Audit Report

Department of Housing and Community Development

Division of Development Finance
Division of Credit Assurance
Division of Neighborhood Revitalization

March 2009

OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Karl S. Aro
Executive Director

Bruce A. Myers, CPA
Legislative Auditor

March 11, 2009

Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Division of Development Finance, the Division of Credit Assurance, and the Division of Neighborhood Revitalization within the Department of Housing and Community Development (DHCD) for the period beginning January 27, 2005 and ending February 29, 2008. DHCD works with partners to finance housing opportunities and revitalize places for Maryland citizens to live, work, and prosper.

Our audit disclosed continued deficiencies in accounting for DHCD's cash flow loan activity pertaining to multifamily projects. We have commented on similar deficiencies in our preceding audit reports dating back to 1998. Specifically, cash flow loan records were incomplete. Consequently, there was no single source within DHCD that provided a comprehensive record of cash flow loan balances and related loan activity. Outstanding cash flow loans, which totaled approximately $227 million as of June 30, 2008 according to DHCD's records, are primarily State-funded loans with customized repayment terms, including provisions for the deferral of scheduled payments due to insufficient project cash flow. Deficiencies also existed in the monitoring of multifamily project loans, which exceeded $945 million as of June 30, 2008.

We also identified certain deficiencies in DHCD's collection efforts on a $688,000 delinquent Neighborhood Revitalization loan in which the last payment was received over two years ago. In addition, we noted shortcomings in award and monitoring procedures related to special loan activities, the Community Legacy and Neighborhood Business Works Programs, and the Community Investment Tax Credit Program.

An Executive Summary of our findings can be found on page 5. DHCD's response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of the audit by DHCD.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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* **Denotes item repeated in full or part from preceding audit report**

Executive Summary

Legislative Audit Report on the
Department of Housing and Community Development (DHCD)
March 2009

- **Complete records of multifamily project cash flow loans were not maintained. Consequently, there was no single source within DHCD that provided a comprehensive record of cash flow loan balances and related loan activity. Accordingly, DHCD's ability to monitor loan performance and to bill amounts due was impaired. Furthermore, with respect to certain multifamily project loans, DHCD did not impose sanctions when required financial reports were not submitted. When the reports were submitted, DHCD did not always review the reports timely to ensure that projects were financially stable and were operating in accordance with requirements.**

  DHCD should maintain a complete record of its multifamily cash flow loans. DHCD should also adequately monitor multifamily projects to ensure that required financial reports are submitted or impose sanctions if reports are not submitted. Once the reports are submitted, DHCD should review the reports in a timely manner.

- **Appropriate collection actions were not taken on a delinquent Neighborhood Business Works Program (NBWP) loan and additional funds were loaned to the delinquent borrower for operating expenses.**

  DHCD should aggressively pursue recovery of the aforementioned defaulted loan and not award additional funding to delinquent borrowers without ensuring that the additional funds will make the project viable.

- **Numerous procedural deficiencies were noted with respect to DHCD's award and monitoring procedures related to certain financing programs. For example, the Community Legacy Board awarded financial assistance to projects that experienced significant start-up delays, indicating that the projects may not have been ready to proceed when assistance was received. Also, DHCD did not obtain sufficient documentation of additional funding commitments from other sources and monitoring reviews of certain special loan programs had not been performed.**

  DHCD should take the recommended actions to improve award and monitoring procedures.

Background Information

Agency Responsibilities

The Department of Housing and Community Development (DHCD) works with partners to finance housing opportunities and revitalize places for Maryland citizens to live, work, and prosper. To deliver these services, DHCD is organized into six units. This audit report includes the operations of the following three units:

Division of Development Finance
Division of Credit Assurance
Division of Neighborhood Revitalization

According to the State's records, fiscal year 2008 expenditures for these three units totaled $269.5 million.

The remaining units of DHCD (Office of the Secretary, Division of Finance and Administration, and Division of Information Technology) are included within the scope of a separate audit conducted by our Office.

The Division of Development Finance (DDF) consists primarily of the Community Development Administration (CDA). CDA works to increase the supply of affordable housing within Maryland for the disabled, the elderly, and families with low and moderate incomes. To assist in this mission, CDA provides loans for the purchase and/or rehabilitation of single family homes and for the acquisition, construction, renovation, and/or rehabilitation of multifamily rental housing, transitional housing, and emergency shelters. Approximately 95 percent of CDA's single family mortgage loans are insured or guaranteed to varying degrees by agencies of the United States government or the Maryland Housing Fund (discussed below), and all of CDA's multifamily loans are insured or guaranteed. DDF also provides rehabilitation and weatherization assistance to improve basic livability, increase energy conservation, and meet unique housing needs, including lead paint hazard reduction, accessibility improvements for seniors, and financing of group homes. These housing programs are funded primarily by revenue bonds issued by CDA, State general obligation bonds, State appropriations, federal funds, and federal tax credits.

The Division of Credit Assurance is responsible for the Maryland Housing Fund (MHF) which was created in 1971 to insure mortgage loans. In 2002, DHCD reopened a limited multifamily program in MHF, insuring mortgage loans known as the Special Housing Opportunity Program (SHOP). In 2004, MHF insurance coverage was expanded to authorize insurance on a case-by-case basis, financed by bonds, on loans made under the Federal Housing and Urban Development Risk Sharing Program. In June 2005, an MHF program was established to insure 40-year single family mortgage loans purchased by CDA. As of November 10, 2008, due to current volatile and unpredictable financial market conditions, DHCD suspended the MHF mortgage insurance program for all new MHF insurance related to single family mortgage loans purchased by CDA. According to audited financial statements, as of June 30, 2008, MHF's outstanding insurance commitments totaled approximately $52 million for single family mortgages and approximately $114 million for multifamily mortgages, and MHF had total net assets of approximately $98 million.

The Division of Neighborhood Revitalization provides funding and technical assistance to local governments, nonprofit organizations, community groups, and businesses. Through this assistance, DHCD revitalizes communities, improves basic infrastructure, creates small business and housing opportunities, rejuvenates traditional business districts and cultural amenities, reuses historic sites, and upgrades parks and playgrounds.

The following chart presents certain financial data pertaining to DHCD's outstanding loans as of June 30, 2008:

	Loans Outstanding (in millions)			
	Single Family	**Multifamily**	**Other**	**Total**
From State Funds	$ 69.3	$ 362.8	$ 80.6	$ 512.8
From Revenue Bonds	2,037.4	582.6	134.5	2,754.5
Total Loans Receivable	$2,106.7	$ 945.4	$215.1	$3,267.3

Source: Audited Financial Statements and DHCD records

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the 10 findings contained in our preceding audit report dated May 12, 2006. We determined that DHCD had satisfactorily resolved five findings. The remaining five findings are repeated in this report.

Findings and Recommendations

Multifamily Projects

Finding 1
Records maintained for cash flow loans were incomplete. Similar conditions have been commented upon in our preceding audit reports since 1998.

Analysis
Although the Department of Housing and Community Development (DHCD) has established separate records to account and bill for cash flow loans and to track loan performance, these records were incomplete. Consequently, there was no single source within DHCD that provided a comprehensive record of cash flow balances and related loan activity. Our four preceding audit reports, dating back to 1998, have included similar comments. DHCD makes cash flow loans to eligible applicants for the acquisition, construction, or rehabilitation of rental housing projects. These loans are generally funded with State funds and are only repayable to DHCD if the project operations result in surplus cash as defined by the loans' regulatory agreements. Our review disclosed the following conditions:

- DHCD did not maintain a record of current outstanding balances for all cash flow loans. As a result, the loans cannot be effectively monitored and billed. To address this issue, DHCD instructed its loan servicer to begin reconstructing the cash flow loan records for the 306 outstanding loans, from four loan programs, which totaled approximately $227.6 million as of June 30, 2008. However, loan records for 268 loans totaling approximately $188.9 million had yet to be reconstructed.

- DHCD did not reconcile the aforementioned billing records with its loan performance tracking records. As a result, DHCD may not be tracking the loan performance (such as monitoring of surplus cash) for all cash flow loans. As of June 30, 2008, our comparison of the billing records to the performance tracking records disclosed a net difference of $4.6 million, consisting of 12 loans that were recorded on just one of the records.

Although DHCD has made limited progress in addressing the inadequate cash flow loan records (such as by standardizing loan documents and defining roles among the different DHCD divisions responsible for managing cash flow loans), the current conditions continue to impair DCHD's ability to effectively manage cash flow loans. We were advised by DHCD management that it is in the process of procuring a loan servicing system for cash flow loans.

Recommendation 1
We again recommend that DHCD maintain a comprehensive loan accounting system which reflects all loan balances and related activity (for example, billings, loan performance) and use the system to manage its cash flow loan activities.

Finding 2
Certain required financial reports were not always submitted and, when submitted, were not reviewed timely. In addition, DHCD did not impose permissible sanctions when these reports were not submitted in a timely manner.

Analysis
Certain required financial reports for multifamily loans were not always submitted and, when submitted, were not reviewed timely. In addition, DHCD did not impose permissible sanctions against borrowers when these reports were not submitted in a timely manner. Timely submission and review of these reports are critical in assisting DHCD to monitor and bill loans (especially cash flow loans) and to identify improper financial activities (such as unauthorized withdrawals of project funds). Our four preceding audit reports, dating back to 1998, have included similar comments. Our review of the reporting status of all projects with reports due in calendar year 2007 disclosed the following conditions as of August 2008:

- Annual audited financial statements and related auditor certifications were submitted from 2 to 9 months after the required due dates for 45 projects, with loan balances totaling approximately $125 million. Furthermore, after receipt of the required 2007 financial statements and certifications for 129 projects, with loan balances totaling approximately $184 million, DHCD had not completed timely reviews of the submitted documents, with delays ranging from 2 to 11 months beyond the required timeframe. DHCD policy requires the borrowers to submit these financial reports within 90 days following fiscal year end. The policy also requires DHCD to complete a review of these financial reports within 60 days of receipt for cash flow loans and 120 days of receipt for all other loans.

- DHCD did not ensure that the borrowers complied with all reporting requirements. Our limited test of completed reviews for 10 projects totaling $25.2 million disclosed that for 5 projects totaling $14.2 million, all of the required audit certifications (such as auditor's report on compliance with specific requirements applicable to DHCD programs) had not been submitted. Although we were advised by DHCD management that all audit requirements do not apply to all projects, management could not document the applicability of this deviation for the five aforementioned projects.

- Operating budgets and operating statements were not always submitted by borrowers and reviewed by DHCD in a timely manner. These reports are critical to the monitoring of the projects financial and operational progress (such as income, expenditures, and occupancy). For example, operating budgets for 56 projects, with loan balances totaling approximately $176.5 million, were submitted between 50 days to over 14 months after the required due dates. For 65 projects, with loan balances totaling $130 million, DHCD had not reviewed the budgets for periods ranging from 17 days to 3 months after the required reviews should have been performed.

  According to DHCD's current practices, borrowers are required to submit operating budgets 60 days prior to the start of the borrower's fiscal year and borrowers are required to submit operating statements within 20 days of the end of the month and/or quarter. DHCD's policy also requires a review of the operating budgets to be completed within 30 days of receipt.

- DHCD had not imposed sanctions (such as increasing reporting requirements, assignment of rent to DHCD, increasing frequency of inspections and audits, declaring the project in default of the loan, and removal of management agent) for the untimely submissions of any of the aforementioned financial reports as allowed by DHCD policy. We were advised by DHCD management that sanctions were not imposed on certain projects because the sanctions may be detrimental to the project.

Recommendation 2
We recommend that DHCD

a. **ensure that project financial reports are received and reviewed timely (repeat),**
b. **ensure that borrowers comply with all reporting requirements, and**
c. **impose sanctions when required reports and certifications are not received timely or document the reason for sanctions not being imposed.**

Neighborhood Revitalization Grants and Loans

The Division of Neighborhood Revitalization assists local communities to identify revitalization areas, develop revitalization strategies and projects and provides financial assistance to develop and expand small businesses, revitalize communities, develop affordable housing, and support community services. We reviewed financial assistance provided through the Community Legacy Program

(CLP) and the Neighborhood Business Works Program (NBWP). In addition, we reviewed the Community Investment Tax Credit Program (CITC). CLP provides assistance to urban neighborhoods, suburban communities, and small towns that are experiencing decline but are believed to have potential with modest public and private investment. NBWP provides below-market interest rate loans to small businesses and loans and grants to nonprofit organizations locating or expanding in designated neighborhood revitalization areas. Through CITC, DHCD awards tax credits to non-profit organizations that the organizations can market to businesses in order to solicit charitable contributions of cash, real property, or goods to support approved projects. Loans from the Division of Neighborhood Revitalization are financed by State appropriations and are not insured.

According to its records, DHCD awarded $23.8 million in financial assistance under the CLP and approximately $5.2 million in NBWP grants during fiscal years 2005 through 2008. In addition, during fiscal years 2005 through 2008, DHCD awarded CITC tax credits totaling approximately $3.9 million.

Finding 3
DHCD did not take appropriate collection actions on a defaulted NBWP loan with an outstanding balance of $688,000. In addition, DHCD loaned an additional $378,000 so the borrower could pay certain operating costs and avoid potential bankruptcy.

Analysis
Our review disclosed deficiencies regarding one NBWP loan originally awarded in 1999 for $385,000. As of June 2008, the outstanding loan amount was $688,059, and DHCD had received no loan payments since April 2006. Specifically, we noted the following conditions:

- Although DHCD declared the loan in default in August 2007 and initiated foreclosure proceedings in December 2007, the foreclosure process was halted by DHCD. Specifically, we were advised that this management decision was made because foreclosure proceedings could potentially trigger other lenders invested in the project to also initiate foreclosure, negatively impacting the revitalization of the surrounding community. Furthermore, DHCD had not initiated collection efforts against either of the two loan guarantors. Consequently, DHCD had not taken appropriate actions to collect the aforementioned loan, as of June 2008. According to DHCD's policy, once loans are delinquent for more than 90 days, corrective actions, such as declaring the loan in default or working with the borrower to get the loan current, should be taken.

- DHCD loaned additional funds totaling $378,000 to this same borrower in May 2005 and November 2006 because the borrower was in urgent need of funds to pay operating expenses (such as miscellaneous debt payments, utilities, advertising, and taxes) and to avoid potential bankruptcy with other lenders. In this regard, DHCD loaned the additional funds to the borrower without performing a documented analysis to determine if the infusion of the additional funds would make the project viable, thereby increasing the likelihood that the loan ultimately would be repaid. Furthermore, when DHCD approved the second modification, the borrower was already delinquent on the loan for six months and had not satisfied other loan requirements.

As of September 26, 2008, of the $2.8 million in delinquent NBWP loans, this borrower represented 24 percent of the delinquency. A similar condition regarding the adequacy of collection efforts for a different NBWP delinquent loan was commented upon in our preceding audit report.

Recommendation 3
We recommend that DHCD

a. aggressively pursue recovery for the aforementioned defaulted loan through the loan guarantors or foreclosure proceedings (repeat), and
b. not award additional funding to delinquent borrowers in the future without a documented analysis demonstrating that the funds would improve project viability.

Finding 4
Certain approved Community Legacy projects were not started timely, as required by State regulations.

Analysis
Our review of Community Legacy Program (CLP) funded projects disclosed certain projects had significant start-up delays, which indicates that the projects had not met State regulations that require projects to be ready to proceed when assistance is received. In a few cases, subsequent changes in project scope raised questions as to whether the projects satisfactorily met CLP's intent to revitalize urban neighborhoods, suburban communities, etc. that are experiencing decline.

According to DHCD records, 51 CLP projects that were awarded assistance during the period from April 2005 to August 2007 totaling $4.7 million had not requested any funds as of July 2008, even though State regulations require applicants to demonstrate that the project is ready to proceed upon receipt of the CLP financial assistance. In some cases, DHCD's project review committee did not recommend the projects to the Community Legacy Board. (While DHCD is responsible for administering CLP and making recommendations to the Board; the Board, which consists of the secretaries of DHCD, Planning, Transportation and Natural Resources, is responsible for awarding funding to the projects.) These delays, coupled with a greater number of projects seeking financing than available funding, may have precluded other projects that were ready to proceed from obtaining program funds.

The following are examples of approved projects we noted with significant delays or changes in scope from the original approved projects:

- In fiscal year 2005, a $150,000 grant was awarded, even though the project review committee noted that the grantee's permanent financing was unsecured. The intended purpose of the grant was to assist the grantee in purchasing property for a combined community homeless shelter and community conference center. In May 2005, $146,250 was advanced to the grantee to acquire the property; however, as of June 2008, only $50,000 had been expended (deposit required by the purchase agreement), but the subject property had not been purchased. As of June 2008, recovery of the grant funds had not been pursued even though the grant agreement stated that the unspent funds were to be returned to the State if the funds were not expended within 90 days of advancement.

- In fiscal year 2006, a $153,750 loan was awarded for the demolition of housing properties for a parking lot, even though the project review committee noted that the properties were part of a Nationally Registered Historic district and the proposed parking lot would not serve the general public. As of June 2008, the funds had not been expended, and DHCD documentation indicated that the borrower intended on using the funds to demolish housing in a different location than that originally included in the project's scope.

- In fiscal year 2005, a $40,000 deferred repayment loan was awarded, even though the project review committee noted that the project would be successful without the CLP financing. The intended purpose of the loan was to acquire a building and renovate it for use as a credit union branch office as part of an economic development project. Three years after the loan was approved, and a few days before the loan period was set to expire, DHCD disbursed the funds to the borrower even though the current plans were to only place an automated teller machine in the building and possibly use the building for a hair salon. As of July 2008, DHCD has not requested repayment of the loan even though the loan agreement required repayment within 90 days of when the building was no longer being used as a bank.

Recommendation 4
We recommend that

a. **CLP financing only be awarded to applicants that have demonstrated that the project is ready to proceed upon receipt of financial assistance,**
b. **DHCD ensure that the scope changes are reasonable given the original project intent as approved by the Community Legacy Board, and**
c. **DHCD review all open CLP projects to verify projects are progressing in accordance with CLP requirements.**

Finding 5
DHCD did not obtain sufficient documentation of additional funding commitments from other sources and did not always ensure that recipients of financial assistance submitted final reports as required.

Analysis
DHCD did not obtain sufficient documentation of additional funding commitments from other sources and did not always ensure that recipients of financial assistance submitted final reports as required by the loan documents. Similar conditions were commented upon in our preceding audit report. We noted the following conditions:

- Our test of 25 projects that were awarded either CLP or NBWP financial assistance totaling approximately $3.6 million during fiscal years 2005 through 2007 disclosed that, for 12 projects that were awarded approximately $2 million, the final grant or loan documents indicated additional funding commitments totaling $40.3 million from other sources for the projects. However, there was no documentation included with the applications to support the validity of these additional funding commitments. Since funding from other sources is generally required to complete these projects, sufficient documentation of additional funding commitments is critical to ensure the viability of the projects, which is required by State regulations. Furthermore, applications for both CLP and NBWP funding require the applicant to submit documentation of all funding commitments.

- Our test of 10 projects that were awarded either CLP or NBWP financial assistance totaling approximately $1.65 million during fiscal years 2005 through 2007 and were required to submit final reports disclosed that, for 4 projects totaling approximately $529,000, the recipients had not submitted final reports as of May 2008. As of this date, these reports range from one to two years past due. DHCD's grant and loan agreements require the recipient to submit a final report within 45 days after the completion of the project. The final report is to include a financial report certified by the borrower/grantee as well as detailed information on expenditures related to the financial assistance provided.

Recommendation 5
We recommend that DHCD

a. **ensure that it obtains, for both current and future projects, appropriate documentation of all outside funding commitments claimed in applications for financial assistance under the CLP and NBWP as required (repeat); and**
b. **ensure that CLP and NBWP financial assistance recipients submit the required final reports.**

Finding 6
DHCD did not always obtain CITC Program reports as required by State regulations.

Analysis
DHCD did not always obtain CITC Program reports as required by State regulations. Our test of 20 non-profit organizations awarded CITC tax credits totaling $744,100 during fiscal years 2005 through 2008 disclosed that, as of June 2008, DHCD had not obtained all required semi-annual reports from 15 organizations, awarded credits totaling $636,800. For example, 3 of those 15 organizations had not submitted any reports. Although DHCD management advised us that additional follow-up actions (such as sending e-mails) were made to obtain these reports, these actions were not documented. State regulations require that non-profit organizations awarded tax credits submit a report twice a year detailing the activity of the project, use of the tax credits and contributions received, and a description of how the organization is marketing the tax credits.

Through a competitive application process, DHCD awards tax credits up to $250,000 to non-profit organizations that sponsor community activities in priority funding areas. The organizations market the tax credits to Maryland businesses in exchange for donations of cash, real property, or goods to support approved projects. After a donation is made, DHCD reviews documentation regarding the donation and certifies the tax credits. Maryland businesses may claim a State tax credit equal to 50 percent of the contributions. This credit is in addition to deductions for charitable contributions claimed on federal and State tax returns. According to its records, during fiscal years 2005 through 2008, DHCD awarded CITC tax credits totaling approximately $3.9 million.

Recommendation 6
We recommend that DHCD

a. **ensure that the non-profit organizations submit semi-annual CITC Program reports as required by State regulations, and**
b. **ensure that any follow-up efforts to obtain missing reports be documented and retained for future reference.**

Single Family and Special Grants and Loans

Finding 7
DHCD had not performed required periodic monitoring of certain special loan programs.

Analysis
DHCD had not performed required periodic monitoring reviews of local government jurisdictions responsible for administering certain special loan programs. Additionally, DHCD did not adequately monitor borrowers' income. For example, we noted the following conditions:

- DHCD had not performed periodic monitoring reviews within required time intervals for 21 of the 26 local government jurisdictions, which were responsible for administering the special loans under the Maryland Housing Rehabilitation Program (MHRP) and the Special Targeted Area Rehabilitation (STAR) Program. As of May 2008, monitoring reviews for these jurisdictions were from 2 to 25 months past due. The local jurisdictions are responsible for receiving applications, evaluating the loan requests, evaluating the building and proposed improvements, performing all underwriting procedures and, in certain circumstances, approving loans up to a maximum amount of $60,000.

  DHCD's special loan program policy requires specific procedures to be performed (such as site visits to agencies for case file reviews and property inspections) every six months for newly contracted jurisdictions and for jurisdictions that have received an unfavorable monitoring report during the latest review. For all other jurisdictions, these procedures are required to be performed annually or in some instances every three years. Without performing monitoring reviews, DHCD lacks assurance that the local jurisdictions are administering the special loan programs in accordance with DHCD's requirements and procedures.

- DHCD did not ensure that the Group Home Financing Program (GHFP), and the Special Housing Opportunities Program (SHOP) loan borrowers submitted annual income certifications of their group home occupants. According to DHCD's database (used to track the certification submissions), annual certifications for calendar year 2006 were not submitted for 119 of the 496 GHFP and SHOP loans, as of March 2008. Although DHCD management advised us that follow-up actions were taken (such as phone calls and letters), these actions were not documented. State regulations require that GHFP and SHOP borrowers annually remit income certifications of their group home occupants to DHCD for verification that the occupants do not exceed the established income limits.

According to its records, DHCD closed approximately $5.9 million in MHRP loans, $3.7 million in STAR loans, and $12.5 million in GHFP and SHOP loans during fiscal years 2007 and 2006. Similar conditions regarding untimely monitoring reviews were commented upon in our prior audit report.

Recommendation 7
We recommend that DHCD

a. perform required monitoring reviews of the local jurisdictions responsible for administering the special loan programs within the required time intervals (repeat), and

b. ensure GHFP and SHOP borrowers submit required annual income certifications and that any follow-up efforts to obtain missing certifications be documented and retained for future reference.

Finding 8
DHCD did not comply with certain information technology guidelines regarding review of system access, data backup practices, and disaster recovery plans.

Analysis
DHCD did not comply with certain information technology guidelines regarding review of system access, data backup practices, and disaster recovery plans for the system that contained the single family module. Specifically, we noted the following conditions:

- DHCD's periodic review of employees' access to its loan monitoring system was not documented. Although access reports were sent to the respective units within DHCD, there was no documentation of subsequent review and approval of noted access. Consequently, DHCD lacked assurance that the reviews were conducted and inappropriate access capabilities were detected.

- DHCD stored the prior two months of data backup copies (such as loan databases and electronic document imaging systems) on-site rather than at a secure offsite location. Consequently, an on-site disaster could cause significant delays in restoring operations.

- DHCD had not tested its disaster recovery plan (DRP) as of July 28, 2008. Specifically, we noted that DHCD had not performed any tests of its DRP involving restoration of the operations of the application and database processing.

The Department of Information Technology's (DoIT) *State Information Technology Access Control Standard* requires that a documented review of system access be conducted at least annually. Additionally, according to the *State of Maryland Disaster Recovery Guidelines*, backup media should be stored off-site in a secure, environmentally controlled location. Furthermore, the DoIT *State Information Technology Security Program Standard* requires that agencies periodically test the disaster recovery plan for each critical system to ensure that contingency procedures will be available in the event of a disaster.

Recommendation 8
We recommend DHCD comply with the aforementioned information technology guidelines.

Audit Scope, Objectives, and Methodology

We have audited the following units of the Department of Housing and Community Development (DHCD) for the period beginning January 27, 2005 and ending February 29, 2008:

Division of Development Finance
Division of Credit Assurance
Division of Neighborhood Revitalization

The remaining units of DHCD (Office of the Secretary, Division of Finance and Administration, and Division of Information Technology) are included within the scope of a separate audit.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

As prescribed by the State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine DHCD's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the findings contained in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of DHCD's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

Our audit did not include certain support services (for example, payroll, maintenance of accounting records and related fiscal functions) provided by DHCD's Division of Finance and Administration. These support services are included within the scope of our audits of the Division. Additionally, our audit did not include an evaluation of internal controls for federal financial assistance programs and an assessment of DHCD's compliance with federal laws and regulations pertaining to those programs because the State of Maryland engages an independent accounting firm to annually audit such programs administered by State agencies, including DHCD.

DHCD's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect DHCD's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to DHCD that did not warrant inclusion in this report.

DHCD's response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise DHCD regarding the results of our review of its response.

DHCD
Maryland Department of Housing and Community Development

March 5, 2009

Bruce A. Myers, CPA
Legislative Auditor
Department of Legislative Services
Office of Legislative Audits
301 West Preston Street, Room 1202
Baltimore, MD 21201

Dear Mr. Myers:

Enclosed please find our response to the Office of Legislative Audit draft report of the Division of Development Finance, the Division of Credit Assurance and the Division of Neighborhood Revitalization of the Department of Housing and Community Development (DHCD) for the period beginning January 27, 2005 and ending February 29, 2008.

I have reviewed the findings and recommendations contained in the report and have committed the DHCD to a plan of corrective action, which is summarized in the attachment. Additionally, our plan of corrective action documents the approximate time frame for compliance with the audit report's recommendations.

The DHCD views the correction of legislative audit findings with the utmost seriousness. You can be assured that every action will be taken to ensure compliance with the audit's recommendations.

If you have any questions regarding our response, please do not hesitate to contact me or Mr. Leroy Rose, Internal Audit Manager, at 410-514-7032 or at rose@mdhousing.org.

Sincerely,

Raymond A. Skinner
Secretary

cc: Mr. Leroy Rose, Internal Audit Manager, DHCD

RAS/lr

DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT (DHCD)

Responses to Findings and Recommendations Contained in the Legislative Audit Report of the Department

For the Period Beginning January 27, 2005 and Ending February 29, 2008

Finding 1
Records maintained for cash flow loans were incomplete. Similar conditions have been commented upon in our preceding audit reports since 1998.

Recommendation 1

We again recommend that DHCD maintain a comprehensive loan accounting system which reflects all loan balances and related activity (for example, billings, loan performance) and use the system to manage its cash flow loan activities.

DHCD's Response:

DHCD concurs with the finding and recommendation. DHCD believes that a multifamily loan servicing system will provide the ability to account for accrued and capitalized interest on a current basis, which is the primary deficiency in the multifamily cash flow loans accounting process. Since prior attempts to develop a multifamily information system were unsuccessful, DHCD has decided to procure an off- the-shelf loan servicing software requiring minimal customization and has already began to develop the scope of services prior to the start of the audit. A request for proposals was issued in November 2008 and the solicitation evaluation process is almost complete. DHCD anticipates obtaining the Board of Public Works approval for the contract in May 2009; with implementation substantially completed by early 2010.

In the meantime, DHCD has dedicated staff in the Division of Finance and Administration (DFA) to ensuring that progress continues to be made in reconstructing the remaining cash flow loans. The reconstruction process requires the loan servicer and DHCD DFA to independently reconstruct each cash flow loan to fully account for accrued and capitalized interest. While more time consuming, this dual reconstruction process ensures completeness and accuracy.

It is important to note that cash flow billings are primarily based upon the cash flow of the project based on the project audit report rather than the loan balances and are therefore not materially impacted by any understatement of accrued and capitalized interest. Furthermore, the reconstruction of cash flow loans was begun with those loans which are active; that is, which are generating surplus cash and are therefore subject to cash flow billings. Any loan which pays off is also fully reconstructed prior to payoff to ensure that the State receives payment in full according to the terms of the loan agreement. Therefore, DHCD believes that the statement that the loans cannot be effectively monitored and billed is inaccurate.

As explained during the audit, DHCD accounts for all outstanding principal balances and cash disbursements and reconciles them to the loan servicer records on a monthly basis. The differences between the billing records and loan performance tracking/Asset Management records reflect differences in the point at which records are included, rather than errors that result in an inability to monitor loan performance. Asset Management is not responsible for performance monitoring of loans in construction, which are managed by Loan Origination from initial closing through construction to final closing, including the approval of all construction draws for the loan. Responsibility for performance monitoring is transferred from Loan Origination to Asset Management after final closing. Audit reports and cash flow payments are not due until after final closing.

Finding 2
Certain required financial reports were not always submitted and, when submitted, were not reviewed timely. In addition, DHCD did not impose permissible sanctions when these reports were not submitted in a timely manner.

Recommendation 2

We recommend that DHCD

a. ensure that project financial reports are received and reviewed timely (repeat),
b. ensure that borrowers comply with all reporting requirements, and
c. Impose sanctions when required reports and certifications are not received timely or document the reason for sanctions not being imposed.

DHCD Response:

The Department acknowledges that, in 2007, 49 projects failed to submit annual audited financial statements when due, and in some cases, took extended periods of time to comply with submission requirements. The assigned Asset Management Officers, however, pursued the submission of these audits with documented follow-up.

Multifamily Asset Management has researched the 140 projects the OLA has identified as having 2007 audit reviews completed in an untimely manner. We note that one of these projects was in an "Inactive/Paid" status at the time of the audit review and ten of these projects were assigned to Workout. We also note that OLA used the date reviewed by the Portfolio Administrator as the "Completed Review Date". The Portfolio Administrator signs off when the audit review and the resolution of issues identified by the Asset Management Officer are completed – a process that can take a long time. As a result, Multifamily Asset Management uses the date of the Asset Management Officer's review as the "Completed Review Date". Applying this date reduces the number of projects for which reviews were not completed on time by 61 (35 cash flow loans and 26 deferred or must-pay loans). The Department feels that the correct number of projects with untimely audit reviews is 68. Of these 68 projects, we have determined that 62 were reviewed within 120 days of the required review completion date (39 within 30 days, 16 within 60 days and 7 within 90 days). While the Department disagrees with the number of audit reviews that were not completed timely, we do agree that continued progress needs to be made in this area.

Multifamily Asset Management conducted a review of the five project files identified by the OLA as not containing complete audits. The missing documentation for one project was found in DocuShare. Another project was only required to submit a compilation and, as a result, the missing auditor's reports were not required. Two additional projects submitted first year audits. The lack of required documentation was noted by the Asset Management Officer and communicated to the project. Because the audits were sufficient as submitted for basic review, no effort was made to obtain the missing schedules for the reviewed year's activity. The final project submitted sufficient data in their audit to determine the required surplus cash payment and to complete a basic review. The project was advised of the requirement for the missing documentation, but inadequate follow-up was done. The assigned Asset Management Officer should have required the submission of the missing schedules, etc.

The Department acknowledges that, in 2007, 57 projects failed to submit operating budgets when due, and in some cases, took extended periods of time to comply with submission requirements. It should be noted that 8 of these were assigned to Workout, and the submission of an operating budget may not have been required for these projects. The Asset Management Officers assigned to the 49 projects not in Workout pursued the submission of the required budgets with documented follow-up. We also acknowledge that for 65 projects reviews of submitted operating budgets were not timely, though the number of days these reviews were late actually ranges from 17 to 105. Seven of these 65 were assigned to Workout. Because of the intensive nature of the involvement of the Workout Specialists, typical requirements for financial submissions and their monitoring are suspended. Multifamily Asset Management will evaluate its Policy and Procedures Manual and make changes that will identify the types and documentation of analytical procedures to be performed as part of the review of operating budgets.

The Department acknowledges that, in 2007, 81 projects failed to submit 115 monthly/quarterly operating statements when due, and in some cases, took extended periods of time to comply with submission requirements. It should be noted that some of these 81 projects were assigned to Workout, and the submission of operating statements may not have been required. The Asset Management Officers assigned to the projects not in Workout pursued the submission of the required statements with documented follow-up. Multifamily Asset Management will evaluate its Policy and Procedures Manual and make changes that will identify appropriate timeframes and the types and documentation of analytical procedures to be performed for the review of operating statements. The Department has limited sanctions that it can apply to enforce its financial submission requirements. Asset Management Officers have used effectively, on a case-by-case basis, the denial of RfR disbursements, operating reserve reimbursements and other project requests as a tool to obtain required documents. The DHCD Report Card (a process that can restrict developers' access to new funds from the Department) has been consistently applied to developers of new projects who are not meeting submission requirements. This is not, however, an effective tool for project owners who do not intend to do new development with DHCD. The application of sanctions must always be weighed against the negative impact it can have on the project. The Department recognizes the need to identify new sanctions and incentives that can lead to projects complying with requirements.

Finding 3
DHCD did not take appropriate collection actions on a defaulted NBWP loan with an outstanding balance of $688,000. In addition, DHCD loaned an additional $378,000 so the borrower could pay certain operating costs and avoid potential bankruptcy.

Recommendation 3

We recommend that DHCD

a. aggressively pursue recovery for the aforementioned defaulted loan through the loan guarantors or foreclosure proceedings (repeat), and
b. not award additional funding to delinquent borrowers in the future without a documented analysis demonstrating that the funds would improve project viability.

DHCD Response

The Department takes pride in operating its programs in the best interest of the State and the communities that it serves. The Department did initiate foreclosure proceedings in December 2007. However, the Department decided to halt the foreclosure process for several reasons. First, after careful consideration and evaluation, the Department believed that foreclosing on the property in question would have a negative impact on the local business community, especially Belvedere Square, which is located just one block from the property in question. Second, it was unlikely that a sale of the property in question would have provided enough sale proceeds to satisfy a bank lien that is superior to the Department's lien. Therefore, if the Department had followed through with the foreclosure process, the holder of the superior lien would have intervened and taken title to the collateral with no sale proceeds remaining for the Department. In the unlikely event that the superior lien holder did not intervene, the Department would have owned the project subject to the lien of the superior lender. The Department does not have the statutory authority to pay off a superior lien holder in order to take title free and clear. Therefore, in aborting the foreclosure process, DHCD acted in the best interest of the State and the community which it works so hard to revitalize and sustain.

While on the surface it may seem prudent to deny additional funding to delinquent borrowers, the ability to modify loans is a very useful tool that allows projects to survive and eventually prosper that otherwise may fail. The NBW loan program provides funding to borrowers that cannot secure 100% financing through commercial sources. These projects are by their nature high risk loans, and there will be times when it is better to provide additional funds to help a troubled project work through difficult economic times. In fact, the NBW statute anticipates providing troubled projects with assistance. The NBW statute provides the program with the authority to modify any term of a loan "to facilitate the successful completion or operation of a project."

Finding 4
Certain approved Community Legacy projects were not started timely, as required by State regulations.

Recommendation 4

We recommend that

a. CLP financing only be awarded to applicants that have demonstrated that the project is ready to proceed upon receipt of financial assistance,
b. DHCD ensure that the scope changes are reasonable given the original project intent as approved by the Community Legacy Board, and
c. DHCD review all open CLP projects to verify projects are progressing in accordance with CLP requirements**.**

DHCD Response

While, "readiness to proceed" has always been an important consideration when recommending Community Legacy (CL) awards, DHCD has taken actions to address this finding and further insure that CL projects proceed in a timely manner. DHCD has changed the Community Legacy grant agreement to give the Department more options for recapturing funds from projects that are not progressing. Specifically, the grantee will need to show progress by the first anniversary of the date of the agreement. In addition, DHCD has shortened the term of the grant agreement from three years to two years to emphasize the requirement that projects progress in a timely manner.

DHCD will continue to have regular portfolio meetings for the Community Legacy Program to identify any problem projects that may exist. As part of these meetings, projects for which funds should be unencumbered are discussed and appropriate follow-up actions are taken. DHCD will unencumber any funds for projects that do not progress in a timely manner.

Finding 5
DHCD did not obtain sufficient documentation of additional funding commitments from other sources and did not always ensure that recipients of financial assistance submitted final reports as required.

Recommendation 5

We recommend that DHCD

a. ensure that it obtains, for both current and future projects, appropriate documentation of all outside funding commitments claimed in applications for financial assistance under the CLP and NBWP as required (repeat); and
b. ensure that CLP and NBWP financial assistance recipients submit the required final reports.

DHCD Response

With reference to the deficiency in the Neighborhood Business Works Program (NBWP), the Department will enhance the controls surrounding this program to ensure that the required documentation for all outside funding commitments is submitted in a timely manner. The Department will also ensure all projects in progress have obtained the financial assistance from the sources stated on the related applications and legal agreements. With reference to the Community Legacy Program (CLP), the Department wishes to mention that there is no statutory requirement for a match; however priority is given to initiatives that leverage significant outside funding commitments.

DHCD has existing controls in place to ensure that the Community Legacy Program (CLP) and Neighborhood Business Works Program (NBWP) recipients submit final reports as required. However, the Department is currently in the process of enhancing the controls to ensure its effectiveness. The Division of Neighborhood Revitalization (NR) will review all closed projects to ensure that the appropriate final reports have been submitted. NR management meets weekly with each project manager to review projects and schedule monitoring visits

Finding 6
DHCD did not always obtain CITC Program reports as required by State regulations.

Recommendation 6
We recommend that DHCD

a. ensure that the non-profit organizations submit semi-annual CITC Program reports as required by State regulations, and
b. ensure that any follow-up efforts to obtain missing reports be documented and retained for future reference.

DHCD's Response

DHCD will enhance the internal controls in this area to ensure all non-profit organizations submit semi-annual reports in a timely manner as required by state regulations. All efforts requesting the submission of such reports will be documented. The Department will also ensure that all tax credits certifications will reflect the true value of the donations net any benefit to the donor. The Department has implemented this control by revising the procedure for processing the tax credit certification form to include a line for total donation. The fair market value of all goods and services received will be deducted. Letters of acknowledgement from the CITC project sponsor will include a statement that the value of the donation is net the fair value of any benefit received by the donor.

Finding 7
DHCD had not performed required periodic monitoring of certain special loan programs.

Recommendation 7

We recommend that DHCD

a. perform required monitoring reviews of the local jurisdictions responsible for administering the special loan programs within the required time intervals (repeat), and
b. ensure GHFP and SHOP borrowers submit required annual income certifications and that any follow-up efforts to obtain missing certifications be documented and retained for future reference.

DHCD's Response

The Department concurs with the finding. In March or April of 2007, DCA/Multifamily Asset Management was assigned the task of ensuring compliance by GHFP and SHOP borrowers with program resident income requirements. The position of Compliance Officer was vacant at the time the function was assigned. DCA filled the position in July 2007. Considerable progress was made in revising and fully implementing the compliance process in DCA, but the individual hired as Compliance Officer left in February 2008. An individual has been selected to fill the position.

The Department has already received the required outstanding documentation. We will also identify and add to our database all GHFP and SHOP loans that are currently active. Finally, the Compliance procedures will be modified so that in the future a clear record of the efforts made to obtain the required documentation and the actions taken if the documentation is not submitted will be maintained.

Finding 8
DHCD did not comply with certain information technology guidelines regarding review of system access, data backup practices, and disaster recovery plans.

Recommendation 8

We recommend DHCD comply with the aforementioned information technology guidelines.

DHCD's Response:

DHCD concurs with this finding and its recommendations.

DHCD has modified the management report produced for the Access Control Lists (ACL) for our loan monitoring system. The resulting ACL report is in a “grid” style, making the permission assignments for the loan monitoring system simpler to identify and approve. The ACL report was most recently prepared and circulated for management review in September 2008, and divisions responded electronically to indicate their review and approval. This ACL review process for DHCD's loan monitoring system will be conducted twice a year.

DHCD completed the relocation of data backup media to a secure and environmentally controlled offsite location in July 2008. These backup media are retained offsite until needed. Excluding the media used for daily backups, all tape media used for non-incremental backups are kept offsite *at* an Iron Mountain facility in Columbia, Maryland.

DHCD conducted an initial Disaster Recover (DR) exercise in December 2008. This DR exercise entailed the restoration for one of DHCD's essential line-of-business applications and its database. A second DR exercise will be conducted before June 2009 on another essential line-of-business application and database, and one or more similar DR exercises will be conducted and documented annually.

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