

The Department has a total of \$5.7 million in loans that cannot be identified to specific borrowers. The Department indicated that the loan files were either lost or misplaced during the Department's transition from the Community Development Department over fifteen years ago. The amount has remained a reconciling item since then and is reflected in the gross receivable amount reported in the City's Comprehensive Annual Financial Report (CAFR). Because the Department has always included the \$5.7 million in its estimated uncollectible amount, there is no impact on the net loan receivable amount reported in the CAFR.

Since the Department has no identifying information to post the loans on its LTS, the LTS does not have any receivable information relating to these loans. Staff sets-up a receivable only if a payment is received or when the borrower requests a payoff. Through these means, LAHD has recorded 10 loans for about \$3 million since 2001. However, there is no assurance that all payments of this type are posted to the LTS.

In addition, LTS also did not include some other loans that were coded incorrectly when they were disbursed. For example, if a disbursement is solely coded as a grant (without a corresponding code for a receivable), a receivable will not be created in LTS. The Department also learns about these loans and records them only when the borrower sends in a payment or requests a payoff. LAHD recorded three of these loans for \$280,000 since 2005.

Recommendations:

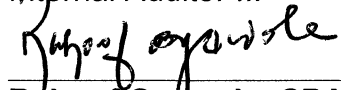
LAHD management should:

- 19. Resolve issues relating to the \$5.7 million in loans that cannot be identified to specific borrowers. If unable to resolve, seek Council approval to write-off the amount so it can remove the amount from its books.**
- 20. Require its Accounting Division to verify that all loans, once funded, are properly coded in the loan tracking and monitoring system.**

Respectfully submitted,

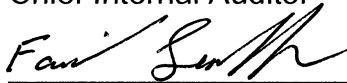


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Chief Internal Auditor



Farid Saffar, CPA
Director of Auditing

February 28, 2007

	Community Redevelopment Agency was awarded \$2 million in new loans.	U	<p>letter is issued and also before the final approval/disbursements.</p> <p>5. Share default information with the Community Development Dept., the Community Redevelopment Agency and other pertinent agencies to ensure that borrowers who are non-compliant with any of their existing loan obligations do not receive new loans.</p>
4.	LAHD did not enforce its loan default and collection procedures and did not adequately pursue delinquent borrowers.	N N N	<p>LAHD management should:</p> <p>6. Ensure that its new Housing Information System (HIMS) has a functionality or mechanism to automatically generate delinquent letters on loans in default.</p> <p>7. In consultation with the City Attorney, identify and assess the probability of collecting amounts owed on loans that have been in probate, litigation, or bankruptcy for more than five years.</p> <p>8. Recommend for write-off any amounts found in recommendation #7 to be uncollectible.</p>
5.	LAHD does not have mechanisms to monitor compliance with the insurance requirements, payment of taxes and changes in legal entity statuses.	U N N	<p>LAHD management should:</p> <p>9. Identify borrowers who may have defaulted on their property taxes, ensure these borrowers are up-to-date on their taxes and/or take appropriate actions to protect the City's interests in case of a tax sale.</p> <p>10. Complete the database to monitor insurance policies. The database should include a mechanism to alert staff when an insurance policy on a property is about to expire.</p> <p>11. Periodically monitor the borrowers' legal entity status to ensure any changes do not affect the Department's ability to protect its investments.</p>

6.	Subordinated loan files tested did not contain evidence of authorization by the Portfolio Management Division, as required.	N	12. LAHD management should ensure that Portfolio Management Division's Director reviews and approves all subordinated loans.
	Section III - Monitoring of Annual Reports and Financial Statements		
7.	LAHD has a backlog of over 700 financial statements submitted by residual receipt borrowers that it needs to review. The backlog could be costing the Department millions in residual receipt income that could be used to further its mission.	U D	LAHD management should: 13. Develop a mechanism to identify and prioritize financial statements with residual receipts for review. Consider adding temporary resources to eliminate the backlog. 14. Consider implementing a rotation review cycle of the financial statements. The Department should work with the City Attorney to modify the language in its agreements to allow for the flexibility to review the financial statements within the rotation cycle it adopts.
8.	LAHD may be able to enhance residual receipt collections by performing more detailed analyses of the financial statements reviewed.	N	15. LAHD management should seek assistance from the City Attorney to modify future, and, if possible, the existing agreements to incorporate the additional information to afford a detailed review of the financial statements.
9.	LAHD's monitoring of service payback and forgivable loans is inadequate.	U	16. LAHD management should develop a mechanism to monitor its service paybacks and forgivable loans to ensure agreed upon social services, a condition for receiving forgivable loans, are being provided.
10.	LAHD's methodology for estimating allowance for doubtful accounts is outdated.	N	17. LAHD management should revise its methodology for estimating the uncollectible amounts to reflect its current collection data.
	Section IV - The Loan Tracking System (LTS)		
11.	LAHD's loan receivable balances and		18. LAHD management should ensure that

	other information in the Loan Tracking System are incomplete and inaccurate.	U	its new Housing Information Management System has the capability to compound, accrue and accurately report interest for all its loan types and generate pertinent loan reports.
12.	The Department has a total of \$5.7 million in loans that cannot be identified to specific borrowers. In addition, some awarded amounts were not shown as loans for improper coding.	U U	LAHD management should: 19. Resolve issues relating to the \$5.7 million in loans that cannot be identified to specific borrowers. If unable to resolve, seek Council approval to write-off the amount so it can remove the amount from its books. 20. Require its Accounting Division to verify that all loans, once funded, are properly coded in the loan tracking and monitoring system.

Description of Recommendation Ranking Codes

U- Urgent-The recommendation pertains to a serious or materially significant audit finding or control weakness. Due to the seriousness or significance of the matter, immediate management attention and appropriate corrective action is warranted.

N- Necessary- The recommendation pertains to a moderately significant or potentially serious audit finding or control weakness. Reasonably prompt corrective action should be taken by management to address the matter. The recommendation should be implemented within six months.

D- Desirable- The recommendation pertains to an audit finding or control weakness of relatively minor significance or concern. The timing of any corrective action is left to management’s discretion.

N/A- Not Applicable