

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

Audit Highlights . . .

We reviewed California Natural Disaster Assistance Program (CALDAP) loans provided to victims of the Loma Prieta earthquake by the Department of Housing and Community Development (department) 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.*

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The Joint Legislative Audit Committee requested that we review 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. 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. We found that:

Finding #1: Despite complaints concerning the quality of repair work, state and local jurisdictions generally provided adequate oversight.

The CALDAP homeowner loan program provided loans to homeowners in need of assistance. However, nearly 45 percent of the homeowner 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. 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.

In an effort to assess the complaints of poor workmanship, Oakland's Community and Economic Development Agency and Berkeley's City Manager's Office have performed recent inspections

of some of the properties in their jurisdictions. Although these inspections have found that many of the complaints are not related to the original CALDAP repair work, some of the complaints have merit.

We recommended that the cities of Berkeley and Oakland continue to provide a process to investigate and evaluate the complaints of CALDAP borrowers.

Department Action: Partial corrective action taken.

The Berkeley City Council approved a resolution on October 9, 2001, accepting the city manager's recommendations for improvements to city processes related to housing loan programs. In addition, the resolution requested that, among other tasks, the city manager (1) work with the State to forgive the portion of the CALDAP homeowners loans associated with rental units; (2) consult with various government contacts to identify a source of funding for grants to correct housing deficiencies in the CALDAP homeowner loan properties; (3) work with the State to reduce the loan balances by the amount paid by individuals above and beyond the CALDAP loan amount to correct work that was incomplete or improperly done, or work that was caused by work that was incomplete or improperly done; (4) work with the State so that each CALDAP property owner who has any loan remaining at the close of the process will have in writing on an annual basis the amount they owe, how they can repay their loan, or the accumulation of interest on a deferred loan; and (5) work with the State to extend loan repayments beyond six months upon the death of a property owner to allow the heirs of the deceased property owner the option of staying in the home.



The City of Oakland has not provided an updated response.

Finding #2: Some borrowers felt limited by the contractor selection process.

A number of borrowers have 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.

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

Department Action: Corrective action taken.

In its initial response to the report, the department agreed that the program design of CALDAP had shortcomings. It also noted that it has not used this program design in its more recent programs.

Finding #3: The department does not provide periodic loan statements.

The department may have 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 loan repayment terms or refinancing restrictions.

We recommended that the department provide periodic loan statements to borrowers that include outstanding principal and interest amounts and specific contact information for borrowers with questions.

Department Action: Partial corrective action taken.

The department reported that it is prepared to send annual loan balance statements to CALDAP borrowers beginning in January 2002. In addition, the department sent letters to all borrowers on June 12, 2001, reminding the borrower of the CALDAP loan and providing information related to department contacts.

Finding #4: Repayment terms of CALDAP loans may cause hardship for the heirs of some low-income borrowers.

Some provisions of the CALDAP owner loans may result in difficult repayment situations for the heirs of a small portion of the program's borrowers. The terms of CALDAP homeowner loans 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.

We recommended that the department review and evaluate its existing policies addressing the repayment of homeowner loans to ensure that its 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.

Department Action: Corrective action taken.

The department reported that it has developed guidelines for decisions regarding forbearance on the foreclosure or other enforcement of CALDAP loans to maximize repayment of public funding while avoiding undue hardships. Because CALDAP operates under guidelines, the department did not undertake revisions to any of its statutes. The department also indicated that its current policy is for departmental management to review decisions to forebear and these decisions are documented in each loan file.

Finding #5: The department's monitoring of CALDAP rental loans has been lacking.

The CALDAP rental loan program assists owners and tenants of rental properties. For this reason, CALDAP rental loan 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 its rental loan 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. Moreover, the department has not always enforced consistent minimum levels of compliance. In addition, 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. However, we found two loans during our review where funds were used for refinancing but that the department is not monitoring to ensure compliance with the required rent restrictions. 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.

To strengthen the process by which it monitors borrowers with rental loans, we recommended that the department 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.
- 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 by refunding tenants' overpayment of rents.
- Ensure that future calculations of maximum allowable rent are applied in the appropriate year. The department should also establish status tracking work sheets for all borrowers with rental loans pursuing forgiveness and borrowers with acquisition or refinancing loans.

Department Action: Partial corrective action taken.

The department reported the following status of its implementation of the recommendations:

- By May 1, 2002, the department intends to update its CALDAP desk manual to provide staff with more thorough detail regarding acceptable minimum levels of compliance.
- The department has identified the type of monitoring required by all loans in its CALDAP portfolio. On October 26, 2001, the department sent letters to borrowers of all three types of CALDAP rental loans restating their obligations to maintain rents and occupancy in accordance with their regulatory agreements. The letters also indicate that these forms and certifications will be sent annually and borrower response will be necessary to ensure that the loan remains in good standing.
- The department has developed policies concerning the term of affordability required to qualify for loan forgiveness. After the policies were documented, the department's legal affairs division reviewed them for consistency with CALDAP and approved them. The department believes this approach provides clearer legal guidance than does a legal opinion.

- The department's program managers have issued written instructions to staff concerning the retention of correspondence and documents in the borrower files.
- The department has adopted loan forgiveness policies and procedures, which include a resolution process of noncompliance issues. On or before May 1, 2002, and annually after that, the department will provide a certification letter to all borrowers who are seeking loan forgiveness.
- The department has adopted a policy entitled "Calculation of CPI Rate of Increase," which will be applicable to CALDAP rental loan program rents. In part, the policy provides (1) after one year of initial occupancy, and annually thereafter, the rents for the assisted units may be increased by the borrower at a rate not to exceed the most recently published annual average percentage change in the U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index, Rent Residential for all Urban Consumers for the West (CPI); and (2) borrowers may appeal to the department for a greater adjustment in rents, if necessary, to ensure the fiscal integrity of the rental housing development. In addition, CALDAP program staff have determined that the department's computer database is capable of incorporating loan forgiveness data fields as well as data fields to record information about borrowers with acquisition or refinancing loans. These necessary enhancements are included in the department's annual work plan and will be implemented during fiscal year 2001-02. Meanwhile, electronic spreadsheets, which facilitate the submittal of operating budgets and rent increase requests, of another of the department's loan programs will be made available to CALDAP borrowers and management agents by December 30, 2001.

