City of Syracuse
Department of Audit
Loan Review

REPORT
OF THE ELECTED
CITY AUDITOR

To the: Honorable Mathew J. Driscoll, Mayor
Members of the Common Council
Members of the Syracuse Economic Development Corporation Board
Members of the Syracuse Industrial Development Agency Board
Members of the Syracuse Urban Renewal Agency Board
Fernando Ortiz, Director, Community Development
David Michel, Director, Economic Development
City of Syracuse, New York

Introduction:

The Audit Department conducted a formal review on the current approval, monitoring and collection procedures for loans issued by the Community Development Block Grant program, Syracuse Economic Development Corporation, Syracuse Industrial Development Agency and Syracuse Urban Renewal Agency. This audit was initiated through concerns of the City Auditor and Councilor-at-Large, Stephanie Miner, prompted by the management letter issued by Testone, Marshall & Discenza, LLP for year ending June 30, 2003. Although the management letter only spoke to Community Development Block Grant loans, the scope was expanded to loans made by the other agencies stated above because they are component units of the City.

This review is authorized by Section 5-501(4) of the City of Syracuse Charter. The examination was administered in accordance with the G*overnment Auditing Standards*, issued by the Comptroller General of the United States and *Standards for the Professional Practice of Internal Auditing,* as circulated by the Institute of Internal Auditors.

These standards necessitate that the audit is planned and performed to attain a reasonable foundation for the judgments and conclusions regarding the function under examination. This review also included evaluations of applicable internal controls and compliance with requirements of law and regulations when necessary to satisfy audit objectives.

The management of the City of Syracuse, New York, is responsible for establishing, maintaining and complying with the internal control structure and for compliance with applicable laws, regulations and contracts.

This report is intended solely for the information of the Mayor, Common Council, subsequent boards and involved departments of the City of Syracuse, New York yet it is understood to be a matter of public record and its distribution is not limited. Further information regarding this audit is available at the City of Syracuse's Audit Department upon request. The Audit Department would like to thank the Community Development and Economic Development personnel who assisted and cooperated with us during our audit.

Scope:

The review was performance in nature and was executed to provide an independent assessment of the current approval, monitoring and collection methods for all loans issued under the Community Development Block Grant program, Syracuse Economic Development Corporation, Syracuse Industrial Development Agency and Syracuse Urban Renewal Agency. The loan scope was expanded due to the facts that Syracuse Economic Development Corporation, Syracuse Industrial Development Agency and Syracuse Urban Renewal Agency are component units of the City and that all accounting and collections for their loans are done by City employees on their behalf.

The current outstanding loans for these entities, as titled on the Investor Trial Balances, are Community Development Block Grant direct rehab and special loans (CDBG), Syracuse Economic Development Corporation restricted, direct unrestricted, entrepreneur investment fund, and urban development action grant loans (SEDCO), Syracuse Industrial Development Agency downtown commercial rehabilitation, HUD 108, and development fund loans (SIDA), and Syracuse Urban Renewal Agency development fund loans (SURA). Per Community Development, these are the only City wide loans in the scope of this review. The City Auditor and the Department of Audit clearly recognize the establishment of the loans under review ranges from the mid 1980s through the 2000s.

Methodology:

To reach this assessment, the Department of Audit held discussions with Economic Development (ED) and Community Development (CD) staff to gain a general understanding of the approval, monitoring and collection procedures currently in place for the loans under review. The Audit Department also analyzed the Investor Trial Balances and Delinquency Reports, provided by the Grants Management Division and dated as of April 30, 2004, to determine the CDBG, SEDCO, SIDA and SURA loans currently outstanding and those in delinquency of sixty days or more. From the Investor Trail Balances, a sample from each loan category which held delinquent loans was selected to test further to assess the efficiency and effectiveness of the current collection procedures in place at ED and CD. Due to the date of reports provided, the period July 1, 2002 through April 30, 2004 was used for all testing purposes. Any subsequent measures implemented by the involved departments after April 30, 2004 are noted below under Additional Auditor’s Notes.

<u>Discussions with Involved Department Staff:</u>

The following information was gained through discussions held with CD and ED staff.

The staff at CD is in charge of the accounting activities regarding all the loans under review. All permanent loan files are kept at the CD offices unless otherwise referred to the Law Department for legal action.

CD is accountable for monitoring and collecting CDBG loans. CDBG loans were loans to individuals for housing rehabilitation. CD is no longer in the business of giving loans to individuals. The loan types that Community Development used to grant are now being handled by Home Headquarters.

ED oversees the collections for all SEDCO, SIDA and SURA loans. Per ED staff, SEDCO is the agency that most frequently grants loans to businesses. Per their Project Mission Statement, SEDCO provides “low cost, permanent financing” to reach their national objectives, “1) Job creation and retention, 2) Elimination of slum and blight and 3) Serious threat to health and welfare.” The applicants must be for profit and legal businesses.

A prospective business works with ED Specialists during the loan application process. An application is completed, financial statements are provided and a one bureau credit report is obtained. The Specialists analyze the information and, using their own judgment, refer all acceptable applications to the loan committee. The loan committee, consisting of a range of professionals from the banking, accounting, law and other business settings, also analyzes this information and uses their own judgment to refer acceptable applications to the corresponding board. The subsequent board is given a summary of the loan request for review and has final authority in approving a loan.

The Delinquency Reports regarding CDBG loans are printed on a monthly basis and represents loans delinquent 90 days or more. CD currently has one staff member, the Grants Management Aide (Aide), responsible for CDBG delinquent loan collection efforts. The Aide documents all collection attempts via phone or mail and any research into the loan with a Record of Telephone Conversation form. All collection documentation pertaining to the CDBG loans is found in the permanent loan file at CD. The Aide intermittently creates a list of loans that in his/her opinion need the attention of the Chief Fiscal Officer (CFO). The CFO makes the decision to refer a loan to the Law Department for legal action or to keep collection efforts at CD.

The Delinquency Reports regarding ED loans are provided by CD on a monthly basis and represents loans delinquent 90 days or more. Economic Development currently has two staff members, Economic Development Specialists (Specialists), responsible for SEDCO, SIDA and SURA delinquent loan collection efforts. Any collection attempts made by the Specialists via phone or mail are documented and kept in a separate file at ED. Per the ED Specialists, all collection letters are reviewed by the Law Department for legality before they are sent to the debtor. If the Specialists deem it necessary, a loan is brought to the attention of the Director of ED for further action. The Director then makes the decision to refer a loan to the Law Department for legal action or to keep collection efforts at ED. The corresponding boards have the final authority on write offs and settlement offers.

SIDA and SEDCO loans follow the allowance method while SURA and CD loans are using the direct write off method. Under the allowance method, a separate reserve account is created to off set the loans deemed uncollectible. Under the direct write off method, loans are taken off the loan base when deemed uncollectible. For loans under the write off method, the Assistant Chief Fiscal Officer writes a loan off the mortgage software while the CFO writes it off the accounting software. For loans under the allowance method, the CFO enters the amount deemed a write off into the allowance balance. The permanent loan files are kept in case of any future payment activity.

Statements that the City is a lender of last resort taking on high risk borrowers were expressed by the involved departments' staff throughout the audit. This was a reason given to the Audit Department by individuals when asked why the loan delinquency ratios were high.

Analysis of Investor Trial Balances and Delinquency Reports:

The following information was gained from the CDBG, SEDCO, SIDA and SURA loan Investor Trial Balances and Delinquency Reports provided by the Division of Grants Management.

As of April 30, 2004, there were 314 total active loans under review with 186 delinquent sixty days or more. These figures represent a combined delinquency rate of 59.24% for the actual number of CDBG, SIDA, SEDCO and SURA loans. Please see the attached Delinquency Rate Report for a detailed breakdown of the delinquency rates per loan category. At 66.23%, CDBG loans have the largest delinquency rate in the group.

As of April 30, 2004, there was a total outstanding balance of $8,479,817.00 in active loans under review and $906,369.06 of this balance is past due sixty days or more. Please see the attached Past Due Report for a detailed breakdown of the delinquency rates per loan category. At $631,384.31, CDBG loans have the largest balance that is past due in the group.

During this analysis, it was uncovered that several loans that are no longer active (paid off) continued to be reported on the Investor Trial Balances. Any loan that has a negative balance is not considered active.

It was also discovered that two CDBG loans clearly delinquent on the Investor Trial Balance were not reported on the Delinquency Report. The Chief Fiscal Officer attributed this to the reports being printed on two different dates. Since the Delinquent Report is used by many users who rely on its accuracy, going forward, the office of Community Development should reconcile the loans on the report to the data found on the Investor Trial Balance before issuing it to any users.

Sample of Delinquent Loans Tested Further**:**

Out of 186 delinquent loans as of April 30, 2004, 33 loans (17.74%) were chosen for further testing. Out of the sample chosen, the average days delinquent was 2,085 (5.71 years). For testing purposes, the time period July 1, 2002 through April 30, 2004 was used. Please see the attached Monitoring and Collections Testing Report for a detailed account for the sample testing.

From 23 CDBG loans selected, four (17.4%) had documented phone or mail collection efforts and 10 (43.5%) had documented research into the loan. It appears that City foreclosures, bank foreclosures or borrower bankruptcy occurred for a range of these loans.

From 10 SEDCO, SIDA and SURA loans selected, seven (70%) had documented phone or mail collection attempts and five (50%) had documented research into the loan. The City was in the foreclosure process for one of the loans as of April 30, 2004.

Findings & Recommendations:

It is the City Auditor's opinion that the delinquency ratios and the amount past due discovered for the loans under review are unacceptable. It is the City Auditor's opinion that Community Development and Economic Development lack defined delinquent loan policies and procedures. It was also determined that a range of CDBG loans on the Investor Trial Balances are uncollectible and should be written off. Suggestions to improve the operational performance and controls are detailed below.

Recommendation #1: "Adjustments to Loan Approval Methods"

It is the City Auditor's opinion that the loan delinquency ratios uncovered call for *immediate corrective action with reference to the methodology utilized in the approval process for future loans.* If the standard of including loans 30 days or more delinquent in the delinquency rate calculation was used, then this rate would increase substantially.

The current loan portfolio's delinquency ratio leads the Auditor to conclude that the City has, in the past, been making poor underwriting decisions. Going forward, the City of Syracuse and its component units should not give loans to businesses that are not viable.

To mitigate potential future losses, the City Auditor recommends Economic Development *create a Loan Underwriter or Credit Analyst position.* This position would be responsible for reviewing the credit, income, assets, loan to values, equity positions and other underwriting criteria deemed appropriate and forwarding recommendations to the Loan Committee. Alternatively, this position could make an underwriting decision and should be held accountable to some degree for delinquency ratios by the loan committee, as a check and balance.

During loan processing stage, *Economic Development should consider obtaining a three bureau credit report* instead of the current practice of getting a report from one bureau when analyzing loan applications. A one bureau credit report is only 33% of the entire borrowers' credit history and is insufficient to make a lending decision of this magnitude. The three bureau credit report will give the involved parties a better risk assessment. The additional charges for a tri-merged credit report (typically $22.00) should be added to the borrower's application fee.

Recommendation #2: "Consolidation of Collection Efforts"

The City Auditor recommends the *collection efforts for SEDCO, SIDA and SURA loans be executed by the Community Development offices, not Economic Development.* Since Community Development is currently responsible for all fiscal related activities regarding said loans, this modification would improve the efficiency of the collections function.

Community Development would have to increase or reassign staff when implementing this recommendation. Under the increase of staff scenario, the additional staff would be justified by improved collections and ultimately, lower delinquency rates. Also, due to these changes, the Economic Development Loan Specialists would concentrate only on attracting potential businesses for the City of Syracuse and processing the loan applications.

Recommendation #3: "Defining Collection Policies and Procedures."

The City Auditor advises the involved departments *collaboratively develop written detailed and unified policies and procedures regarding the collection of loans*. These should include, but are not limited to, definite steps of action to occur on the 31st, 61st, 91st and 121st day of delinquency with system triggers in place to generate said actions. These procedures should also address *when a delinquent loan is to be referred to the Law Department for legal action.* These policies will ensure each loan is getting the proper monitoring and collection efforts.

The City Auditor recommends policies *for the determination of loans uncollectible and subsequent accounting procedures for write offs also be clarified and outlined in an official written policy and procedure manual*. The City may want to ordain the final authority for Community Development related loans' write offs to the Common Council, which will provide an effective check and balance. These policies will ensure the loan balances are properly represented.

There should *be concise practices in place on the supervisory level* of the departments involved to ensure all loans are handled as policies specify.

Recommendation #4: "Delinquency Reports Triggered on Day 31"

The City Auditor advises on *the adjustment of the Delinquency Report to represent loans that are thirty days or more.* While this would temporarily increase the delinquency ratio, it would provide sufficient time for appropriate staff to take the necessary collection steps and would ultimately lead to a lower overall delinquency rate.

Recommendation #5: "Inter-Departmental Meetings"

The City Auditor recommends *regular meetings between Economic Development, Community Development and Law Department staff to discuss the status of current collection efforts on any delinquent loans.* The financial situation uncovered in this review begs for substantial coordinated efforts between the involved departments. The decision on when and how often these meetings occur is at the discretion of the involved parties based on the collection needs of the period.

Recommendation #6: "Contracts and Notes with Enforcement Provisions"

The City Auditor recommends *stronger enforcement provisions in the loan agreements executed* such as liens on real property, general UCC liens and clauses that specify all disputes will be settled within the jurisdiction of Onondaga County in the State of New York.

Management Responses:

The Auditor requested to meet with the Director of Economic Development and the CFO of Community Development. At this meeting, on September 1, 2004 the Auditor met with the Director of Economic Development, the CFO of Community Development, the City of Syracuse Corporation Counsel, the City of Syracuse Director of Administration and Acting Budget Director and two (2) Economic Director Specialists. The management responses are as follows:

Recommendation 1:

The Economic Development stated that there are different criteria for start up companies and therefore it is difficult to ascertain the likelihood of the viability of those loans. *The Auditor recognizes the logic, but re-iterates that a standardized and written underwriting guideline for loans be written and put in a policy and procedure manual. This logically would contain underwriting scenarios for different types of loans.*

Management wanted it be clear that they are utilizing a tri-merged credit report. *The policy was implemented after this suggestion was made by the Auditor to the Economic Development Director at a previous meeting. No new applications have originated and therefore, as of September 1st, no credit reports have pulled. However, ED has incorporated this suggestion going forward.*

Management does not feel that there is enough loan origination activity at ED to justify fully segregating duties by creating a separate position for loan underwriting. *Typically an Underwriter is charged with additional duties beyond simple loan approval and declinations. Had an individual with a strong credit analysis background been involved to date, the portfolio would be performing at a higher standard than a 59% deficiency ratio City and city-agency wide.*

Recommendation 2:

Management stated that the department that originated a loan should be responsible for collecting the loan because they are familiar with the said loan. Management does not agree that the collection process should be consolidated to the department that does the accounting. However, management noted that the accounting function for all City and city agency loans have been consolidated to the Department of Community Development. *The Auditor feels the city should nonetheless consolidate the effort in one department for obvious efficiency reasons. It is noted that the City already has consolidated the accounting function and in the same light should consolidate the collections.*

Recommendation 3

The Economic Development Director stated that the will bring recently created memoranda for collection policies to the respective boards for approval(s). See attachment A1. *The Auditor emphasizes that there should be a City and city agency-wide policy related to collections that is uniform and in writing.*

Recommendation 4

Management wished to insure that the report included the fact that the loans are currently being reported on the 31st day of delinquency. *The Auditor concurs that this is being done, however this is a subsequent event to the audit.*

Recommendations 5 & 6

Management concurred that they should have formal regularly scheduled meetings to discuss the status of the collection of loans.

Management also concurred that stronger provisions should be put into loan documentation to better enforce collections.

Additional Auditor's Notes:

The City Auditor recognizes and supports the efforts made by the involved departments during the audit review to improve the collection process.

A memo (Attachment A1) addressed to the Director of ED, dated July 21, 2004 and presented to the Audit Department at a July 29, 2004 meeting, detailed collection policy recommendations from the Specialists and CFO. Also during this meeting, the City Auditor suggested ED use a three bureau credit report instead of the one bureau report, Recommendation #1, which they agreed would be a beneficial action.

Per a discussion with the CFO at CD on August 5, 2004, efforts are being made to properly account for all loans deemed uncollectible. The CFO stated that all necessary write offs will be done by the closing of Fiscal Year 03/04.

On August 26, 2004 in the Syracuse Post Standard article entitled "City Starts Effort to Collect Loans," the ED Director stated that new loan policies were implemented last month. Presumably, the Director was referring to the recommendations recently made in the July 21, 2004 memo. The Audit Department is pleased that Economic Development began addressing the collection function in July of 2004 as noted in the July 21, 2004 memo. In accordance with Recommendation #3, we suggest this memo be translated into and made part of a strictly written Policy and Procedure Manual.

The Director also claimed in this article that the loan delinquency rate had changed in the past year from nearly 40 percent to between 15 and 20 percent. The City Auditor questioned the Director of Economic Development about these figures. The Director stated that 85% of the loans have been either brought current or they are making some kind of payment or doing a work out plan with the City. By definition, any loan that is not currently up to date on the original loan agreement payment plan is delinquent. Almost 60% of all city loans through the city programs and agencies are delinquent, many seriously so.

Conclusion:

Past loans from the City of Syracuse were, in many cases, not made to individuals and or businesses with the credit, collateral or character required to repay loans. This is the result of many factors including, but not limited to, insufficient credit reporting standards and the inadequate underwriting guidelines. The lack of unified collection procedures also played a role in the extreme loan delinquency uncovered throughout this review.

Clearly, it is unreasonable to ask for a loan portfolio to perform at a rate of 100%. Conversely, a 60% non-performing rate would most likely result in bankruptcy for most lending institutions and would not be acceptable to stockholders. The taxpayers and citizens of Syracuse are the City of Syracuse's stock holders. As such, they deserve strong corrective action by city officials in reversing the portfolio's performance. While the majority of the deficient loans are from previous administrations, it is the responsibility of this administration to begin a concentrated effort regarding these loans in the involved departments and boards.

Such acts will result in a return of the principal and interest due to the city or involved agencies. Thus, these funds could be utilized to achieve the function's missions which are to create jobs, job retention and the elimination of slum and blight. We are not a 'lender of last resort' as had been stated on numerous occasions. The lack of an underwriting standard for future loans will only cause the status quo to continue and will result in the agency working against it's mission as the failed loans cause continued financial stress and limit future funds for potential growth.

It is not being recommended that future analysis of loan applications be so demanding that it becomes excessively restrictive. What is being suggested is an acceptable medium that will provide for the sound reinvestment and investment of taxpayer dollars.

Philip J. LaTessa
Syracuse City Auditor
City of Syracuse
September 1, 2004