

Department of Housing and Community Development:

*Poor Administration of Certain Aspects of
the California Natural Disaster Assistance
Program for Loma Prieta Earthquake Victims
Could Result in Inappropriate Loan Forgiveness*



May 2001
2000-129

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CALIFORNIA STATE AUDITOR

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May 3, 2001

2000-129

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the Department of Housing and Community Development's (department) administration of its California Natural Disaster Assistance Program (CALDAP) for victims of the Loma Prieta earthquake.

This report concludes that the department's poor administration of certain aspects of the CALDAP for Loma Prieta earthquake victims could reduce loan repayments to the State. Although we were unable to substantiate many of the homeowner borrowers' complaints about work quality because of the lack of supporting documentation, we did note a few instances where borrowers were awarded judgments against their contractors for poor or incomplete repair work. Further, the department's inadequate communication with borrowers and the lack of periodic loan statements may have resulted in some borrowers improperly believing that their loans were grants. Moreover, the department does not effectively monitor borrowers with rental loans that are pursuing loan forgiveness to ensure that they provide units to low-income tenants at affordable rents. Specifically, the department did not begin monitoring borrowers with rental loans until 1996, and its current process does not ensure that all borrowers comply with loan forgiveness provisions. As a result, the department could inappropriately forgive repayment of a portion of the \$15.6 million in outstanding rental loans even though borrowers may not have provided affordable housing as required.

Respectfully submitted,

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SUMMARY

Audit Highlights . . .

The Department of Housing and Community Development (department) administers the California Natural Disaster Assistance Program (CALDAP). We reviewed CALDAP loans provided to victims of the Loma Prieta earthquake and found that:

- Despite borrower allegations concerning the quality of repair work, state and local jurisdictions generally provided adequate oversight.*
 - The processes used by some jurisdictions may have caused a few borrowers to believe they were not allowed to select their own contractors.*
 - By not sending periodic loan statements, the department may have contributed to some borrowers' confusion regarding their loans.*
 - The department has not been diligent in monitoring compliance with forgiveness requirements, thereby increasing the risk that some part of \$15.6 million in loans will be inappropriately forgiven.*
-

RESULTS IN BRIEF

The Department of Housing and Community Development (department) has not exercised effective oversight of the California Natural Disaster Assistance Program's (CALDAP) assistance to victims of the Loma Prieta earthquake. After the earthquake in October 1989, the department loaned approximately \$87 million to more than 900 borrowers to repair and rehabilitate damaged or destroyed single-family dwellings and rental housing. Some homeowners, primarily in the cities of Berkeley and Oakland, have expressed concern about poor workmanship by contractors and unreasonable loan terms. These complaints might have been reduced if the department had taken advantage of opportunities to improve its communications with borrowers. Furthermore, over the past 10 years, the department has not sufficiently monitored borrowers in its CALDAP-R program, which provided loans to owners of rental housing. In addition, as a condition of receiving a state loan and having part or all of the loan forgiven, the property owners agreed to rent units to low-income tenants at below-market rents. The department has continued to certify that nearly all of these borrowers are adhering to the terms of their loans, despite the fact that some have overcharged tenants and others have left units vacant. As a result, some borrowers who have not provided housing as required may have their loans forgiven.

The CALDAP-O program provided loans to homeowners in need of assistance. Nearly 45 percent of CALDAP-O borrowers in Berkeley and Oakland have alleged various problems. Some of the complaints date to the early 1990s when the repair work was completed, and relate mostly to poor workmanship by contractors and unreasonable loan terms. We found that the validity of these complaints varied. For instance, some borrowers have stated that the work performed on their homes was unsatisfactory or incomplete, and some said that rehabilitation inspectors did not appropriately perform their jobs. In fact, a few homeowners have succeeded in recovering damages from contractors through legal action. However, based on the available documentation, we found that for the most part, the local agencies administering CALDAP had adequately overseen repairs and inspections.

A number of borrowers have also alleged that they were not allowed to choose the contractors who worked on their homes. We found that the contractor selection processes varied among the local jurisdictions we contacted. Some jurisdictions involved potential borrowers in the contractor selection process more effectively than others. The seemingly restrictive selection process used by some jurisdictions may have resulted in a few borrowers believing that they had to use a specific contractor or were not allowed to select their own. However, we did not find any documentation in loan files to support borrowers' allegations that they were directed to select particular contractors.

The department may have also contributed to some borrowers' confusion regarding their CALDAP homeowner loans by not sending periodic loan statements. Except for a statement of final indebtedness following the payment of all anticipated CALDAP rehabilitation expenses, the department has not provided borrowers with periodic statements of their increasing total indebtedness as interest accrues on their loans. Consequently, some borrowers believed their loans were actually grants while others did not fully understand the loan repayment terms or refinancing restrictions. Although several borrowers alleged they could not get other property loans because of their CALDAP loans, the department will in fact consent to mortgage refinancing as long as the new loans meet certain requirements.

As stated above, the CALDAP-R program assists owners and tenants of rental properties. For this reason, CALDAP-R borrowers are required to comply with certain rent restrictions, and if these borrowers also restrict units to low-income tenants for at least 10 years of their loans, the State will forgive the rehabilitation portion of their loans. Yet the department did not establish a process to monitor Loma Prieta CALDAP-R borrowers until mid-1996, 4 years after most of the rehabilitation work had been completed. This delay was despite the statutory requirement that borrowers requesting loan forgiveness comply annually with specific performance conditions for rent and tenant-income levels. Thus, low-income tenants in those facilities for which the owners had opted for forgiveness had no assurance that they were provided the low-cost housing mandated in the statutes.

Further, the department has not been sufficiently diligent since it began monitoring compliance with the terms of rehabilitation loans in 1996, thereby increasing the risk that some part of the \$15.6 million in eligible loans may be forgiven even though some borrowers may not have complied with the required

terms. The department has not maintained sufficient documents in its files to verify compliance, and supporting data from loan files has not always agreed with the summary records that the staff prepares and provides to the program's managers.

We also found that the department incorrectly applied maximum allowable rent rates. Moreover, the department has classified some borrowers as conditionally compliant despite the fact that they left units vacant for years at a time or charged rents in excess of the maximum allowable. However, in these cases, it is unclear whether the department will require the borrowers to repay a portion of their loans for the noncompliant years. By granting these borrowers greater latitude than statutory provisions allow, the department may ultimately forgive portions of loans that are not eligible for forgiveness.

RECOMMENDATIONS

To ensure that the CALDAP program that provided assistance to Loma Prieta victims effectively conforms to its underlying statutes and guidelines, the department should:

- Provide periodic loan statements to borrowers that include outstanding principal and interest amounts and include specific contact information for borrowers with questions or concerns.
- Strengthen its monitoring process of borrowers using loan funds for acquisition or refinancing and for owners of rental properties who are seeking forgiveness of all or a portion of their loans.
- Provide annual feedback to allow monitored facilities to correct noncompliant activities.

To ensure that future loan programs better achieve their goals, the department should reassess its guidelines and standards of operation for local jurisdictions in areas such as contractor selection and oversight of work quality.

The cities of Berkeley and Oakland should continue to provide a process to investigate and evaluate the complaints of CALDAP borrowers.

AGENCY COMMENTS

The department generally concurred with our recommendations. In particular, it indicated that it would send letters to each borrower within the next 45 days providing loan information and identifying specific points of contact in the department to answer borrower questions. Further, it will initiate an annual process of providing loan statements to CALDAP borrowers beginning in January 2002. It will also develop guidelines to ensure consistent review of decisions to forebear on the foreclosure or other enforcement of its loans. Finally, it will take corrective measures to ensure future rent overcharges do not occur and will review exceptions identified in the report to determine options for appropriate remedies. The cities of Berkeley and Oakland concurred with the report and pledged to continue investigating and evaluating complaints from CALDAP borrowers. ■

INTRODUCTION

BACKGROUND

On October 17, 1989, the Loma Prieta earthquake struck an area extending from Monterey in the south to the San Francisco Bay Area in the north. With a Richter magnitude of 7.1, it had a devastating effect on housing structures: More than 18,900 homes were damaged or destroyed, and the total earthquake damage was estimated at \$6.8 billion. To assist owners and tenants of single-family dwellings and rental housing damaged or destroyed by the earthquake, the Legislature authorized the Department of Housing and Community Development (department) to administer housing rehabilitation programs targeting damaged properties in the counties that were included in the governor's emergency declaration. This assistance, administered through the department's California Natural Disaster Assistance Program (CALDAP), ultimately provided more than \$87 million to about 900 borrowers as shown in Table 1.¹

TABLE 1

CALDAP Loans to Loma Prieta Earthquake Victims

	Residential (CALDAP-O)		Rental (CALDAP-R)	
	Number of Borrowers	Amount	Number of Borrowers	Amount
Original	768	\$40,936,206	136	\$46,500,152
Repayments	294	13,548,868	39	4,337,418
Defaults	23	1,039,793	5	1,237,088
Outstanding	452	26,347,545	92	40,925,646

Source: Department of Housing and Community Development loan data as of December 31, 2000.

The CALDAP program aided property owners with two components: the California Natural Disaster Assistance Program for Owner-Occupied Housing (CALDAP-O), which provided assistance

¹ The department's CALDAP program has provided assistance to California property owners after other disasters. However, for the purposes of this report, our use of CALDAP will refer only to the assistance program related to the Loma Prieta earthquake.

to the owners of single-family homes, and the California Natural Disaster Assistance Program for Rental Properties (CALDAP-R), which helped property owners and tenants of rental housing. Both components provided deferred loans in those situations in which private or other governmental financial assistance was unavailable or insufficient to repair earthquake damage. The deferred loans do not require any periodic payments of principal or interest until the term of the loan is completed. Homeowner loans are deferred until the borrower either transfers ownership of the property or no longer occupies it as the principal residence, while rental property loans are deferred for a maximum term of from 20 to 30 years, depending on the use of the CALDAP funds. Major differences between the components include the terms of the loans, the ability of a subsequent purchaser of the property to assume the loan, and the ability of rental borrowers to seek forgiveness of the rehabilitation portion of their loans by complying with certain rent and tenant-income restrictions. We have provided additional detail about each component in Appendix A.

The California Natural Disaster Assistance Program for Owner-Occupied Housing

As stated above, the Legislature intended CALDAP-O to provide financial assistance for the rehabilitation or reconstruction of owner-occupied dwellings. Statutory provisions placed certain restrictions on the loans provided through the program:

- Loans were limited to \$30,000. However, the department could, on a case-by-case basis, waive this limitation if necessary to permit compliance with health and safety, and seismic safety standards.
- The total indebtedness for any owner-occupied property was limited to 100 percent of the after-rehabilitation value of the property. The department could waive this limitation as well in individual cases to ensure compliance with health and safety, and seismic safety standards.
- Although only affecting a few CALDAP loan applications submitted on or after September 28, 1992, the Legislature further revised the statutes to restrict eligible repairs in excess of \$30,000 to corrections of serious, life-threatening violations of state or local building codes, which includes applicable seismic standards or related improvements that must be corrected before occupancy.

The terms of loans initially required repayment of the principal and interest when the borrower either transferred ownership or refinanced the rehabilitated property. In March 1990, the Legislature eliminated the requirement for repayment if the borrower refinanced the property and added the requirement that borrowers must repay their loans if they fail to occupy the rehabilitated properties as their principal places of residence. The loan agreement prohibits anyone from assuming the CALDAP-O loan, except for the borrower's spouse in the case of death or divorce. In all other cases, the CALDAP-O loan exists as a lien against the borrower's Deed of Trust and, therefore, must be paid before the sale or transfer of property can be completed.

The California Natural Disaster Assistance Program for Rental Properties

Because the Legislature intended CALDAP-R loans to repair rental units and thereby preserve affordable rental housing, the terms of the loans required that recipients give rental priority first to tenants who occupied the units before the earthquake and second to others displaced by the earthquake or related repairs. They also required that borrowers set the rents of the repaired units at or below the pre-disaster rent level for the first year of reoccupancy. The department could then authorize annual increases to a maximum allowable rent level based on a selected inflation index. Borrowers could also appeal to the department for a greater rent increase to ensure the fiscal integrity of the project. In accepting the loan, borrowers agreed to comply with the initial restricted rents and any authorized annual increases for as long as the initial tenant that occupied the unit after the earthquake or related repairs continued to occupy it. In addition, if borrowers used CALDAP-R loans both to acquire and rehabilitate rental units, they had to restrict the rent levels of the units to the maximum levels determined by the department for the life of the loan.

CALDAP-R also offered borrowers the option to obtain forgiveness of all or part of their reconstruction loans if they were willing to meet certain optional low-income rent restrictions.² The department offered this feature as an additional incentive for borrowers to maintain and provide affordable rental units to tenants with annual incomes no greater than 80 percent of the area's median income as determined from annual data provided by the United States Department of Housing and Urban

² This option was not available for those portions of a CALDAP-R loan used for acquisition or refinancing.

Development. If borrowers met these conditions for their CALDAP-assisted units for at least 10 years, the department would forgive a percentage of the rehabilitation portion of their loans equal to the portion of the total loan term during which the units were rented to lower-income tenants. For example, if all of a borrower's assisted units were continuously maintained at affordable rents and occupied by lower-income tenants for 10 years during the 20-year rehabilitation loan, the department would forgive 50 percent of the rehabilitation portion of that loan. It is the department's responsibility to monitor borrowers to determine whether they have met these criteria for loan forgiveness as well as to ensure that they have followed all other CALDAP-R loan requirements as outlined above.

CALDAP Administration and Oversight

To administer the loan application process, the department entered into contractual agreements with 15 city or county jurisdictions, usually the cities or counties that had authority over areas damaged by the earthquake.³ As part of the CALDAP agreements, each local jurisdiction agreed to follow the department's specific program guidelines in addition to the terms of the agreement itself. With respect to repair and reconstruction activities, the local jurisdiction's responsibilities included ensuring that all building contractors working under this program were licensed in accordance with California law. In addition, the local jurisdiction agreed to inspect work to ensure proper code compliance and acceptable performance, and based on these inspections, to require contractors to correct all work that did not conform to the applicable requirements and to withhold payments until the corrections were satisfactorily completed. Finally, the local jurisdiction was to require that the borrower execute and record a Notice of Completion within 10 days of the completion of the repairs.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) requested the Bureau of State Audits to perform an audit of the department's administration of the CALDAP program related to loans provided to residents of the cities of Berkeley and Oakland

³ We have provided additional information about the number of loans for each local jurisdiction in Appendix B. In the very few cases where the local jurisdiction elected not to participate in the program, the department made loans directly to individual borrowers.

after the Loma Prieta earthquake. The audit committee was primarily concerned about complaints from loan recipients alleging that the department provided misleading information to loan recipients, permitted inadequate oversight of work performed by contractors, and haphazardly processed some of the loans.

To understand the program's objectives and governing provisions, we reviewed state statutes as well as the department's program guidelines, comparing the two to ensure that they were consistent. In addition, we met with borrowers from both Berkeley and Oakland to better understand the nature of their complaints. We also discussed program issues and operations, such as the selection and monitoring of contractors performing CALDAP repair work, with local officials in Berkeley and Oakland, as well as with officials from other local jurisdictions. We reviewed homeowner and rental property loan files to determine whether the department had followed the statutory procedures. We reviewed a sample of loan documents from various local jurisdictions affected by the Loma Prieta earthquake to determine whether the terms and conditions of their loan agreements were clearly stated in accordance with statutes and guidelines. We also solicited from borrowers available documentation that supported claims of poor contractor workmanship.

We examined the department's oversight and monitoring requirements to determine the degree of involvement between the department and the local jurisdictions. In addition, we examined the department's procedures to monitor those provisions of the CALDAP program that require follow-up after construction is completed.

We discussed with Oakland and Berkeley officials the steps they were taking to address the continuing allegations. Finally, we reviewed the history of complaints since the Loma Prieta earthquake at the Contractors State License Board (license board) in an attempt to identify a pattern of poor workmanship by specific contractors involved in the CALDAP program. However, there were not sufficient instances or evidence in the license board's database to support any adverse conclusions about the contractors that we reviewed. Because as many as 10 years have passed since many of the alleged cases of poor workmanship and substandard contractor performance occurred, supporting documentation and other substantiating materials often no longer exist. As a result, we were unable to completely assess the activities that occurred at that time.

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AUDIT RESULTS

ADDITIONAL PROCEDURES AND BETTER COMMUNICATION MIGHT HAVE REDUCED THE NUMBER OF HOMEOWNER COMPLAINTS

Although the assistance provided by the California Natural Disaster Assistance Program (CALDAP) to the victims of the Loma Prieta earthquake was intended to provide economic relief to owners and tenants of single-family dwellings and rental housing that were damaged or destroyed in the disaster, some borrowers in the homeowner loan program have alleged problems with the program since its implementation. Some homeowners, particularly in the Berkeley and Oakland jurisdictions, have complained about poor workmanship by contractors, insufficient inspections of the repair work by the local jurisdiction, lack of choice in contractors, and unreasonable financial loan terms. Although we were unable to substantiate many of the borrowers' complaints during our review because of the lack of supporting documentation, we did note a few instances where borrowers were awarded financial judgments against their contractors for poor or incomplete repair work. In addition, some borrowers alleged that the actual financial terms of their loans differed from the initial information they received. Further, the department's lack of periodic loan statements may have resulted in some borrowers improperly believing that their CALDAP loans were grants because they receive no periodic reminder of their current loan obligations. Finally, some CALDAP borrowers do not fully understand the loan repayment and subordination provisions of their loans.

Despite Complaints Concerning the Quality of Repair Work, State and Local Jurisdictions Generally Provided Adequate Oversight

The proportion of CALDAP homeowner borrowers with complaints varied significantly among the local jurisdictions we contacted. Specifically, some jurisdictions, such as the cities of Santa Cruz and San Francisco, recalled having few complaints, while other jurisdictions, such as the cities of Berkeley and Oakland, have received complaints from nearly 45 percent of their 262 homeowner borrowers who received CALDAP loans. Many of the complaints made by CALDAP loan recipients

alleged poor workmanship by contractors who performed repair work. Some of these borrowers believe that the local agencies administering the CALDAP program performed insufficient inspections, thus allowing contractors to perform repairs inadequately and, in some instances, to charge for unnecessary work.

The cities of Berkeley and Oakland have received complaints from nearly 45 percent of their 262 homeowner borrowers who received CALDAP loans.

In order to present their allegations to local and state officials, homeowners from the cities of Berkeley and Oakland organized themselves into a group (borrower group). The borrower group provided us with the specific complaints and allegations from 89 of its members. Most of these complaints alleged poor workmanship by their contractors. Specifically, 29 members of the borrower group stated the contractors never finished the work stipulated in their contracts, while 47 members stated they have paid out-of-pocket costs to correct work that the contractors improperly performed. Of these 47 members, 15 reported spending \$10,000 or more to complete or correct work performed by their contractors, with the highest amount being \$50,000. Also, 3 other members allege they sold their homes because they did not have the available funds to correct poor workmanship. In addition, 7 members alleged that they were not given the opportunity to decide the type or the amount of repair work done to their homes. Some of these homeowner borrowers have had complaints since the completion of the repair work in the early 1990s.

According to some members of the borrower group, the problems with contractors were compounded by their local jurisdiction's failure to perform sufficient inspections. Furthermore, seven members of the borrower group alleged that local officials allowed their contractors to perform unnecessary work on their respective homes. For example, one borrower stated that a contractor was allowed to repaint her home although she believed that the exterior of the house only needed to be washed down. Another borrower alleges that a rehabilitation adviser requested additional CALDAP funds to replace the sidewalk in front of her home although the department had already classified such expenses as ineligible under the CALDAP provisions. In addition, five other borrowers alleged that the local officials did not always ensure that the contractors' work was both correct and complete. For example, one homeowner alleged that her contractor only painted the interior of the house and fixed the bathroom fan although she believed that the contractor was supposed to repair the walls, driveway, garage floor, and the gutters.

However, during our review of files, we found that local and state officials reasonably assessed needed repair work and estimated costs during the project's planning phases. The officials then used these assessments to negotiate rehabilitation contracts with the borrower's contractor. We also found several instances in which inspectors deleted unnecessary work from contractor bids. In addition, we reviewed documentation that showed that the Oakland rehabilitation inspectors examined work of contractors prior to payment. Moreover, for the loan files we reviewed for borrowers in Oakland and Berkeley, we found documentation that the homeowners had accepted the work completed and had authorized the local jurisdictions to pay the contractor for all but two of the files. We also found documentation that homeowners filed Notices of Completion for all but 6 of the 32 files we reviewed.

A few borrowers have been awarded monetary judgments against their contractors for poor workmanship.

We did find that, in a few specific instances, borrowers have been awarded judgments against their rehabilitation contractors for poor workmanship despite their initial authorization of payments to the contractors. For example, although a homeowner approved her contractor's work and authorized payment of more than \$9,800, the Contractors State License Board (license board) later determined that the roof repairs did not meet the accepted standards of the trade. Consequently, the license board awarded the borrower a judgment of \$6,100, which was its estimate of the amount needed to correct the work, from her contractor. Another borrower received a \$13,750 settlement from her contractor for deficient workmanship that resulted in water damage to her home. Although an inspection process existed to review CALDAP repair work, these examples of borrowers obtaining judgments against their contractors suggest that there may have been some problems with the effectiveness of some of the inspections. However, deficiencies in work performed may not have always been apparent at inspections. For example, leaks in roofs or walls may not have been evident until it rained.

In an effort to assess the complaints of poor workmanship, Oakland's Community and Economic Development Agency (Oakland) met with the borrower group to listen to their complaints and to inform them that Oakland has several grant and loan programs that might assist with their repair work. In addition, during November 2000, Oakland staff inspected the homes of nine borrowers to determine the validity of their claims. According to Oakland, it postponed performing any additional inspections in order to prepare information for our audit and to avoid any appearance of a possible conflict of

Recent inspections by Oakland and Berkeley have found that many of the complaints are not related to the original CALDAP repair work.

interest. Specifically, Oakland intends to request that a department representative finish reviewing the complaints in order to provide an unbiased assessment of the CALDAP work performed. Of the nine homes it inspected, Oakland found that nearly all of the borrowers' complaints either were not specifically related to the original CALDAP repair work or were due to normal wear. Also, in several cases, Oakland concluded that the repairs might have failed due to poor maintenance rather than to poor construction.

To review complaints in its jurisdiction, Berkeley's City Manager's Office (Berkeley) hired an outside consultant in November 2000. Berkeley selected this alternative of assessing alleged problems by someone independent of the local jurisdictions and people who originally worked with the CALDAP program to help ensure an objective review. Although the consultant had not issued his final report within the time frame of this audit, he, in conjunction with the deputy city attorney and staff from the city manager's and Berkeley City Housing Rehabilitation offices, compared his preliminary results with the borrowers' CALDAP repair records for nine properties. During this comparison, they noted that four of the properties appeared to have construction problems that related directly to improperly performed CALDAP repair work. They also noted that one borrower's complaints did not relate to any of the CALDAP work performed. For the four remaining properties, the consultant established during his preliminary review that the borrowers' complaints related to repairs that were done using funding from sources other than CALDAP.

Some Borrowers Felt Limited by the Contractor Selection Process

In addition to issues related to poor workmanship in repairing homes, some borrowers have alleged problems with the contractor selection process. For example, 8 members of the borrower group alleged that their rehabilitation adviser selected their contractor, while 19 members indicated they were instructed to choose the lowest bidder from contractors pre-selected by the local jurisdiction. One of the members stated that since the local jurisdiction did not want to wait for the contractor she had selected to become available, the rehabilitation adviser selected another contractor to do the work.

We found that the contractor selection processes varied among the local jurisdictions we contacted. For example, in some jurisdictions, homeowners were asked to find their own

Some jurisdictions required borrowers to find their own contractors; others provided borrowers with a list of potential contractors.

contractors before applying for their loans; these jurisdictions only offered assistance with contractor selection at the specific request of the borrower. The information package provided by the city of San Francisco outlined a process for finding a contractor, suggesting such actions as identifying suitable contractors by observing other work in the neighborhood, talking to other property owners about their contractors, obtaining potential contractors' license numbers and references, inspecting their work, talking to their clients, and finally, calling the license board. However, Oakland's Housing and Community Development division (division), in an effort to assist potential borrowers, frequently provided only a limited list of five potential contractors to borrowers requesting assistance. The division provided the list based on its established policy of rotating the names of eligible contractors onto the list in an attempt to eliminate any selection bias. However, because these borrowers were only provided a small portion of the division's complete list of contractors, some may have believed that they were being directed to use a specific contractor.

Because verifying the content of verbal discussions that took place between borrowers and local officials 10 years ago was often impossible due to the lack of corroborating evidence and imprecise recollections, we reviewed 23 files for documentation of whether borrowers had been informed of their right to select contractors. In doing so, we noted that 6 of the 23 Oakland files we reviewed contained signed documents attesting that the borrowers had independently selected their contractors while the other 17 files contained no such documents. In signing these documents, the borrowers also agreed that the local jurisdiction did not endorse or recommend a particular contractor and that the borrowers should obtain references and visit completed projects by their contractors. We also noted that 4 of the 6 borrowers elected to not obtain references or view examples of the contractors' work while the other two borrowers elected to either obtain references or did not indicate which option they had pursued. In addition, we did not find this document in the loan file of the one borrower in our sample that alleged that Oakland selected the contractor to perform her repair work, although the absence of this independent contractor selection form is not, in and of itself, an indicator that the local jurisdiction directed the selection of a particular contractor.

Finally, one borrower alleged that a local jurisdiction official received financial kickbacks from a contractor that was selected to make some CALDAP repairs. Because its investigation was

inconclusive, the Berkeley police department did not file charges against the contractor. However, the investigator suggested that the city could create a better process of overseeing programs to avoid any possible allegations of mismanagement.

The Department Does Not Provide Periodic Loan Statements

Some members of the borrower group believed that their CALDAP loans were either grants or would be forgiven by the State after the borrower resided at the property for a specified period of time. Other borrowers stated that they do not know how much they owe on their CALDAP loans or who to contact to find out the amount. The fact that a number of borrowers have questions about their loan status suggests that the department has not adequately communicated pertinent information. By providing periodic loan statements and an easy means for borrowers to receive answers to their questions, the department could potentially resolve this issue.

The borrower group alleged that some local officials represented the CALDAP-O loans, which provided assistance to the owners of single-family homes, as grants rather than as loans. For instance, 7 of the 89 members of the borrower group stated that they were told that they did not have to repay the funds received through the program. One of those 7 stated that he was told his loan would be forgiven after 20 years of residence, while another alleged that a city rehabilitation adviser told him his loan would be forgiven after 7 years. Since discussions between borrowers and local officials are usually not documented, we looked for other evidence in the loan files that would either support or refute these allegations. In doing so, we found that we were not able to substantiate such claims during our review of loan files. In fact, we found that borrowers worked with local agencies that performed the loan closings and signings according to written instructions from the department. This procedure should have made it clear to borrowers that they were signing loan documents, as opposed to receiving grants. Further, all loan document packages contained signed promissory notes, and all but four included interest rate disclosure documents.

Although some borrowers assert that they thought they had a grant, all 49 files reviewed included signed promissory notes.

However, despite the specific disclosures contained in the loan documents, the department has not provided adequate instructions to borrowers about how to contact the department or seek resolution of questions about their loans. The need for making

contact information more readily available to borrowers is illustrated by the experience of a member of the borrower group who believed she had a CALDAP loan. According to this homeowner, she attempted on several occasions to contact the department to obtain copies of her loan documentation and to determine her outstanding balance. However, she alleged that she was unsuccessful because she was unsure of whom to contact at the department. During our review, we discovered that her loan application had been denied and that, in fact, she did not have a CALDAP loan or an obligation to repay. After we brought this to the department's attention, it contacted the homeowner and assured her that she had no loan repayment due to the State. Because she had been unable to successfully contact the department, for eight years this borrower has mistakenly believed she was indebted to the State.

Without periodic statements, borrowers may not be aware of their increasing loan balance as interest accrues on the principal.

The department may have also contributed to some borrower confusion regarding CALDAP homeowner loans by not sending periodic loan statements to borrowers. Because the loans are deferred with no payment due, the department has not provided periodic statements, instead only issuing a statement of indebtedness following the payment of all anticipated CALDAP rehabilitation expenses. However, the department stated that it would provide loan statements to borrowers requesting their current balances. Since many borrowers contend that they are unable to reach department personnel, these statements may not be available to all borrowers. In addition to current loan balance information, we would expect loan statements to include useful contact information, such as the names of department personnel and telephone numbers. Without periodic statements, borrowers may be unaware of their increasing total indebtedness as interest accrues on the principal. Although the interest for CALDAP-O loans is annually calculated at only 3 percent of the original principal loan balance, the total interest over an extended period can be significant. For example, a borrower with a loan of \$47,400 (the average total loan for all current Oakland borrowers is \$47,421) will accrue \$28,440 in interest over a 20-year period. Good business practices require that the department inform borrowers of their obligations periodically so that they can manage their financial affairs. In addition, without any periodic notification of the existing liability, the homeowner may be unaware of the increasing repayment obligation and has little motivation to make periodic payments to reduce the liability and keep the final repayment amount manageable.

Borrower Complaints Do Not Accurately Reflect the Department’s Policy Regarding the Subordination of Loans

Some borrowers have alleged that they could not get additional loans on their property because of their CALDAP loans. These borrower complaints relate to the department’s subordination policy. Subordination exists when the holder of a loan or debt grants repayment priority to another loan or debt, thus allowing the other debt to be repaid in full before payment of the subordinated loan. When a borrower who already has a mortgage on the property obtains a CALDAP loan, the mortgage has repayment priority over the CALDAP loan. However, the CALDAP program includes subordination restrictions to prevent additional debt from being given repayment priority ahead of the CALDAP loan. This prevents the property’s existing equity from being reduced through loans that might be used to finance debt consolidation or to purchase automobiles rather than for investment in the property.

However, the department will subordinate its deed of trust to other financing in specified situations—for instance, if the new loan is necessary to correct defects in the home that could affect the health or safety of occupants. Moreover, the department will subordinate to a new loan that is used to make a balloon payment of an existing debt against the property or to lower monthly housing costs through refinancing. We have presented the department’s subordination criteria in Table 2.

Repayment Terms of CALDAP Loans May Cause Hardship for the Heirs of Some Low-Income Borrowers

Some CALDAP-O loan provisions may result in difficult repayment situations for the heirs of a small portion of program borrowers. CALDAP-O terms specify that loan repayment is not required until ownership of the repaired property is transferred or the property is no longer the borrower’s principal place of residence. For example, when a borrower dies, California law and the terms of the promissory note prohibit the loan from being assumed except by the surviving spouse, which means that any other heir must repay or refinance the loan to inherit the property. However, in some cases, the heirs may not have sufficient financial assets to repay or refinance the loan. If, for instance, the heirs are disabled or dependent adults, the department should have a method to determine, on a case-by-case basis, the action it believes is in the best interest of the State.

CALDAP homeowner loans cannot be assumed by anyone other than the borrower’s spouse.

TABLE 2

The Department's Subordination Policy for CALDAP-O Loans

The department will subordinate to new loans only if:

The total principal of the senior loan is unchanged or decreased and the department's security interest is not jeopardized; and
The borrower's total family income does not exceed 80 percent of the county's median income (adjusted for family size); or
Borrowing becomes necessary to protect the health or safety of the occupants or to pay health care costs for the borrower or the borrower's immediate family.

To pay a balloon payment of an existing mortgage or to lower monthly housing costs:

The new loan may not exceed the current balance of the existing mortgage being refinanced plus up to 7 percent of that amount to pay for all or a portion of the closing costs of the new loan.

The total loan-to-value ratio of the new loan must stay below 100 percent of the current market value of the property.

The borrower must apply all the proceeds of the loan to the existing property debt. No proceeds may be used for non-mortgage debt reduction.

The new loan will not place the CALDAP loan in a lower repayment position.

To pay medical expenses or to repair health and safety building code violations:

The funds used to pay for medical expenses or improvements must be placed in a supervised escrow account and relevant bills paid out of this account.

A qualified third-party inspector must document the health and safety building code violations.

In one recent case, the death of the borrower resulted in a CALDAP-O loan of nearly \$300,000 becoming due and payable. However, the joint heirs did not have sufficient credit to refinance the CALDAP loan, and the estimated value of the property was inadequate to repay both the existing mortgage and the CALDAP loan. Although the loan is currently in default, the department has agreed to delay foreclosure on the property as long as the heirs make an interim payment on the loan by October 3, 2001, and payment of the remaining loan amount by December 31, 2003. At either date, the department could begin foreclosure if the heirs do not meet these requirements. Although the department has used its discretion in this case, it does not have a system to evaluate other hardship cases consistently. Its current policy on loan repayments does not address situations such as this.

THE DEPARTMENT DOES NOT EFFECTIVELY MONITOR BORROWERS WITH RENTAL LOANS TO ENSURE THEY PROVIDE UNITS TO TENANTS AT AFFORDABLE RENTS

Under the statutes implementing CALDAP, the department is responsible for ensuring that rental property owners involved with the program comply with its restrictions. However, the

By overcharging their low-income tenants, renting to ineligible tenants, and keeping units unoccupied for extended periods of time, several borrowers have not fulfilled the conditions for having their CALDAP loans forgiven.

department did not monitor CALDAP rental loans prior to 1996, and its current monitoring process does not ensure that borrowers meet eligibility requirements for loan forgiveness. Specifically, the department does not annually certify loan forgiveness status for all of its borrowers, nor does it sufficiently maintain critical supporting evidence in its files, such as rent and tenant-income surveys and loan forgiveness status letters. In addition, we found that several borrowers with rental loans have overcharged their low-income tenants, rented to tenants who do not meet income eligibility requirements, and kept rental units unoccupied for excessive lengths of time. As a result, borrowers who did not comply with rental restrictions may have part or all of their rehabilitation loans forgiven. If the department forgives loans to noncompliant borrowers when they request forgiveness in the future, its actions could be considered a gift of public funds, which is a violation of the State Constitution.

In addition, we identified two borrowers who used loan funds for refinancing purposes but were not being monitored by the department. This occurred despite the department's guidelines requiring that assisted units of properties with refinancing loans comply with rent restrictions for the entire length of the original loan. The department's loan tracking system could not directly identify every rental loan that included refinancing as a use of funds. The department monitors borrowers who used funds for refinancing and also opted for loan forgiveness, but it does not monitor borrowers who used loan funds for refinancing rental property and did not opt for loan forgiveness. According to the department, tenants of these borrowers it is not monitoring are third-party beneficiaries to the agreement between the department and the property owners and have legal standing to seek recovery if rent levels are not maintained at authorized levels. Because the department does not always ensure that these borrowers who have not opted for loan forgiveness maintain their units at appropriate rent levels, it is exposing the State to potential litigation.

The Department's Monitoring of CALDAP Rental Loans Has Been Lacking

Statutory provisions prior to October 1993 allow all borrowers with rental loans the opportunity to receive forgiveness of the rehabilitation portion of their loans in exchange for providing a public benefit, which in this case is affordable housing for low-income tenants. According to the Regulatory Agreement, a document signed when the loan was finalized wherein the

Borrowers that are pursuing loan forgiveness agree to maintain all of their rental units affordable to and occupied by lower-income households.

borrowers agree to comply with program restrictions for the entire duration of the loan, borrowers that selected the loan forgiveness option agree to maintain all of their assisted units affordable to and occupied by lower-income households. The department provides each borrower with the maximum rent and tenant-income levels based on a methodology agreed to in the Regulatory Agreement. The percentage of loan forgiveness is based on the ratio of the original loan term to the number of years during which borrowers followed the above standards. For example, to qualify for 50 percent loan forgiveness, a borrower would have to maintain appropriate rent and tenant-income levels for 10 years on a 20-year loan and 15 years on a 30-year loan. To qualify for 100 percent forgiveness, borrowers would have to maintain appropriate rent and tenant-income levels for the entire duration of their loans.

In March 1993, the department revised the wording in the Regulatory Agreements for calculating loan forgiveness. Specifically, the department's interpretation in this Regulatory Agreement states that the amount of loan forgiveness will be based on the proportion of total, complete, and consecutive years (not less than 10) of full compliance by the borrower to the total number of years in the loan term. However, the department's other Regulatory Agreements do not explicitly state that compliance must be maintained consecutively by the borrowers even though CALDAP statutes prior to 1993 state that loans shall be forgiven in a percentage amount that equals the percentage of the loan during which the units are continuously maintained by the borrower at affordable rents and occupied by lower-income households. From a legal perspective, continuous may not have the same meaning as consecutive. All but three borrowers with rental loans that are currently pursuing forgiveness signed Regulatory Agreements that did not specify consecutive years of compliance. Because these Regulatory Agreements differ from each other, the department needs to clarify its policy so that it will hold all borrowers to the same standards.

The department established a monitoring process for borrowers with rental loans to ensure compliance with the provisions in the Regulatory Agreement. However, because statutory language defining the number of units required for borrowers to qualify for rental loans evolved over time, the department established its monitoring responsibilities as two sections within the department. The department stated that, in April 1994 it directed its Rental Loan Management section to monitor rental loans with five or more units; in July 1996 it directed its Owner Loan

Management section to monitor loans with four or fewer rental units. Each of these sections operates its monitoring responsibilities independently of the other and, as such, has a completely different process for monitoring its borrowers. However, we found that neither process is effective to ensure that borrowers are in compliance with the Regulatory Agreement. Because state law requires that borrowers meet specific requirements to receive loan forgiveness, it is reasonable to assume that the department would adopt monitoring procedures to ensure such compliance. Although the department stated that it established its monitoring functions in April 1994 for borrowers with five or more rental units, we could not find any evidence that monitoring actually took place until 1996. Likewise, the department did not begin to monitor borrowers with four or fewer units prior to July 1996.

Because it did not establish a monitoring process until 1996, the department may decide to assume borrowers complied with loan forgiveness provisions—some for as many as five years—prior to 1996.

Because it did not establish a monitoring process from the beginning of the program, the department has indicated that it will lean towards assuming compliance with loan forgiveness provisions for all borrowers—some for as many as five years—for the period before July 1996. By assuming compliance, the department could forgive up to 25 percent of some borrowers' rehabilitation loans that have 20-year terms and up to 17 percent of some borrowers' rehabilitation loans that have 30-year terms, even though several borrowers did not meet the conditions of loan forgiveness during this period. In fact, for borrowers with four or fewer units, we noted several instances of borrower noncompliance in the period before July 1996. In our review of the department's records, we found that 8 of 35 (23 percent) borrowers charged excessive rents to low-income tenants between 1990 and 1996. One borrower overcharged two low-income tenants more than \$3,000 over a 5-year period. Since those tenants moved out of the assisted units several years ago, it is unlikely that they can recover the overcharges. Although the department is aware of this borrower's overcharging, it still lists the borrower as compliant for every year of the loan including the 5 years for which the borrower overcharged the tenants. Moreover, if the department forgives this loan in full at the end of the loan term, it will inappropriately reduce repayments to the State's General Fund by \$68,724 for the 5 noncompliant years.

Although we were able to determine compliance with rent restrictions prior to 1996 in many cases, we were unable to determine whether all borrowers with rental loans rented to low-income households because the department did not maintain the critical supporting records in its files. Without sufficient evidence

One borrower overcharged two low-income tenants more than \$3,000 over a five-year period, yet the department shows the borrower as “in compliance” for every year of the loan.

of compliance with low-income provisions in all of its files, the department cannot demonstrate that its borrowers were in compliance prior to the implementation of its monitoring efforts.

The Department’s Annual Loan Forgiveness Certification for Borrowers With Facilities of Four or Fewer Units Is Not Effective

There are 35 borrowers currently pursuing forgiveness with rental loans for facilities that have four or fewer units. Together, the rehabilitation portion of these loans amounts to \$3.4 million of the total CALDAP rental loans. To monitor these borrowers, the department uses a process it calls the Annual Project Proforma (APP). Each year, the department sends each borrower an APP survey form that requires the borrower to list rent and tenant-income levels. After the department receives the completed survey, it analyzes the information and determines whether the borrower complied with the loan forgiveness criteria. According to the department, if it concludes that rent and income levels are within allowable levels, it certifies compliance for that particular year and sends a letter confirming the status to the borrower. If it concludes that rent or income levels are not within allowable levels, the department either rejects certification, which means that the borrower will not be forgiven for that year’s percentage of the loan, or it conditionally re-certifies the borrower for the particular year. When the department rejects the borrower’s certification, it indicates that the borrower will have to repay, at maturity, that portion of the loan that relates to the noncompliant year. However, when the department conditionally re-certifies the borrower, it continues to classify the borrower as in compliance as long as the borrower complies with the conditions for loan forgiveness in future periods. To verify information submitted by the borrowers on the APP survey forms, the department stated that, in 1999, it began conducting on-site visits for one-third of the borrowers every year, so that each borrower will be reviewed approximately every three years.

We reviewed the files of all 35 borrowers with four or fewer rental units and found that the department’s files are missing critical records supporting its certification process for 33 of the 35 borrowers for one or more years for the period between 1996 and 1999. Specifically, we could not find 44 (31 percent) of the status letters and 16 (11 percent) of the APP surveys for this period. Most significantly, 29 of the missing status letters were for 1999 alone. When asked why so many status letters were missing, the department stated that it failed to make duplicate

copies for its files; however, it asserts that it sent status letters to all its borrowers and that it also contacted some borrowers to verify receipt. The department stated that since some APP surveys were taken by telephone, the surveys themselves would not be in the file. However, without sufficient evidence of status letters and APP surveys in the files, the department is unable to demonstrate that it used appropriate methods to determine whether its borrowers are in compliance with the Regulatory Agreement. Therefore, if noncompliant borrowers request forgiveness when their loans reach maturity, the department will not have sufficient evidence to approve or deny such requests. As a result, if the department inappropriately forgives the loans of noncompliant borrowers with four or fewer units, its actions could be considered a gift of public funds, which is a violation of the State Constitution. The 33 borrowers whose files are incomplete account for nearly \$3.3 million in loans.

Without sufficient evidence of its certification efforts, the department is unable to demonstrate that it used appropriate methods to determine borrowers' compliance with the loan forgiveness provisions.

The problem of this missing documentation is further compounded by the fact that the department does not ensure that its summary records agree with the status letters and APP surveys it has in the files. Each year, the department prepares a summary of the certification process and a year-end narrative report designed to inform management of the effectiveness of its monitoring activities. However, we found nine instances in which the department's supporting documentation in the files differed from its summary spreadsheet. In seven of these cases, the department's summary spreadsheet indicated that it conditionally re-certified borrowers as compliant for a particular year; however, the status letters in the files indicated that forgiveness was rejected for the same year. In another case, one borrower's status was conditionally re-certified as compliant according to the department's summary spreadsheet despite the fact that the status letters in the department's files indicated the borrower was actually re-certified as compliant for the same year. In the remaining case, the department's summary spreadsheet indicated that it rejected compliance for one year, when the status letters in the files stated the borrower was conditionally re-certified as compliant for the same year. As a result, the majority of the department's discrepancies in the summary records inappropriately favor the borrower because the department may believe that borrowers are conditionally re-certified for certain years, when the status letters indicate that they were actually rejected for the same years.

Twenty-one of the 35 borrowers charged their low-income tenants more than the maximum allowed rents as a result of department errors.

We also found that the department does not correctly apply maximum allowable rents, thus allowing many borrowers to overcharge their low-income tenants inadvertently. Each Regulatory Agreement states that for not less than one year of occupancy following the completion of the property's rehabilitation, borrowers shall charge rents not to exceed the amount charged immediately prior to the disaster, plus any allowable rent increases permitted by the department. Further, an attachment to the Regulatory Agreement provides the base rent, which is the borrower's pre-disaster rent level plus allowable increases made by the department. After one year of initial occupancy, and annually thereafter, borrowers may submit to the department all proposed rent adjustments based on a rate not to exceed the regional Consumer Price Index (CPI). Borrowers may appeal to the department for a greater rent increase to ensure the fiscal integrity of the project. The department erred, however, in calculating the maximum allowable rents, in many cases using the CPI percentage for one year and applying that calculated rent to the previous year, resulting in higher allowable rent rates for many borrowers. For example, the maximum allowable rent for a particular unit that the department calculated using the October 1997 CPI was used for the January 1997 rent. However, the October 1997 CPI should have been used for the January 1998 rent adjustment. This situation occurred because the department was late in preparing its calculation and applied its adjustments to the wrong period. Using our calculations, we found that 21 (60 percent) of the 35 borrowers pursuing forgiveness with four or fewer units overcharged their low-income tenants as a result of the department's errors. Since the inception of the program, these borrowers cumulatively charged excessive rents in 83 cases.

In addition, we determined that several borrowers charged their low-income tenants above the department's maximum allowable rent standards; however, it is unclear whether their loan forgiveness status will be permanently denied for noncompliant years. Based on the department's calculations, 15 (43 percent) of 35 borrowers overcharged their low-income tenants in 27 cases from 1996 through 1999. In 10 of those cases (37 percent), the department identified the overcharges and conditionally re-certified the borrowers as compliant. However, in 11 cases (41 percent), the department re-certified the borrowers as compliant even though they overcharged their low-income tenants based on the department's maximum allowable rent calculations.

For the remaining 6 cases (22 percent), the department either rejected or conditionally re-certified the borrowers; however, it did so for reasons other than overcharges. Therefore, some borrowers may be re-certified in the future despite overcharging their low-income tenants.

The department does not consistently require borrowers to remedy overcharges.

Furthermore, the department is not consistent in requiring borrowers to remedy overcharges, and its conditional re-certification status offers greater latitude to some borrowers. For example, one borrower overcharged its tenants in 1996 by \$450 per month according to the department's calculation and \$459 per month according to our calculation. In this case, the department conditionally re-certified the borrower's compliance due to the overcharges in 1996 and requested that the borrower immediately lower the rent to the maximum allowable. However, the department did not require the borrower to refund the overcharged rent to the tenant. By requesting that the borrower reduce rent rates, the department is putting borrowers on notice that they must adhere to maximum allowable rent levels, and it is attempting to protect low-income tenants who occupy rent-restricted housing. However, because the department did not require the borrower to refund money to the tenant, it fell short in actually ensuring that this borrower was compliant for the 1996 year. Thus, its conditional re-certification status was not appropriate because the tenant of this borrower was still overcharged in 1996.

In another example, a borrower overcharged its tenants in 1996 by \$21 per month, according to the department's calculation, and \$28 per month according to our calculation. In this instance, the department conditionally re-certified the borrower's compliance due to overcharges; however, unlike the previous example, it did not require this borrower to reduce rent rates. Instead, it directed the borrower to hold rent levels constant until future CPI adjustments increased the maximum allowable rent to the current rate being charged. As a result, the borrower continued to overcharge its low-income tenants for three years until the CPI adjustments caught up to the current rent rate. After this occurred, the department retroactively re-certified the borrower's compliance status for 1996. Despite the overcharges up to 1998, the department has listed this borrower as compliant since 1996. Although this position was advantageous to the borrower, who benefited from the highest rent rate possible, it conflicted with the program's objective for loan forgiveness, which is to provide affordable housing for lower-income households. When the department does not consistently require corrective action from

noncompliant borrowers, it leaves itself vulnerable to charges of unequal treatment. Since forgiveness is based on a percentage of compliant years, the department's conditional status grants borrowers greater latitude than the statutory provisions allow. Thus, borrowers who should be required to repay portions of their loans may have these loans forgiven.

Because the department's files were missing or had incomplete documentation, we could not, in several instances, determine whether tenants met the lower-income thresholds.

Moreover, although the department is required to ensure that borrowers rent their units to tenants that meet lower-income guidelines, we could not determine whether tenants were lower-income in several instances because of insufficient or incomplete documentation in the files. Of the 71 total rental units owned by the 35 borrowers with four or fewer units, we could not determine compliance for 23 units (32 percent) in 1996, 16 units (23 percent) in 1997, 9 units (13 percent) in 1998, and 3 units (4 percent) in 1999. For those borrowers having files with sufficient documentation, we found that they primarily rented to lower-income tenants. However, we found three instances where borrowers rented their units to tenants that had incomes higher than allowed. Tenants who, subsequent to occupancy, fail to meet income eligibility requirements are allowed up to six months to find new living arrangements. Based on the information provided by one borrower on the APP survey for the 1996 year, one tenant who did not meet income requirements occupied a unit for at least one year. In this case, the department indicated that it failed to identify the ineligible tenant because it used an incorrect income limit for the year. When the borrower submitted the APP survey for the following year, the ineligible tenant no longer occupied the unit. Nevertheless, because the department failed to identify the ineligible tenant, it incorrectly determined the borrower compliant for loan forgiveness for that year. For the two remaining cases, we found evidence that the department identified the ineligible tenants in 1996 and appropriately directed the borrowers to correct the situation within six months. Although each of these two borrowers removed the ineligible tenants, one of these borrowers re-rented the unit to another ineligible tenant, who subsequently stayed for more than one year until the department directed the borrower again to correct the situation within six months. Even though this borrower did not comply with the provisions for loan forgiveness, the department incorrectly determined the borrower compliant for that year.

Finally, we found that the department ineffectively enforced its own regulations dictating that vacancies held beyond a reasonable time period be classified as ineligible for loan forgiveness.

Six borrowers violated the department's policy by keeping their rental units vacant for more than six consecutive months; however, the department classifies all six as compliant with loan forgiveness requirements.

According to our review, 6 (17 percent) of the 35 borrowers failed to maintain the occupancy of their units for more than six consecutive months in 36 cases. The department stipulates that vacancies caused by needed repairs, poor market conditions, lack of funds, and undesirable applicants should be limited to a maximum of three to six months, and that vacancies caused by borrowers' inability to conduct the renting process because of their age or if the property is for sale are limited to a maximum of six months to a year. However, even though the department agreed with our vacancy assessments, it still classified the borrowers in question as compliant. The department stated that, during vacancy periods, borrowers either spent time and resources to ready their units for new tenants or corrected faulty or incomplete work performed during the rehabilitation period that contributed to the excessive vacancies. Further, the department stated that borrowers needed to process tenant applications by verifying their eligibility. After the department established its monitoring activities, it assisted borrowers with locating tenants to help minimize vacancy periods. Despite these actions, several borrowers have still left their units vacant longer than allowed by loan forgiveness requirements.

Although most of these vacancies lasted for less than one year, some lasted for a year or more. For example, we found that one borrower's rental unit remained vacant for four consecutive years. In another case, a borrower failed to rent out all three of the available units for six consecutive years. The statutes allowed borrowers loan forgiveness in exchange for their providing affordable housing to lower-income households. Therefore, when rental units remain vacant for excessive lengths of time, borrowers should not be eligible for forgiveness for the noncompliant years.

The Department Does Not Annually Certify Loan Forgiveness Status for Borrowers With Rental Loans for Five or More Units

There are 17 borrowers with five or more units that are currently pursuing forgiveness of their rental loans. Together, the rehabilitation portion of these loans amounts to \$12.2 million of the total CALDAP rental loans. Although the department implemented a process to monitor borrowers with five or more rental units, it falls short in actually certifying compliance with loan forgiveness provisions. Nevertheless, the department asserts that not one borrower with five or more units has been found out of compliance to a degree that would adversely affect that borrower's loan forgiveness status. The department monitors

each borrower using an Annual Performance Evaluation (APE), which is a percentage score based on several factors, such as fiscal responsibilities, maintenance, tenant occupancy, and administration. Although the tenant occupancy section of the APE addresses issues such as rent levels and tenant income eligibility, the APE score itself is not designed to indicate compliance or noncompliance with loan forgiveness provisions. Therefore, one cannot assume a borrower is compliant just because of a high score and, conversely, one cannot assume that a borrower is not compliant based solely on a low score.

The department uses the APE as a scoring system to evaluate how often it needs to perform on-site monitoring. Although the APE has “annual” in the title, it is not performed annually; rather, it is prepared after the department completes an on-site visit to a borrower, roughly every three to five years. In addition, the department does not evaluate annual compliance with loan forgiveness by reviewing disclosure information pertaining to rent and tenant-income levels for borrowers with five or more rental units. Instead, the department stated that it reviews rent levels for loan forgiveness during its on-site visits. As a result, it cannot ensure borrowers have met the compliance requirements for years between its site visits, a period that could be as long as four years. Although it may not be cost-effective to perform on-site visits each year, we believe the department could review annual disclosure information pertaining to rent and tenant-income levels, as it does for the facilities with four or fewer units.

The files for borrowers with five or more units did not contain sufficient evidence to determine whether the borrowers were in compliance with loan forgiveness requirements.

Not only does the department fail to annually certify compliance with loan forgiveness provisions for borrowers with five or more units, but it also does not maintain sufficient documentation to support compliance with rent and tenant-income levels. We reviewed the files for 12 of the 17 borrowers with five or more rental units, and although we found various APE scoring sheets, the supporting evidence used to calculate the scores, such as rent reports and tenant-income certifications, was not always in the files. Therefore, we could not verify that any of the 12 borrowers actually rented each of their units at affordable levels or ensured that lower-income households occupied each of the units.

In an attempt to verify compliance with loan forgiveness provisions, we visited facilities for 3 of the 12 borrowers. One of three borrowers maintains a total of 7 rent-restricted units, and for all 7 units, we found that rent levels were well within maximum allowable limits for the period 1990 through 2000. However, the remaining two borrowers charged their low-income tenants

higher than allowed rents during the period from 1990 through 2000. One of the two borrowers overcharged low-income tenants for one year by only \$7 per month, but the problems with the other borrower were more significant. Specifically, this borrower maintains a 24-unit apartment complex, of which only 5 units were eligible for CALDAP funding since the borrower had upgraded the other 19, and CALDAP provisions prohibit upgrades to units above the pre-disaster conditions. Therefore, not all of this borrower's units are subject to CALDAP rent restrictions. After rehabilitation, the borrower and the department agreed that each of the 5 CALDAP units would have the same rent rate; however, they never designated the specific units that would be rent-restricted under CALDAP loan forgiveness provisions. As a result, this borrower rotates the designated CALDAP-restricted units when tenants relocate, which makes the department's monitoring even more difficult than if occupancy were constant.

We reviewed the five units that the borrower stated had been CALDAP-restricted for the current tenants over the past two to seven years. Based on our maximum allowable rent calculations, we found overcharges for all five of the CALDAP units for the period 1995 to 2000 in which the current tenants have occupied the units. These overcharges ranged mostly between \$14 per month (\$168 per year) to \$42 per month (\$504 per year). However, one low-income tenant was overcharged by \$51 per month (\$612 per year) in 1996. These overcharges are mainly due to the department inappropriately deciding in October 1996 to allow the borrower to include an allowance for utility costs of \$44 per month. Just four months earlier, the department denied the borrower's request to add the same utility allowance because it stated that utility allowances are only applicable when tenants pay for all or a portion of the utilities, in which case the utility allowance is subtracted from the maximum allowable rent. When we brought this matter to the department's attention, it stated it had made an error when it allowed the adjustment in October 1996. However, the department's error does not explain the overcharges that occurred before that date. Consequently, this borrower could receive forgiveness for the period he overcharged his tenants prior to October 1996.

Not all borrowers are ensuring that their tenants meet income eligibility requirements.

In addition to these problems, we found that all three borrowers we visited displayed weaknesses in their tenant-income eligibility certification processes. Two of the three borrowers indicated to us that they verify income when tenants apply for apartments; however, the remaining borrower stated that he verified income only when he thought a tenant looked to be ineligible. Despite

Because the department does not ensure borrowers with five or more units have complied with the terms for loan forgiveness, it could inappropriately forgive a portion of \$12.2 million in loans.

income verification upon application, not one borrower could demonstrate until recently that it had updated tenant-income status annually for tenants that stayed multiple years. Beginning in 1998, one borrower began to annually re-certify all tenants' incomes and, interestingly, this is the same borrower that charged rents in accordance with the rent restrictions. We attempted to verify tenant-income eligibility; however, because borrowers did not always maintain such information, we could not determine compliance for many cases. For those cases we were able to test, we found no tenant incomes that were greater than the maximum amount allowed. Although the process of verifying income upon application ensures that tenants are low-income when they move in, it does not ensure that tenants remain eligible for low-income housing in subsequent years. Because the department does not ensure that borrowers annually re-certify their tenants' incomes or ensure that borrowers charge affordable rent levels, it could inappropriately forgive a portion of \$12.2 million that relates to borrowers with five or more units. As such, this action could be considered a gift of public funds, which is a violation of the State Constitution.

The Department's Monitoring of Rental Loans Used for Acquisition or Refinancing Is Limited

According to the Regulatory Agreements and the underlying statutes, borrowers using rental loans for both rehabilitation and acquisition or refinancing must restrict the rents of those units for the entire duration of the loan. Since acquisition loans have 30-year maximum terms, and the department did not have a list of acquisition loans aside from those pursuing forgiveness, we examined all loans with maximum terms of 30 years and identified only one borrower with an acquisition loan that did not opt for forgiveness. In November 1995, the department applied the CPI adjustments for 1990 through 1994 to determine that the borrower had complied with the rent requirements. The department then visited the borrower's property in 1996 and concluded that the units complied with rent restrictions. Based on the limited information from that visit, the assisted units comply with the required rent restrictions. However in another case, the department originally monitored a property where the borrower opted for forgiveness of the rehabilitation portion of the loan and where funds were also used for acquisition. In 1997, after the borrower repaid the rehabilitation portion of the loan, the department stopped monitoring the property even though the acquisition portion of the loan was still outstanding. In March 2001, when we brought this situation to the attention

of the department, it responded that monitoring should resume because of the requirement that acquisition loans continue to comply with rent restrictions. However, for the one year (1996) for which we have information, the rent levels charged by the borrower were less than the maximum rents allowed and, therefore, in compliance with the agreed rent restrictions.

The department did not monitor two loans used for refinancing to ensure compliance with required rent restrictions.

In addition to the acquisition loans, we identified two loans with 30-year terms where the borrowers did not opt to pursue forgiveness of the rehabilitation portion of the loan and used a portion of their funding for refinancing of existing property debt. Although the department's guidelines require that assisted units of properties with refinancing loans comply with rent restrictions for the entire length of the original loan, we found no evidence in our review of loan files to demonstrate that the department is monitoring these two loans to ensure compliance with the required rent restrictions.

Even though these loans are not eligible for forgiveness, the department still has ongoing monitoring responsibilities. According to the department, tenants for these borrowers are third-party beneficiaries to the Regulatory Agreement and have legal standing to sue the sponsor (landlord) and the State if rent levels are not correctly calculated or if assisted units are rented at market rates. Therefore, because the department does not monitor any of these borrowers unless they choose to pursue forgiveness of their loans, it exposes the State to potential litigation.

RECOMMENDATIONS

To ensure that the current loan program that provided assistance to Loma Prieta victims effectively conforms to its underlying statutes and guidelines, the department should take the following actions:

- Send periodic loan statements to borrowers that include outstanding principal and interest amounts and include specific contact information for borrowers with questions.
- Review and evaluate existing policies addressing the repayment of homeowner loans to ensure that these policies adequately address difficult repayment situations. If the department determines that a revision of these policies or procedures

is, in certain limited circumstances, in the State's interest, it should pursue a statutory revision to allow it the needed operational flexibility.

To strengthen the process by which it monitors borrowers with rental loans, the department should take the following steps:

- Ensure that minimum levels of compliance are specified in writing and are sufficiently detailed in accordance with underlying statutes and guidelines.
- Monitor all applicable borrowers—both those that are pursuing loan forgiveness and those that received funds for acquiring property or refinancing—to ensure they meet the terms and conditions of their Regulatory Agreements.
- Obtain a legal opinion concerning the meaning of the terms continuous and consecutive as they relate to compliance for rental loans and loan forgiveness.
- Retain documents such as periodic status letters, correspondence, and borrower disclosure information of rent and tenant-income levels in borrowers' files to verify compliance with loan forgiveness conditions.
- Provide sufficient annual feedback to allow monitored facilities to correct noncompliant activities. The department should allow conditional certifications only when borrowers agree to correct noncompliance, such as requiring borrowers to refund tenants' money for overcharges.
- Ensure that future calculations of maximum allowable rent are applied in the appropriate year. The department should establish status tracking work sheets for all borrowers with rental loans pursuing forgiveness and borrowers with acquisition or refinancing loans.

To ensure that future loan programs better achieve their goals, the department should reassess its guidelines and standards of operation for local jurisdictions in areas such as contractor selection and oversight of work quality.

The cities of Berkeley and Oakland should continue to provide a process to investigate and evaluate the complaints of CALDAP borrowers.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

A handwritten signature in black ink that reads "Elaine M. Howle". The signature is written in a cursive, flowing style.

ELAINE M. HOWLE
State Auditor

Date: May 3, 2001

Staff: Nancy C. Woodward, CPA
Art Monroe, CPA
Bryan Beyer
Dee Cheney

APPENDIX A

Comparison of Terms for Homeowner and Rental Loans

Table 3 on the following pages highlights the primary differences between the California Natural Disaster Assistance Program assistance for residential and rental housing. While these two components are similar because each provides assistance to earthquake victims, significant differences exist. Some of the major differences between the residential and rental programs include when the loans are due and payable, the maximum funding available, the ability to have another party assume the loan, the use of funds to acquire damaged properties, and the option for forgiveness of the rehabilitation portion of the loan.

TABLE 3**Comparison of Terms for Homeowner and Rental Loans**

Homeowner Assistance Loans	Rental Housing Assistance Loans
<p>Eligibility</p> <p>The property must have been damaged in a disaster for which the governor has proclaimed the area in which the property is located to be in a state of disaster.</p> <p>Legal owner and resident of property at the time of the disaster.</p> <p>Must remain the borrower’s principal place of residence after repairs.</p> <p>The department will not consider either individual or family income in determining loan eligibility.</p> <p>Credit report only required if loan exceeds \$30,000 or the loan-to-value ratio exceeds 100 percent.</p> <p>Borrower does not qualify for adequate assistance from other public or private sources, including insurance, sufficient to complete needed repairs.</p>	<p>The property must have been damaged in a disaster for which the governor has proclaimed the area in which the property is located to be in a state of disaster.</p> <p>Borrowers must own or propose to acquire rental property damaged by a disaster.</p> <p>Applicants for rehabilitation loans must show that they have registered with a disaster assistance center.</p> <p>Credit reports are examined.</p> <p>Loans may be provided to borrowers who do not qualify for loan assistance from a federal agency, or, to the extent that federal financial assistance is insufficient to accomplish the necessary rehabilitation or would require rent increases above the unit rents charged prior to the disaster.</p>
<p>Loan Limits</p> <p>Not to exceed \$30,000. The department may waive this limitation in individual cases to ensure compliance with health and safety standards, seismic safety standards, and general property improvements relating to these standards.</p> <p>Total indebtedness against the borrower’s dwelling shall not exceed 100 percent of the after-rehabilitation market value as determined by accepted appraisal techniques. The department may waive this limitation in individual cases to ensure compliance with health and safety standards, seismic safety standards, and general property improvements relating to these standards.</p>	<p>There are no maximum per unit loan limits.</p> <p>The loan shall not exceed 100 percent of the combined costs of rehabilitation and refinancing existing indebtedness or rehabilitation and acquisition costs.</p> <p>The loan, together with any existing indebtedness on the property, shall not exceed 100 percent of the after-rehabilitation value of the property. The department may waive this limitation in individual cases to ensure compliance with health and safety standards, seismic safety standards, and general property improvements relating to these standards.</p>
<p>Loan Rate and Terms</p> <p>Fixed rate, simple interest of 3 percent per year.</p> <p>No fixed loan term.</p> <p>Principal and interest are payable when (1) the residence is sold or ownership is transferred (does not apply to a spousal transfer), (2) the borrower breaches loan agreements, or (3) the dwelling is no longer the borrower’s principal residence.</p>	<p>Fixed rate, simple interest of 3 percent per year.</p> <p>Payments deferred until the end of the loan: 20 years for rehabilitation and 30 years for rehabilitation and acquisition loans.</p> <p>A buyer of the property may assume the loan if approved by the State and the local agency.</p> <p>As a condition of assistance, borrowers must agree to various rent restrictions depending on whether the loan funds are used only for rehabilitation or for acquisition and rehabilitation.</p>

Homeowner Assistance Loans

Rental Housing Assistance Loans

Use of Funds

To bring damaged dwellings into compliance with minimum rehabilitation standards or to finance the reconstruction of dwellings destroyed as a result of the disaster.

Must meet local building codes and criteria for cost effectiveness.

May be used in conjunction with other funds.

Fees necessary for construction.

To permit compliance with health and safety standards, seismic safety standards, and general property improvements relating to these standards.

Rehabilitation, replacement, or acquisition of rental properties damaged by disaster.

Repairs to eliminate code violations resulting from the disaster.

Elimination of serious code violations not caused by the disaster, as well as seismic reinforcement and fire safety improvements to correct hazards that pose a health and safety threat to occupants and must be repaired to receive a building permit.

Acquisition of property damaged by the disaster.

Refinance existing debt to achieve affordable rent.

Fees necessary for construction.

Make handicapped accessibility improvements when necessary for existing occupants.

Disallowed Uses of Funds

Upgrades or luxury quality materials.

Repair of nonessential unattached structures.

Personal property.

Work items paid by other funding sources.

Upgrades or luxury quality materials.

Repair of nonessential unattached structures.

Personal property.

Work items paid by other funding sources.

Conditions for Forgiveness

Not available for homeowner loans

Only applicable to the rehabilitation portion of the loan.

Must keep rents affordable to lower income households for at least 10 years. The percentage of the loan to be forgiven ranges from 30 percent to 100 percent of the rehabilitation portion of the loan depending on the loan term and the length of time rents have been kept affordable.

If the borrower maintains the assisted units at affordable rents for at least 10 years and then sells the assisted rental property to a nonprofit organization that agrees to maintain all the assisted units at affordable rents for the remaining loan period, the original borrower's loan forgiveness shall be computed based on at least 15 years of compliance.

Collateral

Loan secured by a deed of trust on the residence.

Loan secured by a deed of trust on the rental property.

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APPENDIX B

CALDAP Loan Activity by Local Jurisdiction

Table 4 on the following page highlights the extent of California Natural Disaster Assistance Program (CALDAP) assistance to homeowners and rental property owners. The table identifies those areas that received significant CALDAP assistance based on the total original loan balance and the relative amount of indebtedness to the State as of December 31, 2000, for each of those local jurisdictions.

TABLE 4

CALDAP Loan Activity

Local Jurisdictions	Number of Original Borrowers With One or More CALDAP Loans	Total Original Principal Loan Balances	Number of Borrowers With Outstanding Loan Balances	Loan Balance Outstanding as of December 31, 2000
Homeowner Loans				
Santa Cruz	170	\$11,701,970	93	\$ 7,340,566
City of Oakland	209	9,130,901	146	6,923,513
City of Berkeley	53	3,356,397	34	2,389,557
Santa Clara	45	3,028,661	20	1,643,570
City of Los Gatos	41	2,607,809	15	1,028,976
Direct loans by the Department of Housing and Community Development	32	2,265,491	21	1,593,476
City and County of San Francisco	49	1,913,960	23	1,003,584
County of Monterey	38	1,639,974	21	960,745
City of San Mateo	19	1,295,473	13	909,482
City of Watsonville	44	1,288,050	22	667,546
City of San Jose	21	1,005,002	10	593,527
City of Hollister	12	508,176	9	424,726
City of Alameda	9	499,739	7	357,739
City of Richmond	19	453,382	13	330,604
City of Gilroy	4	129,072	2	67,785
Alameda County	3	112,149	3	112,149
Total homeowner loans	768	\$40,936,206	452	\$26,347,545
Rental Loans				
City of Oakland	48	\$20,032,359	34	\$17,376,246
City of Santa Cruz	22	11,952,628	16	11,729,477
City and County of San Francisco	28	9,545,600	17	8,501,337
City of Watsonville	13	3,085,091	10	1,810,529
City of Santa Clara	3	435,216	3	435,216
Direct loans by the Department of Housing and Community Development	3	310,554	1	173,500
City of Alameda	2	280,630	2	247,878
County of Monterey	3	272,613	3	272,613
City of Berkeley	3	196,955	1	97,695
City of San Jose	3	189,977	3	189,977
City of Los Gatos	1	85,777	1	85,777
City of San Mateo	5	77,296	0	0
City of Richmond	2	35,456	1	5,401
Total rental loans	136	46,500,152	92	40,925,646
Total, All Loans	904	\$87,436,358	544	\$67,273,191

Agency's comments provided as text only.

Business, Transportation and Housing Agency
Maria Contreras-Sweet, Secretary
980 9th Street, Suite 2450
Sacramento, California 95814-2719

April 25, 2001

Elaine M. Howle
State Auditor
Bureau of State Audits
555 Capitol Mall
Sacramento, CA 95814

Dear Ms. Howle:

Attached is the Department of Housing and Community Development's (Department) response to your draft report, *Department of Housing and Community Development: Poor Administration of Certain Aspects of the California Natural Disaster Assistance Program for Loma Prieta Earthquake Victims Could Result in Inappropriate Loan Forgiveness* (#2000-129). After reviewing the Department's response, we agree with their approach to improving program oversight and communication with California Natural Disaster Assistance Program (CALDAP) borrowers.

Specifically, the Department will take the following actions:

- Send a letter to each CALDAP borrower providing general information about the CALDAP loan and the name and telephone number of a specific loan officer to contact to discuss questions or concerns about the loan.
- Initiate annual loan statements to CALDAP borrowers beginning in January 2002, to coincide with the conclusion of the tax year.
- Develop guidelines to ensure the consistent review of decisions to forebear on the foreclosure or other enforcement of its loans.

Elaine M. Howle
April 25, 2001
Page 2

- Request a legal opinion regarding borrower compliance with the terms of the regulatory agreement in order to achieve loan forgiveness.
- Improve its document retention practices for CALDAP loan files.
- Review and take action to address instances of excess rent payments identified in the audit, and continue to seek improvements to its automated systems to improve the accuracy of the rent increase authorization process.
- Initiate a management review of its overall monitoring program to evaluate its effectiveness and determine whether adequate resources are provided.

The Business, Transportation and Housing Agency (Agency) will carefully monitor the Department's actions in response to this audit, and will support its efforts to make needed improvements.

Thank you for the opportunity to respond to your audit. If you need additional information, please do not hesitate to contact me, or Michael Tritz, Chief of the Agency's Office of Internal Audits, at (916) 324-7517.

Sincerely,

(Signed by: Maria Contreras-Sweet)

MARIA CONTRERAS-SWEET
Secretary

Attachment

DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT
OFFICE OF THE DIRECTOR
1800 Third Street, Room 450
Sacramento, CA 94252-2050
www.hcd.ca.gov
(916) 445-4775
Fax (916) 324-5107

April 23, 2001

MEMORANDUM FOR: Maria Contreras-Sweet, Secretary
Business, Transportation and Housing Agency
980 – 9th Street, Suite 2450
Sacramento, CA 95814

(Signed by: Julie Bornstein)

FROM: Julie Bornstein
Director

SUBJECT: Bureau of State Audits Review of the California Natural Disaster Assistance Program

The Department of Housing and Community Development (HCD) was pleased to assist the Bureau of State Audits in its review of the California Natural Disaster Assistance Program (CALDAP). We concur with a majority of the recommendations and are committed to the implementation of measures to improve upon our responsiveness to the CALDAP borrowers as well as the consistent application of our policies and procedures. We will begin these efforts with a mailing to all CALDAP borrowers to make sure they know who to contact to obtain information about their loans.

We offer the following additional comments on the audit results that are not covered elsewhere in responses to specific recommendations.

- The report points out that the HCD did not initiate monitoring of its CALDAP loan portfolio until 1996. It is noted that redirection of staff for CALDAP monitoring was first authorized by the Legislature in the 1995-96 Budget and that HCD began its monitoring efforts of CALDAP loans at that time. In addition, during the 1995-1996 Budget process, the Legislature expressed interest in HCD reducing the cost and scope of its monitoring program. As a result, 25 positions for monitoring were authorized on a two-year limited term basis only. This was intended to allow HCD to get its monitoring program up and running, perform a risk assessment of its entire loan portfolio and present a plan for streamlining operations to reduce staffing levels by 33% beginning in 1997-98. HCD diligently completed the tasks outlined in its plan to establish an effective monitoring program within these constraints and has continued monitoring its loan portfolio. HCD also developed a consolidated database to assist in tracking loan and grant awards, but to date has been unable to enhance this tool to include key features to further facilitate monitoring.

This is the first audit of HCD's monitoring functions since these significant staffing reductions occurred. The audit results may indicate resource issues that need to be addressed in the future. In addition to carrying out the corrective measures outlined in this document, HCD will conduct a management review of its overall monitoring function to determine if improvements are needed in other program areas and whether adequate resources are being provided.

- The report indicates that HCD's monitoring practices may have placed State funds in jeopardy of loss or of gifting, because annual monitoring and certification did not occur in the case of specified rental loans where forgiveness of the rehabilitation portion of the loan is sought by the borrower. Forgiveness may be authorized by HCD starting after 10 years of compliance with rent and occupancy requirements and increasing incrementally thereafter, depending on the loan term. Although HCD recognizes the benefit of annual monitoring, this is not required by statute. It is also the borrower's responsibility to maintain appropriate records and have them available for HCD's inspection. HCD is developing guidelines for authorizing loan forgiveness and will have this framework in place before borrowers' requests for full or partial forgiveness are considered. As a result, HCD does not anticipate loss or gifting of State funds.
- The report indicates instances in which residents of rental housing assisted by the CALDAP Program paid higher rents than those allowed under program guidelines. In addition to taking corrective measures to ensure future overcharges do not occur, the Department will review each of the cases identified by the Bureau of State Audits to determine options for appropriate remedies.

Specific Audit Report Recommendations and Responses:

To ensure that the current loan program that provided assistance to Loma Prieta victims effectively conforms to its underlying statutes and guidelines, HCD should take the following actions:

Recommendation 1:

Send periodic loan statements to borrowers that include outstanding principal and interest amounts and include specific contact information for borrowers with questions.

Concur. The Department currently distributes loan balance statements to borrowers upon request, and is working to develop a system to distribute these statements on an annual basis for all CALDAP borrowers in January 2002 to coincide with the conclusion of the tax year. The statements will include the principal loan balance, interest accumulated to date, the interest percentage rate, and the amount of interest that accumulates on a monthly basis. A contact phone number will be provided should the borrower have questions concerning the information provided within the statements. Thereafter, these statements will routinely be sent in January each given year.

In addition, to immediately improve communication with our CALDAP borrowers and ensure they know how to obtain information about their loans, the Department will send letters to each borrower within the next 45 days. The letter will provide general information about the loans as well as the specific telephone number for the Monitoring and Management Branch loan officer responsible for answering any questions the borrower may have.

Recommendation 2:

Review and evaluate existing policies addressing the repayment of homeowner loans by a borrower's heirs to ensure that policies are not causing unnecessary hardship. If HCD determines that, in certain limited circumstances, revisions of its current policies or procedures addressing loan repayments are in the State's interest, it should pursue a statutory revision to allow it the needed operational flexibility.

Concur. The Department believes it has the inherent authority to forebear on the foreclosure or other enforcement of any of its loans as may be necessary to maximize the repayment of loans and protect the State's interests, consistent with the purposes of the program. Decisions to forebear are currently reviewed by departmental management and documented in each loan file. To further ensure consistency, however, HCD will develop guidelines to govern such decisions in CALDAP loans to maximize repayment of public funding while avoiding undue hardships. A statutory change is not required for this purpose. By statute, these guidelines need not be promulgated as regulations.

Recommendation 3:

To strengthen the process by which it monitors borrowers with rental loans, the department should take the following steps:

- A. Ensure that minimum levels of compliance are specified in writing and are sufficiently detailed in accordance with underlying statutes and guidelines.

Concur. The Department's statutes, guidelines and loan documents already provide requirements for minimum levels of compliance. Furthermore, the Department has a CALDAP desk manual to provide consistent direction to staff. However, the Department will update the desk manual to more thoroughly detail the acceptable minimum levels of compliance.

In addition, borrowers who have received acquisition or refinance loan proceeds will be sent information restating their obligation to maintain rents in accordance with their regulatory agreement. Borrowers that have exercised the loan forgiveness provision will be sent information restating their responsibility to rent all of their units to income eligible residents and to maintain rents according to the Regulatory Agreement. The provisions for compliance with the Regulatory

Agreement related to loan forgiveness will be made explicit and at a minimum will require the annual submittal of tenant eligibility and income and rent roll information by the borrower.

- B. Monitor all applicable borrowers—both those that are pursuing loan forgiveness and those that received funds for acquiring property or refinancing to ensure they meet the terms and conditions of their Regulatory Agreements.

Concur. Although statutes do not require annual monitoring, the Department will increase its level of effort to annual monitoring of these borrowers to the degree resources allow.

- C. Obtain a legal opinion concerning the meaning of the term continuous as it relates to compliance for rental loans and loan forgiveness.

Concur. The Monitoring and Management Branch will request a legal opinion regarding borrower compliance with the terms of the regulatory agreement in order to achieve loan forgiveness. The Department will use the opinion as it develops more specific policies and procedures on loan forgiveness (see response to Recommendation E, below.)

- D. Retain documents such as periodic status letters, correspondence, and borrower disclosure information or rent and tenant-income levels in borrowers' files to verify compliance with loan forgiveness conditions.

Concur. The Department recognizes the importance of maintaining copies of all correspondence to and from borrowers as a fundamental and necessary business practice. Staff will be instructed to file hard copies of all correspondence and documents to CALDAP loan files in a timely manner.

- E. Provide sufficient annual feedback to allow monitored facilities to correct noncompliant activities. The department should allow conditional certifications only when borrowers agree to correct noncompliance, such as requiring borrowers to refund tenants' money for overcharges, in the current period.

Comment. The statute does not require annual loan forgiveness certification (or feedback on such certification.) However, the Department recognizes the benefit of annual monitoring and will increase its level of effort in this area to the degree resources permit. The Department is also developing more explicit policies and procedures for addressing forgiveness that will include guidance on various options for resolving non-compliance for all rental loans and will also describe appropriate remedies, including rent roll back or rebates.

- F. Conduct sufficient and effective supervisory review of monitoring activities. Specifically, the department should ensure that future calculations of maximum allowable rent are consistent with and based on the correct CPI percentage and applied in the appropriate year.

Concur. The Branch supervisors will periodically review monitoring activities and provide training as appropriate to ensure that the correct CPI factors are being used and also ensure staff review of all rent increase requests before authorizing approval. In addition, the Department will explore the degree to which automated processes can be established within the Community Affairs Program Information System (CAPIMS) to facilitate calculation of allowable rent increases and identification of any discrepancies between allowable increases and increases reported or requested by the borrowers.

- G. The department should establish a status tracking worksheet for all borrowers with rental loans pursuing forgiveness and borrowers with acquisition or refinancing loans.

Concur. The Department uses an Oracle database (CAPIMS) to track and maintain information regarding the CALDAP rental loan portfolio. The Department will research incorporating into the History Table, a loan forgiveness compliance data field or value. With this insertion, the Department could create a report that would list loan forgiveness compliance dates, itemization of noncompliant issues and correction dates of noncompliant issues. These reports could be periodically run on individual borrowers and on particular groups of borrowers to aid loan officer and management oversight.

- H. To ensure that future loan programs better achieve their goals, the department should reassess its guidelines and standards of operation for local jurisdictions in areas such as contractor selection and oversight of work quality.

Comment: The Department concurs that good program design, including the underlying statute and guidelines/regulations used to implement programs are essential to good program outcomes. The CALDAP program was designed quickly as an emergency response to households in need of assistance following the Loma Prieta Earthquake and was used in subsequently declared natural disasters. Rental program loans were made to the existing building owners, rather than experienced non-profit or for profit sponsors skilled in the administration of rent-restricted units, which is typical of other successful affordable housing programs HCD administers. Because of their presence near the borrowers and the pre-existence of local housing rehabilitation program frameworks and resources, legislation authorized local governments to participate in extending owner loans and provided flexibility. However, local governments were not required to participate in subsequent monitoring of individual owner loans or to receive loan repayments to recycle in the future. HCD would not recommend a similar program design in the future and has not used this model for later programs. The CALDAP program was

not activated for the Northridge Earthquake, when voters rejected a general obligation bond measure to fund it, or for subsequent disasters.

Notwithstanding the challenges of the CALDAP design, 2,630 households were assisted over the life of the program. Over \$21 million in loan repayments and accrued interest have been made to the General Fund as required by statute. HCD is committed to efficient monitoring and oversight until all loan repayments are made or regulatory terms completed.

I will provide a 60-day progress report on the corrective actions outlined in this memo. Should you have any questions or require additional information on HCD's oversight of CALDAP, please do not hesitate to call me at 445-4775 or contact Judy Nevis, Chief Deputy Director, at the same number.

Agency's comments provided as text only.

City of Berkeley
Office of the City Manager
2180 Milvia Street
Berkeley, CA 94704

April 25, 2001

Ms. Elaine M. Howle
California State Auditor
Bureau of State Audits
555 Capitol Mall, Ste 300
Sacramento, CA 95814

Re: City of Berkeley – Draft Audit Response

Dear Ms. Howle:

We completed our review of the draft audit (redacted) report entitled “Department of Housing and Community Development: Poor Administration of Certain Aspects of the California Natural Disaster Assistance Program for Loma Prieta Earthquake Victims Could Result in Inappropriate Loan Forgiveness.” Our response to the recommendations made on pages 3 and 9 in the draft report is as follows:

State Audit Recommendation (same on both pages):

“The cities of Berkeley and (another city) should continue to provide a process to investigate and evaluate the complaints of CALDAP borrowers.”

City of Berkeley Response:

The City Council has already directed the City Manager to investigate the complaints of the Berkeley residents who participated in the CALDAP Program. The process in place and mentioned in this audit, resulted from that directive. That process will continue until it is completed, at which time a final report will be issued.

It should be noted that any claims the participants may have had against the City are subject to the provisions of the TORT CLAIMS ACT which would have required a claim to be filed by the property owner within six (6) months or no later than one (1) year of the accrual of their cause of action. That time period has passed. Any decision to compensate or rectify problems would be a policy decision made by the Berkeley City Council.

Interviews with City staff left us with the conclusion that there was some confusion at the State level regarding the implementation of the program. These messages were in the area of funding availability for various types of rehabilitation work.

We appreciate the opportunity to respond to the redacted version of the audit report. Please provide the complete and final audit report as soon as it is available.

Elaine M. Howle, California State Auditor
April 24, 2001
Page 2 of 2

Sincerely,

(Signed by: Weldon Rucker)

Weldon Rucker
City Manager

Agency's comments provided as text only.

City of Oakland
Community and Economic Development Agency
Housing and Community Development Division
250 Frank H. Ogawa Plaza, Suite 5313
Oakland, California 94612-2034

April 24, 2001

Elaine M. Howle
California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle,

The Housing and Community Development Department of the City of Oakland has reviewed the report prepared by the Bureau of State Audits, entitled "*Department of Housing and Community Development: Poor Administration of Certain Aspects of the California Natural Disaster Assistance Program for Loma Prieta Earthquake Victims Could Result in Inappropriate Loan Forgiveness, Report No. 2000-129*".

The recommendations contained in the report will be adhered to as prescribed. City of Oakland staff will develop an updated process to investigate and evaluate the complaints of CALDAP borrowers. Though not specifically called for in the audit recommendation, Oakland Housing and Community Development staff will submit a request to the State Department of Housing and Community Development to develop a referral process to obtain their review of certain investigative findings.

Oakland Housing and Community Development will continue its collaboration with the borrower group members in its jurisdiction, to address complaints and other pertinent issues related to their CALDAP loans.

Sincerely,

(Signed by: Roy L. Schweyer)

ROY L. SCHWEYER
Director

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press