HOUSING LOAN PROGRAM:
Funding supports goals, but low repayment may jeopardize long-term success

March 2014

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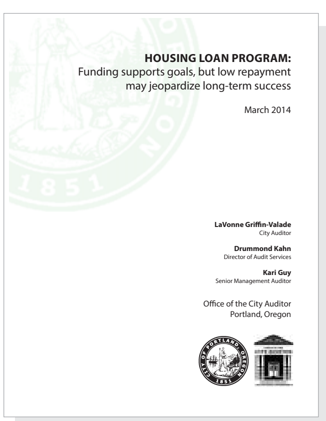

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March 24, 2014

TO: Mayor Charlie Hales
Commissioner Nick Fish
Commissioner Amanda Fritz
Commissioner Steve Novick
Commissioner Dan Saltzman
Traci Manning, Director, Portland Housing Bureau

SUBJECT: Audit Report – *Housing Loan Program: Funding supports goals, but low repayment may jeopardize long-term success* (Report #449)

The attached report includes the results of our audit of the Portland Housing Bureau (PHB) loan programs. My office completed a risk assessment of the newly-created PHB in 2012, and identified the loan programs as an area needing further review. In this audit we reviewed loans closed by PHB, as well as PHB's annual project review.

With the need for affordable housing far exceeding available dollars, it is critical that the City fund the most cost effective projects – achieving the desired outcomes at the lowest possible cost. We found that projects funded by PHB were consistent with the PHB Strategic Plan and provided housing for the City's most vulnerable residents. However, because PHB had not defined outcome measures or cost parameters, it was not clear whether these projects were the most cost effective. In addition, in many cases PHB used loan products with minimal repayment requirements. This will limit funds available in future years to finance new projects. We recommend improvements in the management of PHB's loan portfolio to ensure operational consistency and long-term funding stability.

Further, we have recommended the Bureau meet its quarterly reporting requirements and strengthen oversight procedures. This is particularly important because PHB and the Commissioner-in-Charge separately have significant discretion in making project funding decisions that do not require approval from City Council.

During our audit fieldwork, PHB was already working to improve the loan program. We ask PHB to provide us a status report in one year, through the Commissioner-in-Charge, detailing steps taken to address the audit recommendations.

We appreciate the cooperation and assistance we received from PHB management and staff as we conducted this audit.

L. Griffin-Valade

LaVonne Griffin-Valade
City Auditor

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Attachment

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Summary

The Portland Housing Bureau (PHB) provides loans and grants to develop or rehabilitate affordable housing. As defined in PHB's Strategic Plan, investments are focused on projects that provide housing for the City's most vulnerable residents.

In the past three years – since PHB assumed responsibility for these loan and grant programs from the Portland Development Commission – PHB provided over $83 million of tax increment and federal funds to 36 different development and rehabilitation projects. These projects range from remodeling older apartment buildings to constructing new buildings. Almost all of these projects, and the bulk of the $83 million, support residents at or below 60 percent of median income, with many projects also providing supportive services, such as transitions from homelessness or drug and alcohol treatment.

The objectives of this audit were to determine whether funded projects maximize the benefits of loan dollars consistent with City housing goals, and whether PHB ensures program goals are met. While the projects PHB funded align with the mission and priorities in PHB's Strategic Plan, it is less clear that the loans provide the best long-term results for residents and the City. PHB has not defined outcome measures for the loan programs, or evaluated the most cost-effective way to achieve those outcomes. In addition, PHB is not consistent in how different loan products are used, and the majority of loans require little or no repayment.

Of the total portfolio of $357 million in outstanding loans, PHB estimates that only about $54 million (approximately 15 percent) will be repaid. This limits the opportunity for PHB to invest in new projects in the future, since most loan funds – more than $300 million – will be spent once rather than loaned, recovered, and used again for additional future projects.

There are inherent trade-offs between providing housing to the lowest income populations and achieving a return on the public investment. With projected declines in tax increment funding from urban renewal areas, and uncertainty over the level and continuity of federal funds, it is important for PHB to clearly define their desired outcomes and the most cost-effective way to achieve them. Balancing the programs' social goals with the return on the financial investment will allow PHB to provide loans both now and into the future.

During our audit, PHB was already working to improve loan administration and oversight. We make a number of recommendations to expand on these efforts and improve the long-term viability of the loan programs.

Background

The Portland Housing Bureau (PHB) began operations on July 1, 2010, when housing staff and the housing loan portfolio of the Portland Development Commission were combined with the former Bureau of Housing and Community Development. The new bureau is responsible for housing policy, its implementation, and the distribution and oversight of public and other funds that address the housing interests of the City.

PHB is not a direct developer of affordable housing, but provides financing to developers of low-income housing that may not be available in the real estate market. Through underwriters, PHB originates loans and grants to for-profit and not-for-profit developers to assist with affordable housing development and rehabilitation. The Bureau is then responsible for managing and tracking the loans and grants in their portfolio, which includes an annual review of the project's finances, management, and physical condition, among other things.

In 2012, we issued an audit report identifying the key risks of the new Housing Bureau. Our 2012 report found that without adequate resources, guiding policy, and robust tools, the loan portfolio may not be effectively managed, and the impact of City resources may not be maximized.

Most funds provided to build or rehabilitate multi-family housing development

In the three fiscal years since PHB began managing the loan portfolio in 2010, PHB provided loans or grants for 36 projects totaling $83.7 million (Figure 1). All rental projects are rent and income restricted for 60 years, and include a regulatory agreement signed by the project developer with detailed project restrictions.

Figure 1 **PHB financial assistance** (FY 2011 through FY 2013)

Housing type	PHB financial assistance (millions)	Units
New multi-family	$45.6	689
Multi-family rehabilitation	$29.0	915
Single-family for sale	$7.8	87
Single-family rental rehabilitation	$.7	11
Facility	$.7	
Total:	**$83.7***	**1,702**

Source: Audit Services Division analysis of housing data
* Due to rounding, total does not sum

PHB funds a wide variety of projects. Projects include new multi-family developments, rehabilitation projects, and building or remodeling single-family homes. In many cases, the projects also receive funding from other sources, such as traditional bank loans, tax credit equity, or direct grants or loans from other state and local agencies.

PHB typically selected projects by evaluating developers' responses to Notices of Funding Availability. Some projects may also be initiated by the bureau to rehab existing investments. Proposed projects are evaluated by PHB staff, then by an evaluation committee. Selected projects are reviewed by a Housing Investment Committee made up of staff from PHB, the Portland Development Commission, and the City's Office of Management and Finance. Final funding decisions are then made by the PHB Director, the Commissioner in Charge of the Housing Bureau, or City Council, depending on the funding level.

New multi-family projects represent the largest dollar amount of new funding, and include projects such as Gray's Landing, a development in the South Waterfront neighborhood. This project funded 209 units targeted at households making 60 percent or less of median family income, with 42 of those units targeted to veterans.

Rehabilitation projects included both projects with existing PHB loans and projects that had been operated at subsidized or market rates in the private sector. Many of the projects in this second category were targeted to privately-owned buildings at risk of losing affordability.

Uptown Tower Acquisition and Rehab	
PHB funding:	$700,000
Total funding	$16 million
PHB funding as % of total:	4%
Units	72
Affordability	60% MFI
PHB Investment per unit	$9,700
Total Investment per unit	$224,600
Loan-to-value	NA
Interest	4.5%
Payments	Based on cash flow years 1-15, Amortized years 16 to 25
Term	25 years

For example, the Uptown Tower, a 71-unit building in the Goose Hollow neighborhood, was sold and renovated in 2011. The building is home to seniors, very low-income, and disabled residents.

PHB also provides funding for building or remodeling single-family homes for sale to eligible low-income buyers. When the property is sold to an eligible homeowner, some portion of the PHB loan is repaid, and a portion is converted to a grant to the home buyer.

PHB provides both federal and local funds

The funding used for housing financial assistance was either from urban renewal area tax increment funds (TIF) or federal programs. Federal sources include the Community Development Block Grant Fund (CDBG) and the HOME Investment Partnership Program (HOME). Both of these sources are annual entitlements from the U.S. Department of Housing and Urban Development (HUD). The third federal source is a loan pool from HUD, referred to as "Section 108." The City may loan these Section 108 federal funds for the construction or acquisition and rehabilitation of affordable housing. If loans are not repaid by the borrower, these funds must be repaid from the City's CDBG entitlement.

Figure 2 PHB financial assistance by fund (FY 2011 through FY 2013)

	Funding Source	Dollars (millions)	New units	Rehab units
Federal: ($22.9 million)	CDBG	$9.5	182	276
	HOME	$8.5	97	156
	Sec. 108	$4.9		106
Tax Increment Financing: ($60.8 million)	North Macadam	$24.0	209	
	South Park Blocks	$9.5		296
	River District	$9.0	122	
	Interstate	$8.3	48	68
	Lents	$6.8	21	36
	Gateway	$3.1	77	
	Downtown Waterfront	<$0.1		8
	Total:	**$83.7**	**756**	**946**

Source: Audit Services Division analysis of housing data

Both Federal and TIF funds available to PHB for housing programs are estimated to decline over the next five years. PHB estimates that its TIF annual housing spending will drop from the $40-$54 million range spent between 2009 to 2014 to a "new normal" in the $17-$23 million range from FY 2015 forward. Federal HOME and CDBG funds are also estimated to decrease over the period of the forecast, and funds available for Section 108 loan guarantees will be exhausted unless PHB applies for additional funds.

In a time of declining revenues, it is important for the City to ensure that limited funds are spent in a cost effective manner, meeting the City's housing goals at the lowest cost. We conducted this audit to determine whether the City had clear goals for these loan programs, whether project selection maximizes the benefits of housing loan dollars consistent with the goals, and whether PHB has the systems in place to protect the City's investment for the long term.

Audit Results

PHB Strategic Plan prioritizes funding for most vulnerable

The City has wide-ranging housing goals, described in a number of different policy documents. At the high level are broad goals, such as the Portland Plan's goal to "Provide for a supply of housing that meets expected growth, is diverse in terms of unit types and price…" Other specific housing priorities are captured in the Ten-Year Plan to End Homelessness, the policy for No Net Loss of Housing in the Central City, and the Affordable Housing Preservation Ordinance, among other documents.

Many urban renewal plans also include housing goals. City Council set aside 30 percent of tax increment financing (TIF) funds for housing, and further limited TIF funds to be used on projects affordable to households with incomes below 100 percent of median income. Projects funded with TIF dollars must be consistent with urban renewal area plans.

PHB focused these general policies by identifying investment priorities in its Strategic Plan. The top priority is to provide more rental housing for the most vulnerable residents. Other priorities address moving people quickly from homelessness, and helping Portlanders from communities of color buy a home. These priorities were further refined in the annual Notice of Funding Availability (NOFA) which limited funds for rental housing to projects serving households at or below 60% Median Family Income (MFI), with a preference for projects serving households at or below 30% MFI. Median income levels for a family of four are shown in Figure 3.

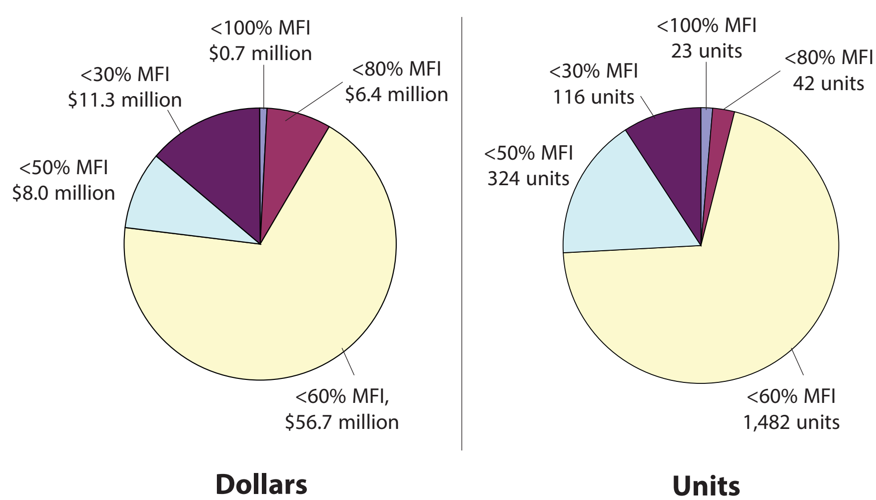
Figure 3 **Median Family Income (MFI) for a family of four (2013)**

Percent of Median	Income
30%	$20,800
50%	$34,700
60%	$41,640
80%	$55,500
100% (median)	$68,300

Source: Portland Housing Bureau and U.S. Department of Housing and Urban Development

The 36 projects we reviewed reflect these investment priorities. All rental projects include restrictions on rents, so that projects will be affordable to residents at a certain income level. The projects funded included a range of housing sizes, from single room occupancy to 2 or 3 bedrooms. Almost all of the projects PHB funded were restricted to residents making less than 60 percent MFI. Projects at the 80 percent to 100 percent MFI were all homeownership subsidies for single-family projects (Figure 4).

Figure 4 **Financial assistance by income level** (FY 2011 through FY 2013)



Source: Audit Services Division analysis of housing data

Some projects also include supportive housing services. For example, the Kehillah Housing development in southwest Portland provides 14 units for developmentally disabled adults. Services provided to residents include life skills training classes such as meal planning, medication management, and job training, and the development has an onsite manager available to residents.

Kehillah Apartments New Construction	
PHB funding:	$275,000
Total funding	$3,526,500
PHB funding as % of total:	8%
Units	15
Affordability	50% MFI
PHB Investment per unit	$18,300
Total Investment per unit	$235,100
Loan-to-value	NA
Interest	0%
Payments	50% of excess cash flow
Term	60 years

Sponsors of other projects also provide direct services, such as drug and alcohol addiction treatment, support to transition from homelessness, or job training. Many of the projects also include federal Section 8 rental assistance.

While the City's housing policies are broad, PHB focused the broad goals on specific priorities in its Strategic Plan, and refined those annually through the Notice of Funding Availability. We found that PHB's funding decisions in the first three years of managing the loan programs were consistent with these priorities.

PHB has high level of discretion in decision making but limited transparency

In May 2010, before PHB assumed responsibility for PDC's housing loan portfolio, City Council approved clear delegations of authority and regular reporting requirements for the housing loan program. Council authorized a Housing Investment Committee (HIC) to recommend approval or rejection of loans and grants to the PHB Director. The PHB Director is then authorized to approve or reject financing consistent with loan guidelines of up to $2 million, and the Commissioner in Charge may authorize financing of up to $3 million. Financing over $3 million must be approved by City Council. To ensure that Council and the community are aware of the financial assistance PHB provides, PHB was required to provide quarterly information to Council on all approved financial assistance, and all exceptions to guidelines.

The level of approval authority is higher than most other City grants or purchasing (Figure 5). The high level of approval authority is offset by the requirement for frequent, detailed reporting to Council. However, PHB did not provide the required reports to Council until after we completed fieldwork on this audit. PHB is also required to submit annual reports to TIF funding but has not done so since FY 2010-11. PHB noted that they do communicate with Council and the public about loan decisions in other ways, including budget submittals and press releases.

Figure 5 Approval authority for various City financial decisions

Approval authority	PHB Financial Assistance (grants & loans)	Grants–Other Bureaus	Construction; Goods and Services	Professional & Technical Services
Bureau Director	up to $2,000,000	up to $5,000	up to $5,000	
Chief Procurement Officer			up to $500,000	up to $100,000
Commissioner in Charge	up to $3,000,000			
City Council	over $3,000,000	over $5,000	over $500,000	over $100,000

Source: City loan and purchasing guidelines

Funding proposals to PHB are evaluated based on five criteria:

- Financing
- Investment priorities
- Team qualifications
- Readiness to proceed
- Equity

According to the Bureau, in practice, the scoring and project evaluation are highly judgmental. Staff review and evaluation committee review are based on different criteria, and may have different outcomes.

Bureau staff noted that the evaluation process changed in the last three years, with a more detailed scoring rubric developed. But they also indicated that maintaining flexibility in the scoring process allows them to use professional judgment to select the best projects. The safeguard to prevent abuse of this discretion should be the transparency provided by quarterly reports to Council, and clearly defined parameters around project costs, desired outcomes, and loan types offered. As discussed in the following sections, PHB has not yet defined these parameters.

Another safeguard is the review provided by the Housing Investment Committee, and approval by the Commissioner or Council for the largest loans. Housing Investment Committee guidelines were developed when the Committee was created, but are still in draft form and not consistent with current practice. PHB also does not have guidelines for Commissioner or Council approval; in one case, PHB was unable to locate documentation for Commissioner approval of a loan over $2 million. PHB is currently updating Multi-Family Housing Investment Guidelines. Those guidelines should be clear on the authority and procedures of the Housing Investment Committee, and the method for documenting Commissioner or Council approval.

To ensure that the high level of discretion held by the PHB director is transparent, PHB should submit the required reports to Council. In addition, PHB should develop clear policies and procedures to guide Housing Investment Committee review and Director, Commissioner, or Council project approval.

Loan products minimize financial return

PHB provides funds to eligible borrowers using a number of different financial products. The type of financial assistance product PHB uses is decided by management with input from PHB underwriters. The main product types, as defined in adopted Financial Assistance Guidelines, are:

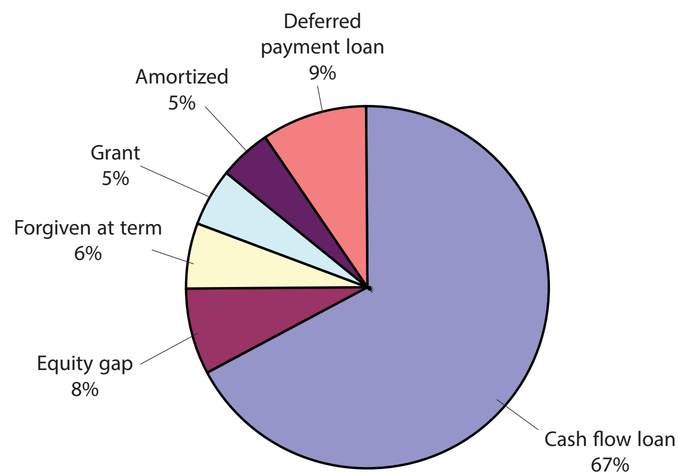
- *Housing development subordinate loan / amortizing loan*: This loan type has a set term and interest rate. Repayment is based on an amortized schedule, possibly with additional payments based on project cash flows.
- *Housing development subordinate loan / deferred payment loan*: All or a portion of this loan for a for-sale property may be converted to a grant to the homeowner at the time the property is sold.
- *Equity gap contribution*: This is a zero interest rate loan with no term. The loan is outstanding until repaid. The loan amount is due on sale, transfer, change of use, or refinance. Scheduled payments are based on excess cash flow.
- *Cash flow*: This is like an equity gap contribution, but with a set term and a balloon payment at the end of the term. Loan guidelines define equity gap and cash flow loans as a "last resort" to be used only when other financing has been maximized.
- *Non-profit facility grants*: This is for the acquisition or rehabilitation of community facilities. Grants are not repaid, although if a grantee violates the regulatory agreement, PHB can recover the grant money.

The City Council may also approve loans and grants outside of the Financial Assistance Guidelines. The financial assistance we reviewed included Council-approved grants for multi-family housing and some loans forgiven at term, neither of which are included in the guidelines.

The type of financial product used determines the probability of repayment. For accounting purposes, PHB estimates the current value of outstanding debt. PHB assumes that 50 percent of amortized or deferred payment loans is collectable, but that only 5 percent of cash flow loans and 0 percent of equity gap loans will be collected. The majority of financial assistance provided for FY 2011 through FY 2013

– more than three-quarters of all loans – was in the form of these "last resort" cash flow and equity gap loans (Figure 6), leading to a very low likelihood of repayment. Two additional loans (6 percent of total) don't fit neatly into any of the categories as the loans will be forgiven after a defined term. In other words, PHB expects that over 80 percent of its loans will recover between zero and five percent of the amount it loaned. PHB management stressed that the low estimated repayment is not due to borrowers defaulting on loan payments, but rather a result of the loan products used.

Figure 6 **Loans by type** (FY 2011 through FY 2013)



Source: Audit Services Division analysis of housing data

The use of these loan types partly reflects the types of projects funded. Lower income units require a larger subsidy, and extensive resident services reduce funds available to the borrower to repay a loan. The policy choice to target investments toward the most vulnerable populations and provide supportive housing services will narrow the funding options available and reduce the likelihood of repayment.

At the end of FY 2013, $68 million of the $83.7 million in new financial assistance was outstanding. Of this $68 million, PHB estimates that $6.4 million – less than ten percent – is collectable. Of the total loan portfolio of $357 million outstanding, PHB estimates about $54 million will be repaid. The percentages PHB uses to determine loan collectability were inherited from PDC. PHB is currently reviewing loans to ensure that all are properly classified, and reviewing the classifications and percentages collectable to better align with current loan products.

In some cases, the lack of repayment directly impacts other PHB programs. Federal CDBG funds are used by the bureau to provide for direct housing services such as shelter and emergency services. Combined HOME and CDBG loan repayments declined from $3.3 million in 2003 to $1.4 million in 2012, and are projected to continue to decline. CDBG funds are also used as a guarantee of the Section 108 revolving loan funds from HUD. In FY 2013, PHB used $219,000 of its CDBG funds to repay Section 108 loans.

PHB should consider the likelihood of repayment as they develop investment priorities for the strategic plan update. Allocating some funds to projects that could support amortized loans with the potential for repayment could increase the long term viability of the housing assistance program.

Use of some loan products not consistent with guidelines

Some of the loan products PHB used for the 36 projects we reviewed appear inconsistent with financial assistance guidelines. For example, the equity gap loan guidelines require that the project sponsor pay 50 percent of excess cash flow until the loan is repaid. In practice, nine projects were funded with equity gap agreements with no payment requirement. In two of the projects, PHB reports to the Housing Investment Committee noted that the projects could not support debt and that the funding should be provided as a grant. However, since there is no multi-family grant product in the Financial Assistance Guidelines, this would have required approval by Council. Instead, projects were funded with equity gap agreements, with no repayment provisions.

With no interest and no payments, there is no chance these funds will be repaid and used to fund future projects, yet the borrower must carry the debt on their books for many years. The benefit of keeping non-paying debt on the City and borrowers' books is not clear, because the same regulatory agreements are used for both grants and loans.

We also reviewed a sample of loans that were restructured in the past year. In most cases, the loans were converted to equity gap agreements because borrowers were not able to make scheduled payments. Again in one case, staff noted that the project was not able to support the debt and recommended write off, but instead the loan was restructured to a no-interest, no-payment equity gap agreement.

There were also inconsistencies in loan products between similar projects. Some projects with minimal or no projected cash flow were required to make cash flow payments, while other projects that anticipated cash flow were not. Loans for some projects were forgiven or converted to grants after a defined term, but other projects serving similar populations were not. Providing different repayment terms to similar projects raises a question of fairness, and may result in disparate impacts to borrowers or residents.

PHB should ensure that the financial assistance they offer is consistent with adopted City guidelines. Updating the financial assistance guidelines to reflect loan and grant products now offered, and clarifying the circumstances and project types when different loan products will be used, should help provide more certainty to PHB and more fairness to borrowers. In particular, PHB should determine whether a grant product for multi-family housing should be included in the guidelines, and either revise or follow the requirement for cash flow payments on equity gap agreements.

Projects funded may not be most cost-effective

A cost-effective housing finance system would provide the greatest benefits at the least cost. This intent is reflected in the PHB Strategic Plan, which states that PHB will "wisely spend our money in a way that produces the best long-term results…" It is unclear whether projects funded by PHB meet that intent, due to a lack of outcome measures or clear standards for total project costs.

PHB reports on specific program outputs annually – the number of units created and the number of loans closed. They also report the income restrictions on funded units. However, PHB has not defined or reported on the desired outcomes from the funding decisions, such as the number of homeless persons who found and stayed in permanent housing, or the number of families who transitioned out of rent restricted housing and into market rate housing. PHB managers told us this reporting is the next step, and they are working to define desired outcomes from the housing production programs.

More clearly defined outcomes would help PHB focus their limited loan dollars on the projects with the greatest benefits.

Project costs include both direct costs of construction and providing services, and indirect costs, such as lost tax revenue when private housing is acquired and operated by a nonprofit. PHB loan guidelines address construction costs with the requirement that the loan amounts per unit must compare favorably with "PHB Published Averages" based on income level served. However, PHB has not published average amounts per unit. PHB staff told us they have not yet developed a system to define average costs. In scoring applications to the most recent Notice of Funding Availability, PHB staff intended to provide higher scores to projects that stayed below a defined cost per square foot. But staff told us that the costs in proposed projects were all well above the criteria PHB established.

In the absence of a system to define average costs, staff look to other recent funded projects to determine if costs seem reasonable. This creates a risk of escalating costs if one expensive project becomes the standard for the next projects.

We looked at the costs per unit for various categories of funded projects to determine whether costs were generally consistent. Within similar project types, we saw a large variation in project costs. Estimated project costs for new multi-family construction ranged from $189,000 per unit to $387,000 per unit. Costs per unit may not be the best measure because of variations in a project's unit size or its common areas. But high construction costs could be a warning sign that the City will receive less value (or fewer units) for each housing dollar invested.

Other measures could help PHB evaluate whether projects are cost effective. These include the ratio of loan dollars to property value, the dollars leveraged by the PHB investment, or the borrowers' contribution. Again there was large variation for each of these measures in funded projects:

- Of the 17 funded projects with an appraisal, six projects had PHB loan amounts that exceeded the appraised property values. A loan-to-value of greater than 100 percent is both inconsistent with loan guidelines and means that if something goes wrong with a project, it is extremely unlikely that PHB will be able to recover the funds.

- Leverage also varied widely, from PHB providing less than five percent of project funding and filling the final gap to make a project possible, to PHB funding 100 percent of the project.
- In many cases, the borrower contributions were minimal. In fact, PHB managers told us that some non-profits may rely on the developer fees they receive from PHB to fund ongoing operations.

For example, PHB funded The Firland project in the Lents neighborhood for the acquisition and rehabilitation of an existing 19-unit apartment building. The project will be rent-restricted for 60 years, and the sponsor is working with other nonprofit providers of supportive housing services. PHB provided the majority of funding for the project, and the loan amount exceeded the appraised value of

The Firland Acquisition and Rehab	
PHB funding:	$2,114,000
Total funding	$3,194,400
PHB funding as % of total:	66%
Units	19 (1 and 2 bedroom)
Affordability	30% - 50% MFI
PHB Investment per unit	$111,300
Total Investment per unit	$168,100
Loan-to-value	242%
Interest	0%
Payments	None
Term	Until repaid or at 60 years

the property. The financial contribution by the developer was to not take the full fee for completing the project up front (part of the loan awarded) but to be paid over the first four years of operation. The property will also now qualify for a low-income housing tax exemption due to the sale to a nonprofit entity, eliminating the annual property taxes paid.

In contrast, a PHB loan of $975,000 leveraged over $10 million from other sources to construct the Magnolia apartment building on Martin Luther King Boulevard. The project included construction of 50 new units, including some permanent supportive housing services for qualifying tenants and rents restricted for 60 years. For a smaller investment of PHB dollars, and only a moderately higher unit cost, the City gained many new housing units with support services for residents.

The Magnolia New Construction	
PHB funding:	$975,000
Total funding	$11,897,100
PHB funding as % of total:	8%
Units	50 (1 and 2 bedroom)
Affordability	30% - 60% MFI
PHB Investment per unit	$19,500
Total Investment per unit	$237,900
Loan-to-value	40%
Interest	0%
Payments	50% of excess cash flow
Term	30 years

PHB must make many choices in determining the appropriate funding allocation: rehab or new construction; permanent supportive housing services or none; small or family-sized units; and others. More measurable outcomes and clear benchmarks on costs would help PHB select the most cost-effective projects. For example, outcome measures for the current housing programs may be the percent of homeless families that stay in permanent housing for more than one year, or the percent of the City's renters that pay more than 30 percent of their income for rent. By defining the outcomes they are trying to achieve, PHB can evaluate currently funded projects to determine which projects provide the best outcomes at the lowest cost. This can then help them focus limited future dollars on projects most likely to achieve the desired social outcomes.

Annual review process is time-consuming and ineffective, but PHB is working to improve

PHB reviews each project in its portfolio annually to ensure compliance with the project regulatory agreement and conditions of federal funding. The analysis includes financial performance, compliance with rent and income restrictions, affirmative marketing, and physical condition. An effective review process would help ensure that the social benefits of the project are provided while protecting the City's financial investment.

We identified several best practices for loan review that we collected from for-profit, non-profit, and governmental lending institutions. These best practices include:

- A policy to guide the loan review system;
- Timely review of information;
- Clear and consistent methodology for the annual review;
- A system of risk rating to identify loans that need a higher level of review;
- Method for following up on identified problems, and compliance actions if problems are not resolved; and
- Analysis of the trends in the portfolio to inform management and future underwriting.

We reviewed a sample of asset management files against these criteria. PHB had a policy governing the loan review system, and the staff review was detailed and thorough. However, PHB policy and practice were not consistent with any of the other best practices identified. When the City transferred the housing loan program from PDC to PHB, staff levels were decreased, and responsibility for the financial review shifted. According to PHB management, this increased the existing backlog of annual reviews.

In the sample of files we analyzed, we found that PHB's review was sometimes conducted years after the borrower's information was submitted, and bills for cash flow payments were sent to borrowers two or three years late. There were disagreements between borrowers and PHB staff about the review methodology, particularly for cash flow payments. PHB did not have a system for risk-rating loans or a method to follow up and enforce identified problems. In some cases we reviewed the borrower was nonresponsive, so the same questions and bill for cash flow payments were sent during the following year's review.

There were also challenges with the tenant and inspection portions of the review. The reviews were focused on tenant and rent compliance, with no review of the supportive housing services such as addiction counseling. In some cases the physical inspections were rated as "good" shortly before the borrower requested major rehabilitation funding.

PHB recognized these problems and began work to improve the program before we started this audit. They have completed or are in the process of taking the following steps to improve the annual review process:

- Contracted with an external group to do a physical condition assessment of property in the loan portfolio and a financial analysis of viability of the portfolio. Through this analysis, PHB began to work with borrowers with high risk projects that were unsustainable financially or in need of rehabilitation to ensure the projects continue to provide the intended affordable housing.
- Combined monitoring and reporting efforts with other public housing agencies, called "streamlining," to reduce redundancies in monitoring practices across agencies.

- Reorganized staff and changed processes to assign a lead staff person to each borrower. This staff person will work with the borrower to resolve any disagreements about the content of the annual review or the required cash flow payment.
- Added a second staff person to conduct the annual reviews, and set time goals for completion of the review.
- Began implementing a new loan development software system that will allow them to more easily capture loan data and trends.
- Began developing guidelines to provide a detailed description of the annual review process.

We reviewed a draft of the guidelines that was about 75 percent complete at the time of our audit work. The guidelines address many of the concerns we noted in our file reviews, such as providing clear methodology for grading projects through the annual review and criteria for placing high-risk projects on a watch list for more detailed review.

Some items in the guidelines could still be strengthened, including more detailed methodology for the cash flow analysis and a method to review supportive services. In addition, PHB may need to further define borrowers' duty to respond to problems and potential compliance actions. PHB should also evaluate how data from the new housing loan development software system can be used to inform future underwriting and policy decisions.

Together with improved staff capacity, these changes to the guidelines have the potential to bring PHB in line with best practices for annual project review, and better protect the City's housing investment.

Recommendations

Over the last three years, PHB has provided financial assistance to housing projects that further the City's housing goals. To ensure future financial assistance is cost effective and provides the best long-term results, we recommend the Commissioner in Charge direct PHB to:

1. **Submit the required quarterly reports to Council and develop clear policies and procedures to guide Housing Investment Committee review and Director, Commissioner, or Council project approval.**

2. **When developing investment priorities for the update of the strategic plan, consider the likelihood of repayment for various project types.**

   Allocating some funds towards projects with the potential for repayment could increase long term viability of the housing program.

3. **Update the financial assistance guidelines to reflect loan and grant products that are now offered and clarify the circumstances and project types for which different loan products will be used.**

   In particular, PHB should determine whether a grant product for multi-family housing should be included in the guidelines to better achieve intended outcomes and review the requirements for equity gap agreements.

4. **Prioritize work to develop measureable outcomes for the housing loan programs and develop and follow cost benchmarks for different types of housing projects.**

   Defining desired outcomes, and evaluating and defining costs to achieve those outcomes, should help PHB focus its limited funding on the most cost-effective projects.

5. **Continue current work to strengthen the annual review process.**

   As the guidelines are finalized, consider including more detailed methodology for the cash flow analysis and review of supportive services.

   In addition, PHB may need to further define the borrower responsibility to respond to identified problems, and potential compliance actions. As the new loan management system is implemented, PHB should ensure this data is available to inform decision-making by underwriters and bureau management.

PHB is currently working to develop measurable outcomes and to improve the annual review system. However, because of the significance of these matters, these may be topics for future audit review. In addition, in the course of our audit work we noted the high level of approval authority delegated by Council to the PHB Director. A City-wide review of Council delegation of authority for contract, grant, and loan approval may also be a worthwhile subject for a future audit.

Objectives, scope and methodology

The objectives of this audit were to:

1. Determine whether the City has clear goals in place to guide housing loan programs;
2. Determine whether PHB project selection is maximizing the benefits of housing loan dollars, consistent with stated goals; and
3. Evaluate whether PHB's asset management system protects the City's investment and ensures program goals are met.

To accomplish these objectives, we interviewed PHB program managers and staff to gain an understanding of the history and management of the loan portfolio. We focused our work on financial assistance provided to multi-family projects. Loans to single family homeowners for home repairs or downpayment assistance were not included in the audit scope. We reviewed City housing policies and PHB procedures and documentation related to project selection, and annual project review.

We also interviewed borrowers who hold current PHB loans, and private-sector affordable housing lenders. In addition, we reviewed research and audit reports related to housing financial assistance and loan annual review.

To characterize PHB financial assistance provided we reviewed documentation for all grants and loans issued in FY 2011, 2012, and 2013 – the first three years PHB controlled the loan portfolio. We used a combination of sources to document loan information, including Housing Investment Committee reports, commitment letters, and loan documents. Loan data is rounded in the report.

To assess the annual project review process we selected a sample of projects and evaluated those against program policies and best practices. This included a review of hard-copy asset management files.

During our audit, PHB was in the process of implementing a new information system. In the course of the data conversion, PHB noted some concerns about data reliability. We opted not to use data from PHB systems for the purposes of this audit. Instead, we used high-level summary data from the City's audited Comprehensive Annual

Financial Report, and project-specific data based on a review of source loan documents. When we noted potential issues with loan data in the course of our audit work, we communicated that to PHB management.

We conducted this performance audit 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.

RESPONSES TO THE AUDIT

CITY OF

PORTLAND, OREGON

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March 17, 2014

LaVonne Griffin-Valade, City Auditor
1221 SW 4th Avenue, Room 140
Portland, Oregon 97204

RE: Portland Housing Bureau Audit Response

Dear Auditor Griffin-Valade:

Thank you for your recent review of the City of Portland Housing investment programs.

As you noted, the Portland Housing Bureau (PHB) has been diligently and systematically working to update the policies and systems that provide the structure for the City's investment in Portland's affordable housing infrastructure since the Bureau was created three years ago. The recommendations from the audit have either been completed or are already in process, and your work helps confirm that direction and sharpen our focus. The Bureau's founding values include Stewardship and Transparency as well as Equity and Innovation, and achieving consistent and transparent investment practices are a vital part of those values.

An important question you raise points to the often conflicting expectations of the Bureau's work. The formation of the Bureau brought the City goals of ending homelessness and providing affordable housing under one roof. Without affordable housing, we can't end anyone's homelessness. And we strive to house the children, families, women, disabled people and veterans that are among our most vulnerable citizens.

The audit found the Bureau has been successful in setting and meeting our policy goals in providing housing for the City's vulnerable citizens. Yet there is also a hope that the investments the City makes in housing for people with lower incomes can also generate enough revenue to fuel substantially more lending, in the manner of a bank. A portion of the repayment goes into future investment, but the profit of the lending is also invested to lower rents so that the most vulnerable can be housed. These and other outcomes the public receives for an investment of public housing dollars are based on policies developed over time. In the coming year, PHB will work with the community to 1) quantify the benefits and outcomes the public is receiving for the investment of their dollars, and 2) review with the community and policy makers whether they are the right outcomes.

Specific to the audit recommendations:

1. PHB is current on Council reporting and the reports are available the bureau's website. Clarified policies and procedures guiding Housing Investment Committee review and approval processes are being drafted for completion by the 4th quarter of FY14.

2. PHB will define the desired economic and programmatic outcomes of its affordable housing investments including the possibility of funding projects which could increase long term viability of the housing program.
3. Revised financial assistance products will go to Council in April of 2014. Updated Multifamily Housing Investment Guidelines will be finalized by fiscal year end.
4. Cost benchmarking will be included in the Notice of Funds Availability to be released in the spring of 2014.
5. An update of the Asset Management Guidelines has been drafted and will be finalized in the 4th quarter of FY14.

We support the City Auditor Office's work and appreciate your willingness to better understand PHB's work. Thank you for this audit.

Sincerely,

Commissioner Dan Saltzman

Traci Manning, PHB Director

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Housing Loan Program: Funding supports goals, but low repayment may jeopardize long-term success

Report #449, March 2014

Audit Team: Kari Guy

LaVonne Griffin-Valade, City Auditor
Drummond Kahn, Director of Audit Services

Other recent audit reports:

Sexual Assault Response: Progress made toward a victim-centered approach (#445, February 2014)

City of Portland 23rd Annual Community Survey Results (#450, October 2013)

Human Capital Management Software: Most modules now implemented, but additional costs exceed $3 million (#437, October 2013)

This report is intended to promote the best possible management of public resources. This and other audit reports produced by the Audit Services Division are available for viewing on the web at: www.portlandoregon.gov/auditor/auditservices. Printed copies can be obtained by contacting the Audit Services Division.