
Audit of the Department of Hawaiian Home Lands' Homestead Services Division

A Report to the
Governor
and the
Legislature of
the State of
Hawai'i

Report No. 13-02
April 2013



THE AUDITOR
STATE OF HAWAII

Office of the Auditor

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Jan K. Yamane
Acting State Auditor
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“Out of control.”

- Loan specialist describing
her loans

Recommendations

Responses

Prior Audits

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Audit of the Department of Hawaiian Home Lands' Homestead Services Division

Report No. 13-02, April 2013

Lack of commission guidance and lax loan management favor lessees over other beneficiaries

The Department of Hawaiian Home Lands administers about 200,000 acres of public lands set aside for agricultural and pastoral use to be leased to native Hawaiians, upon which they may live, farm, ranch, and engage in commercial or other activities. The department, led by a nine-member commission, must provide financial and technical assistance to native Hawaiians (those with at least 50 percent Hawaiian blood), which enables them to enhance their economic self-sufficiency and promote community-based development. According to the Hawaiian Homes Commission Act of 1920, by doing this, the traditions, culture, and quality of life of native Hawaiians will be self-sustaining.

As of June 30, 2011, there were 9,922 homestead leases statewide and 26,170 applicants waiting for homestead leases. In FY2011, the department issued 177 new homestead leases. That year, the department collected \$61.1 million in revenues and accrued \$70 million in expenses.

Commission fails to meet its fiduciary obligations

We found that the roles and responsibilities of the commission are not clearly defined and the commission lacks tools to aid it in prudent trust administration. For instance, according to the commission chair, the commission is more concerned with keeping lessees on the land than with collecting on delinquent loans, ignoring its broader responsibilities. In addition, the department does not provide sufficient monthly delinquent loan totals or other data to the commission and has not done any meaningful analysis of direct loan program profitability or other current and upcoming obligations. With little information on the department's more than \$588 million in direct loans, loan guarantees, and insurance obligations, the commission is unaware of the potential impact of its loan award decision making and is unable to meet its fiduciary duty.

Department's lax management of loans undermines accountability to beneficiaries as a whole

We also found that the department has vague policies and few standards governing its direct loans (those it underwrites directly as well as insured and guaranteed loans that have been reassigned to the department for delinquent collection). For example, the department and commission have not reassessed loan interest rates since 1995. In addition, an estimate used to calculate household expenses for determining loan eligibility has not been updated in a decade, meaning the department may be underestimating the cost of living and miscalculating lessees' ability to pay off loans. As a result, the department may be making loans to borrowers who cannot afford to make their payments.

Agency response

The department agreed that much can be done to enhance its performance, and that its higher risk portfolio requires active loan monitoring and collection policy enforcement to control delinquent loans. It recognized our concern that lax management of lessee loans undermines its ability to serve all beneficiaries and says it will aggressively look at loan delinquency issues and that actions will be taken against the most chronic delinquent borrowers. It will also review best practices to improve internal controls and provide adequate staffing for its loan program.

The department disagreed that an external benchmark such as Hawai'i's subprime mortgage delinquency rates would help commissioners identify whether DHHL's delinquency trends diverge from the rest of the market, asserting it is unfair to judge DHHL's performance solely on standards established by commercial lenders. The department misunderstands our point that such a benchmark would provide perspective on performance trends of other loans provided to less creditworthy borrowers and whether DHHL's performance runs counter to the markets.

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Submitted by

THE AUDITOR
STATE OF HAWAI'I

Report No. 13-02
April 2013

Foreword

This report on our audit of the Department of Hawaiian Homelands' Homestead Services Division was prepared in response to a proviso in Act 106, Session Laws of Hawai'i 2012. We conducted the audit pursuant to Article VII, Section 10 of the Hawai'i State Constitution and Section 23-4, Hawai'i Revised Statutes, which require the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

We wish to express our appreciation for the cooperation and assistance extended to us by members of the Hawaiian Homes Commission, the chair and staff of the Department of Hawaiian Homelands, and other individuals whom we contacted during the course of our audit.

Jan K. Yamane
Acting State Auditor

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Chapter 1

Introduction

This audit of the Department of Hawaiian Home Lands' Homestead Services Division was requested by the 2012 Legislature through a proviso in Act 106, Session Laws of Hawai'i (SLH) 2012 (the Supplemental Appropriations Act of 2012). The proviso requires the Auditor to conduct a financial and management audit of the Homestead Services Division for fiscal year 2012 and to report on the status of the direct, insured, and guaranteed loan programs administered by the division. The audit is to include or address: 1) the total amount of the direct, insured and guarantee loans, related delinquencies, issues relating to the processes and procedures of the direct and indirect loans, and their impact on the department's mission and goals; 2) responsibilities of the division that are not adequately achieved due to inadequate resources; 3) issues relating to the division's strategic and financial plan, its budgeting process, and its process of forecasting financial needs to address its loan program; and 4) the method for determining priorities for expenditures for the division.

Background

The federal Admission Act of 1959 granted the State of Hawai'i title to certain lands that were previously ceded to the United States. These lands, known as *ceded lands*, were placed in a public trust and their use restricted: proceeds or income of trust lands were to be used for five purposes, one of which is bettering the conditions of native Hawaiians. The Admission Act also required Hawai'i to adopt the Hawaiian Homes Commission Act of 1920 (HHCA) within its constitution. Under the HHCA, *native Hawaiians* are defined as individuals having at least 50 percent Hawaiian blood.

Hawaiian Homes Commission Act

The HHCA was incorporated into the State Constitution in 1959 when Hawai'i was granted statehood and responsibility for the commission and Hawaiian home lands was transferred to the State. Under the Hawai'i State Government Reorganization Act of 1959, the commission's powers were transferred to the newly created Department of Hawaiian Home Lands (DHHL). Most recently amended by Act 349, SLH 1990, the 1959 HHCA created a Hawaiian Homes Commission to administer about 200,000 acres of public lands, which were designated as *available lands* set aside for agricultural and pastoral use to be leased to native Hawaiians. Certain areas within the tracts of available lands were specifically excluded from Hawaiian homesteading: namely, forest reservation lands, all cultivated sugar lands, and all public lands already

held under a certificate of occupation, homestead lease, right of purchase lease, or special homestead agreement.

The HHCA has five express purposes:

- Establish a permanent land base for the benefit and use of native Hawaiians, upon which they may live, farm, ranch, and engage in commercial or other activities;
- Place native Hawaiians on lands set aside in the act in a prompt and efficient manner and assure long-term tenancy to beneficiaries and their successors;
- Prevent alienation of the land fee title, so that lands set aside in the act will be held in trust for continued use by native Hawaiians in perpetuity;
- Provide adequate water and infrastructure to make homestead lands useable and accessible; and
- Provide financial and technical assistance to native Hawaiians, so that by pursuing strategies to enhance economic self-sufficiency and promote community-based development, the traditions, culture, and quality of life of native Hawaiians will be self-sustaining.

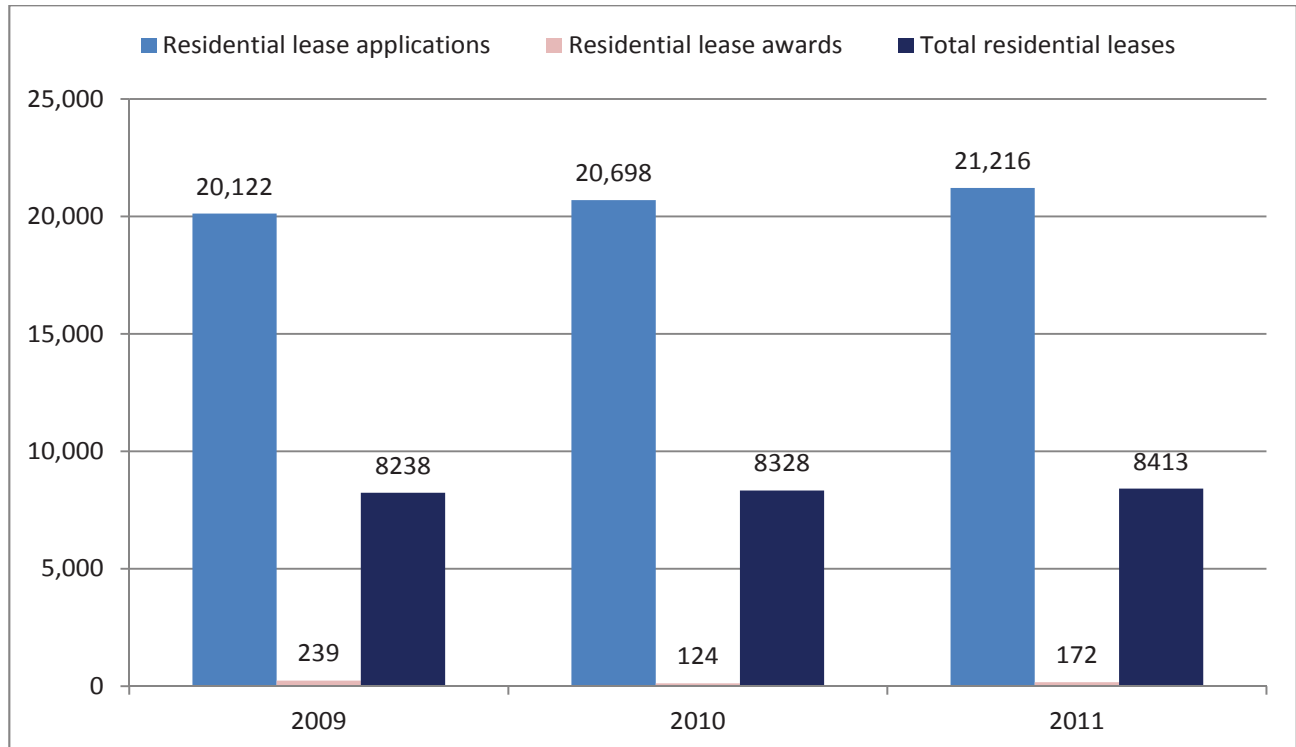
Under the HHCA, the United States and the State of Hawai‘i acknowledge a shared solemn trust and their fiduciary duty to faithfully administer the provisions of the act on behalf of native Hawaiian beneficiaries. Except for provisions that increase benefits to lessees, or relate to administration of the 1920 act, the HHCA can be amended only with the consent of Congress.

Homestead services – organization

Pursuant to the HHCA, the State provides homestead services to native Hawaiians via the Department of Hawaiian Home Lands. Services include awarding homestead leases, which are granted for residential, agricultural, or pastoral purposes. Aquacultural leases are also permitted. The intent of the homesteading program is to provide for economic self-sufficiency of native Hawaiians through the provision of land. Other benefits provided by the HHCA include financial assistance through direct loans or loan guarantees for home construction, replacement, or repair, and for the development of farms and ranches; technical assistance to farmers and ranchers; and the operation of water systems. Pursuant to provisions of the act, the department provides direct benefits to native Hawaiians in the form of 99-year homestead leases at an annual rent of \$1. In 1990, the Legislature authorized the department to extend leases for an aggregate term not to exceed 199 years.

As of June 30, 2011, there were 9,922 homestead leases statewide and 26,170 applicants waiting for homestead leases. In FY2011, the department issued 177 new homestead leases. Exhibit 1.1 shows the number of homestead lease applications, awards, and total leases as of fiscal years ended June 30, 2009, 2010, and 2011.

Exhibit 1.1
Hawaiian Homestead Lease Applications and Awards, FY2009–FY2011

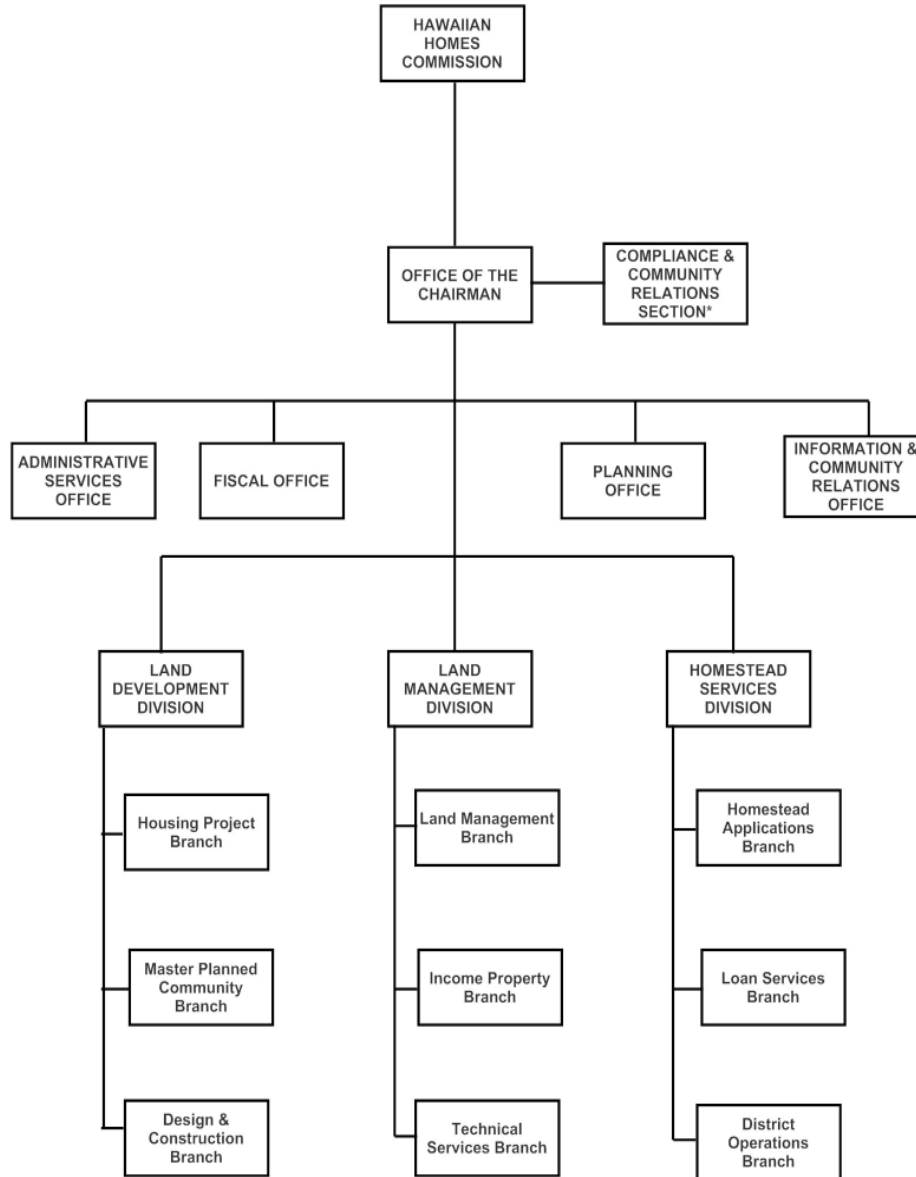


Source: Department of Hawaiian Home Lands' annual reports

Relevant department offices and divisions

The Department of Hawaiian Home Lands is headed by the Hawaiian Homes Commission and organized into five offices and three operating divisions. Exhibit 1.2 shows an organizational chart of the commission and department.

**Exhibit 1.2
Hawaiian Homes Commission and Department of Hawaiian Home Lands
Organizational Chart**



* Also referred to as Enforcement Office (E Team)

Sources: Department of Budget and Finance and Office of the Auditor

The **Hawaiian Homes Commission** is an executive board comprised of nine members appointed by the governor with the advice and consent of the state Senate. Members must be residents of Hawai‘i’s various counties, including three from Honolulu; two from Hawai‘i (one from East Hawai‘i and one West Hawai‘i); two from Maui (including one from Moloka‘i); and one from Kaua‘i. The ninth member of the commission is the chair, who is appointed by the governor from among the members of the commission. Members must be residents of the state for at least

three years prior to appointment, and at least four members must have at least one-quarter Hawaiian blood. The chair of the commission serves as the full-time administrator of the Department of Hawaiian Home Lands; the other commission members serve without pay.

The **Department of Hawaiian Home Lands** is comprised of five offices. Of these, the **Office of the Chairman** manages the daily operations of the department, sets directions, and provides leadership support to all department offices and divisions, and supports the commission. It also directs the preparation and presentation of proposed plans, programs, budgets, and projects, and recommends the adoption of policies, rules, and legislative proposals to the commission; and houses the Enforcement Team, whose role is explained further below. The **Fiscal Office** provides financial information, accounting services, and establishes internal financial control policies and procedures for the department.

Three operating divisions carry out the department's programs. The **Land Management Division** manages all the department's non-homestead assets; markets and manages revenue-producing land and property; conducts land and real property appraisals; recommends terms and conditions of land and real property transactions; provides for the acquisition of land and land exchanges; and develops and maintains land inventory and real property transaction records.

The **Homestead Services Division**—the primary focus of this audit—is involved in the direct servicing of homestead lessees and applicants for homestead leases. The division plans, organizes, and carries out programs and activities involved in leasing homestead lots for residential, farming, ranching, and aquacultural purposes. The division also provides loans and other financial assistance to native Hawaiians. The division has three branches.

The **Homestead Applications Branch** ensures applicants meet the blood quantum requirement of the Hawaiian Homes Commission Act. The branch maintains records of all transactions involving applications, including new applications and requests for transfers, reinstatements, rescissions, and successorships. During FY2011, the branch processed 1,880 applicant transactions. As of June 30, 2011, there were 41,948 applications for residential, agricultural, and pastoral homesteads—an increase of 957 applications over the previous fiscal year. The number of applications and applicants differs because rules allow applicants to hold an application for a residential lease as well as one for either an agricultural or a pastoral lease.

The **Loan Services Branch** administers loan origination, loan servicing, and loan collections. It provides information and assistance to lessees applying for new residential construction, home improvement, home

replacement, farm and ranch, commercial, and home loans made by the U.S. Department of Agriculture Rural Development, the Federal Housing Administration (FHA), the U.S. Department of Veterans Affairs (VA), and other agencies, which are guaranteed by the department. In FY2011, the branch issued 16 direct loans totaling \$2.1 million.

The **District Operations Branch** has offices located on O‘ahu, Kaua‘i, Moloka‘i, Maui, and in East and West Hawai‘i. The offices provide frontline support to homestead lessees, applicants, and community associations by managing homestead areas and assisting with various departmental projects. Neighbor island offices also provide services to all other department divisions and serve as local liaisons to the chairman’s office. The branch interacts with private, federal, state, and county agencies to provide and coordinate services for beneficiaries. The O‘ahu District Office manages, coordinates and finalizes processing of all transactions and legal documents for homestead lessees statewide, including participating in contested case hearings and preparing submittals to the commission. It also prepares recommendations for commission action regarding homestead lease matters, and operates and maintains the lease recordation system.

The **Land Development Division** develops property for both homesteading and income-producing purposes. The division’s **Housing Project Branch** provides marketing for homestead leases and awards. According to the department’s 2011 annual report, this branch is part of both the Homestead Services and Land Development Divisions; however, the department’s official organization chart depicts this branch as officially under the Land Development Division.

Homestead services – operations

Pursuant to the HHCA, one of the primary goals of the department is to place native Hawaiians on Hawaiian homestead lands. This is carried out by providing homestead services including infrastructure, financial support and technical assistance to native Hawaiians. Six key processes support homestead services operational activities:

- homestead lease application;
- lease award;
- loan award;
- delinquent loan collection;
- contested case hearing; and
- lease cancellation.

The *homestead lease application* process involves determining an applicant's qualifications (i.e., blood quantum), maintaining applicants' records and files, certifying an applicant's eligibility for lease awards, developing and compiling the waiting lists, and preparing recommendations for commission action. The process is handled by the Homestead Applications Branch. The *lease award* process generally involves notifying applicants of lease offerings and processing applicants from the department's wait lists to contractor and house design selection, lot selection and lease execution. Awards are processed by the Housing Project Branch in collaboration with the Homestead Services Division. The *loan award* process, *collection* process, and *contested case hearing* process are key focal points of this audit, and are described in greater detail below. The *lease cancellation* process includes vacating, appraising, and re-awarding a new lease for properties where a lease has been cancelled. Cancellations are processed by the Enforcement Team, the Homestead Lease Coordinator, and the Loan Service Branch in the Homestead Services Division. Re-awards are processed using some of the same procedures as first-time lease awards.

Homestead loan programs

The department participates in several homestead loan programs: *guaranteed*, *insured*, and *direct*. This audit of the Homestead Services Division focuses on *direct* loans, which include all loans for which the department is directly responsible—that is, loans directly underwritten by the department as well as delinquent insured and guaranteed loans that have been reassigned to the department for collection.

The state, which retains ownership of leased lands, guarantees loans and consents to loan insurance to provide incentive to other lenders (e.g., banks) to finance native Hawaiian lessees. The department has agreements with lenders and agencies (such as FHA and VA) for guaranteed and insured loans. The department also provides direct loans as a lender of last resort to lessees that do not qualify with other lenders and loan programs. Direct loans are approved, serviced, and financed in whole or in part by the department. Direct loans also include any guaranteed or insured loans which have reverted to the department for collection (meaning the borrower has become seriously delinquent to the point that the original commercial lender is now looking to the department for its guarantee or insurance; the department is left to follow up with the borrower to recoup its losses).

Lenders' requests for guaranteed and insured loans, as well as applications for direct loans, are processed by the Loan Services Branch. The branch also recommends approval and ratification of loans to the chair and commission.

Delinquent loan collections

Direct loan payments are due on the 19th of each month. Government and bank loans reassigned to the department are due on the 1st of each month. Loans are considered delinquent when a borrower fails to pay the required installment by that date; however, late fees are not assessed until after a ten-day grace period. Except for East Hawai‘i, statewide collection activities are performed by the Loan Services Branch on O‘ahu, which monitors delinquent accounts and contacts delinquent borrowers to arrange repayment of past due amounts. According to the department’s administrative services officer, East Hawai‘i has its own collection assistant, a position that was established due to the historically high delinquency rate in that area. Collection efforts continue until a loan becomes more than 120 days delinquent, at which time the Loan Services Branch can request the commission hold a contested case hearing, as provided under the commission’s rules.

Contested case hearings

Contested case hearings can be held for any borrower 120 days or more in default on a loan, or for any lessee in violation of a lease. The process allows borrowers/lessees an opportunity to protect their interests in their leases. Hearings are managed by the Enforcement Team (known as the E Team), which is housed within the Office of the Chairman and reports directly to the department director and deputy director. According to a department enforcement administrator, the E Team gathers evidence on delinquent loans and designates a hearings officer for each case (generally, a privately contracted attorney). Hearings officers may examine witnesses and evidence; issue subpoenas; regulate the course and conduct of the hearing; and make written recommendations to the commission. The commission’s resulting Decision and Order (D&O) can include cancelling the terms of a lease.

Funding

The major source of funding for the homesteading program was originally provided by the HHCA as 30 percent of all revenues derived from leasing cultivated sugarcane lands and water licenses. However, in recognition of waning sugarcane lease revenues, the 1978 Constitutional Convention expanded the department’s entitlements to include “sufficient” general fund appropriations to cover the department’s operations. The department also receives income from leases of its available lands and from specific legislative appropriations. Additionally, Act 14, Special Session Laws of Hawai‘i 1995, provided the department with \$600 million, payable in \$30 million installments over 20 years, to compensate the department for lands improperly conveyed prior to statehood. Act 14 specified that the payments were not to diminish funds the department is entitled to under the State Constitution.

The department’s revenues for FY2011 totaled \$61.1 million and its expenditures totaled \$70 million. The department’s slight increase in net assets for fiscal years 2009, 2010, and 2011 was due to the \$30 million annual infusion from Act 14. Without these settlement moneys, the last installment of which will be paid during the fiscal year ended on June 30, 2015, the department’s expenditures would have exceeded its revenues. Exhibit 1.3 shows the department’s revenues and expenditures for FY2009–FY2011.

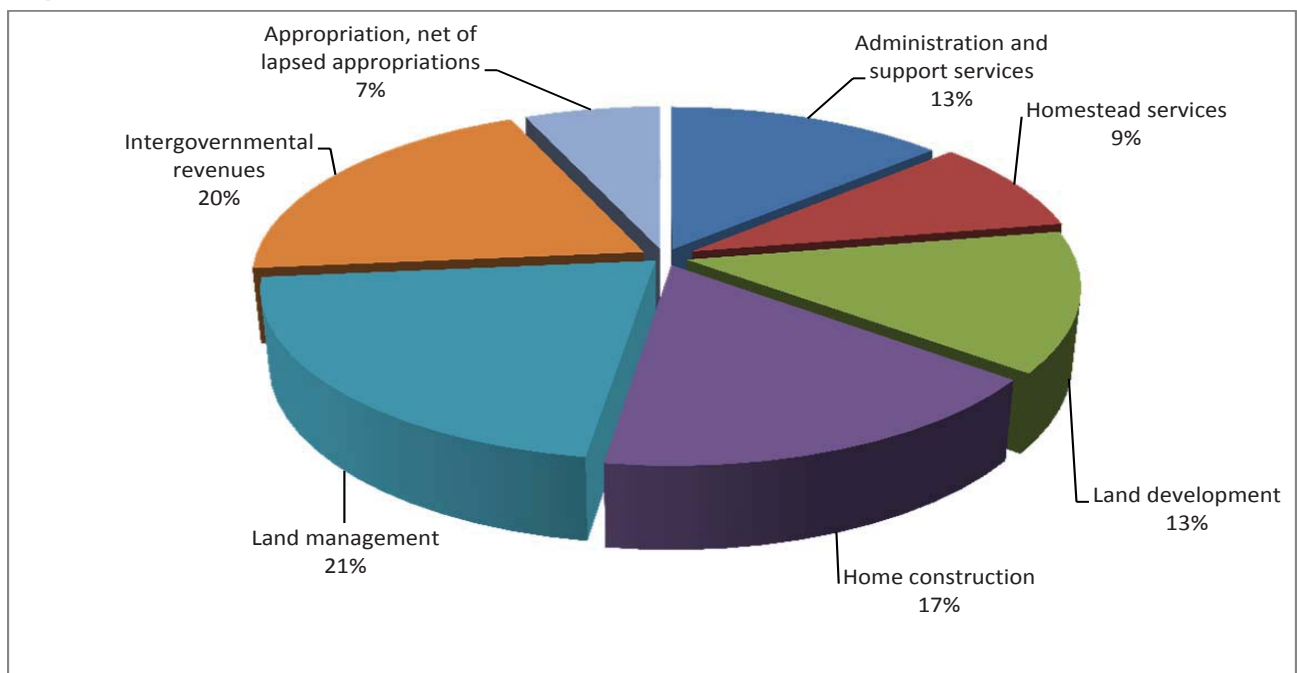
**Exhibit 1.3
Department Revenues and Expenditures, FY2009–FY2011**

Changes in net assets (millions)	FY2009	FY2010	FY2011
Total revenues	\$36.8	\$64.1	\$61.1
Total expenses	\$64.6	\$68.0	\$70.0
Excess/deficiency	-\$27.8	-\$3.9	-\$8.9
Transfers	\$30.0	\$30.0	\$30.0
Change in net assets	\$ 2.2	\$26.1	\$21.1

Source: DHHL Financial and Compliance Audit 2009, 2010, 2011

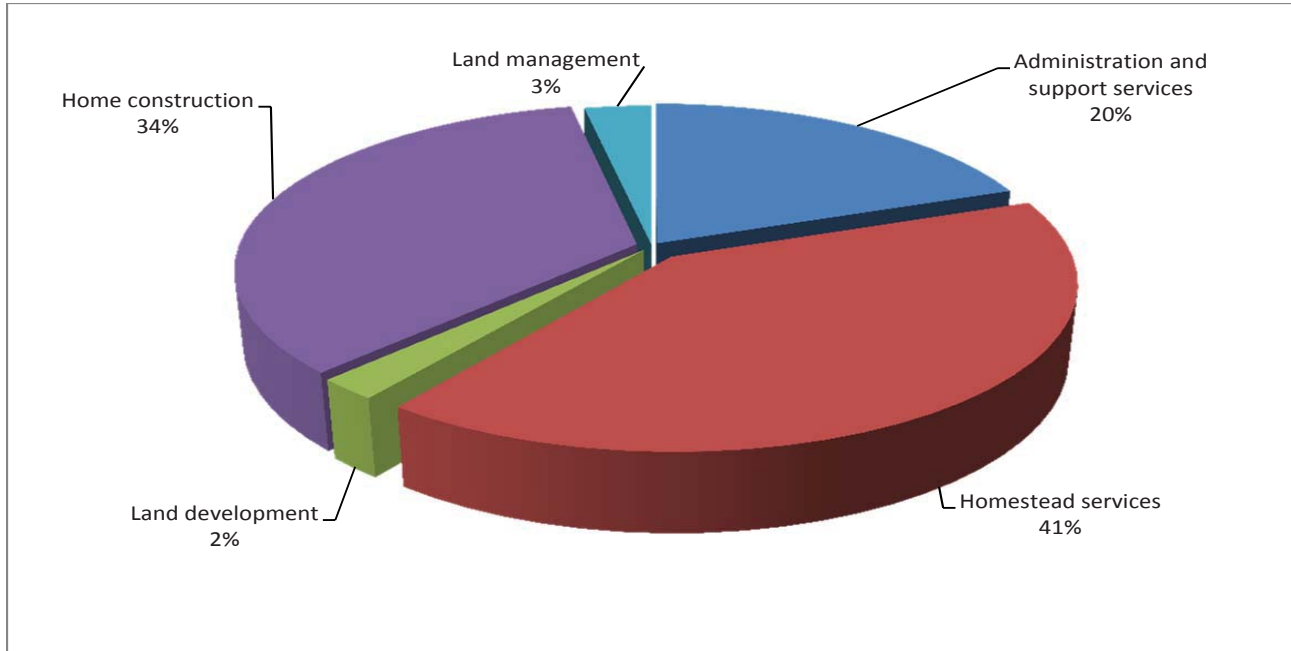
Exhibits 1.4 and 1.5 illustrate the department’s revenues and expenditures, respectively, by category for FY2011.

**Exhibit 1.4
Department Revenues, FY2011**



Source: Office of the Auditor

Exhibit 1.5
Department Expenditures, FY2011



Source: Office of the Auditor

Prior Audits

We have conducted five audits specific to the department and four fund reviews covering the department’s revolving funds, trust funds, and trust accounts. Of these five audits, three are relevant to the Homestead Services Division.

In 1993, our *Management and Financial Audit of the Department of Hawaiian Home Lands*, Report No. 93-22, found that neither the Hawaiian Homes Commission nor the department had effectively carried out its responsibility under the HHCA to return native Hawaiians to the land. Our findings included: 1) the commission had not given sufficient policy direction to guide the department and had not exercised necessary oversight to hold the department accountable for its programs; 2) the department lacked written policies and formal plans to direct its programs and had not developed effective management systems to properly implement and manage its programs; 3) the department’s collection on delinquent loans was poor; and 4) the department had assumed a potential liability that exceeded the limit permitted by statute.

In our 1995 *Follow-up Report on Management and Financial Audit of the Department of Hawaiian Home Lands*, Report No. 95-16, we found that in June 1994, the department adopted a Loan Delinquency Action Plan to address its delinquent loan problem. The plan was designed to reduce the department’s direct loan delinquency ratio to 30 percent by

June 30, 1995. However, despite the plan and the department's statement that it had actively worked to reduce its loan delinquency ratio, we found both the ratio and number of delinquencies had actually increased.

In 2002, we reported in our *Financial Audit of the Department of Hawaiian Home Lands*, Report No. 02-13, deficiencies specifically related to the Homestead Services Division, which included: 1) information on applicants was not always current or accurate; 2) the department was ineffective in managing its outstanding loans and written collection policies were not enforced; 3) loan guarantees were not properly monitored; and 4) beneficiaries were still waiting for homestead leases.

Objectives of the Audit

1. Assess the adequacy of the Homestead Services Division's management of its loan portfolio risk.
2. Assess the appropriateness of the division's loan issuance, collection, and monitoring efforts.
3. Make recommendations as appropriate.

Scope and Methodology

This audit focused on the management and finances of the Department of Hawaiian Home Lands' Homestead Services Division and its direct, insured, and guaranteed loan programs for the previous three fiscal years. We examined relevant activities from July 1, 2008 through June 30, 2011. We conducted interviews with commissioners, departmental personnel, and legislative staff and other stakeholders. We reviewed planning, loan, personnel, and other documents; and we tested loan documents for compliance with applicable policies, procedures, agreements, and other relevant criteria. We did not specifically address whether responsibilities of the division are not adequately achieved due to inadequate resources, as this issue was subsumed within our work focusing on the appropriateness of loan issuance and reassignment processes and procedures.

Our audit was performed from June 2012 through October 2012 and conducted according to the Office of the Auditor's *Manual of Guides* and 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 the evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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Chapter 2

Lack of Commission Guidance and Lax Loan Management Favor Lessees Over Other Beneficiaries

Rising loan obligations and delinquencies pose a solvency risk for the Department of Hawaiian Home Lands (DHHL). However, accountability for homestead loans is lacking at the commission and department levels, resulting in loans being administered in an imprudent fashion that favors delinquent lessees. The commission has not fulfilled its fiduciary responsibilities to prudently mitigate overall loan risk and impartially administer the Hawaiian Homes Commission Act (HHCA) on behalf of all beneficiaries, having instead favored one class of beneficiaries—lessees—over those on a growing waitlist for leases and an unknown number of people who have yet to apply. As of June 30, 2011, there were about 9,200 beneficiary leases and nearly 26,200 applicants seeking leases. The department, in turn, inadequately manages direct loans by not establishing clear issuance and collection procedures. It also has not provided adequate delinquency information to commissioners to encourage informed decisions affecting loan risk exposure.

We also found that the commission, in an attempt to adhere to the HHCA goal of providing long-term tenancy, has thwarted collection or cancellation of chronically delinquent homestead leases. Allowing delinquent lessees to accumulate debt runs counter to the act's goal of enhancing economic self-sufficiency for Hawaiians. It also ties up leases and staff resources to the detriment of beneficiaries who are still waiting for leases and undermines placing native Hawaiians on the land in a prompt and efficient manner, as envisioned by the act.

Summary of Findings

1. The Hawaiian Homes Commission fails to meet its fiduciary obligations through its inattention to loan risk guidance.
2. The department's lax management of lessee loans undermines its ability to serve all its beneficiaries.

Commission Fails to Meet Its Fiduciary Obligations Through Its Inattention to Loan Risk Guidance

The State Constitution and the HHCA entrust the State with trust obligations relating to the management of Hawaiian home lands. The purpose of the act is to enable native Hawaiians to return to the land to support their self-sufficiency and self-determination and preserve their values, traditions, and culture. This includes placing native Hawaiians on homestead lands in a prompt and efficient manner, assuring long-term tenancy to beneficiaries and their successors, and providing financial support and technical assistance to native Hawaiian beneficiaries. However, the commission may not fully understand its fiduciary obligation to mitigate risks resulting from its loan operations and to administer the act impartially for all beneficiaries. Commissioner responsibilities are not clearly defined and commissioners lack data and analyses of loan obligations. As of June 2012 department loan obligations totaled more than \$588 million—of which \$83 million is delinquent and could pose a solvency risk to departmental finances.

The commission may not understand its role as fiduciary

We found that the commission, as a whole, may not fully understand its role as fiduciary and that individual commissioners are ill-prepared to perform their duties. The roles and responsibilities of the commission are not clearly defined and the commission lacks tools to aid in prudent trust administration. Consequently, the commission has not asserted its authority to set loan program risk policies for the department. Lacking guidance, the commission has been unable to ensure the act is administered on behalf of all beneficiaries of the trust, having instead favored those who hold leases. The commission also has assumed loan liabilities without recognizing and mitigating loan risks. Ultimately, the commission falls short of fulfilling its fiduciary duty to exercise “such care and skill as a person of ordinary prudence would exercise in dealing with one’s own property in the management of Hawaiian home lands,” as is required by state law and the department’s administrative rules.

The commission is unsure of its responsibilities

As the executive board of the department, the commission is the fiduciary for the ceded lands placed in the public trust established by the HHCA. The act does not explicitly specify the commission’s fiduciary duties. However, the State’s *Uniform Prudent Investor Act*, Chapter 554C, Hawai‘i Revised Statutes (HRS), provides that impartiality is one of those fundamental duties. This duty requires that when two or more beneficiaries exist, a trustee must act impartially in investing and managing the trust, after taking into account differing beneficiary interests. Moreover, when exercising trust powers, a trustee—in this case, each commissioner—is required to apply the *prudent person rule*. Chapter 554A, HRS, the *Uniform Trustees’ Powers Act*, defines

a *prudent person* as one who, in exercising trust powers, is reasonable and equitable in the view of the interests of the beneficiaries and acts with the same diligence, discretion, and judgment as would be expected in managing the trustee's own affairs. This duty is further embedded in the department's administrative rules, which require commissioners to exercise such care and skill as a person of ordinary prudence would in managing their own property.

We found that the commission struggles with its duties of impartiality and prudence. According to the chair, some commissioners feel it is their responsibility to serve as watchdog over the department and advocate for beneficiary lessees. Once the commission puts a lessee on the land, the chair said, it is reluctant to make a delinquent lessee homeless by terminating a lease. The chair added that the commission is more concerned with keeping lessees on the land than with collecting delinquencies. A failure to collect delinquencies or cancel accompanying leases runs counter to the trustee duty of impartiality by elevating an individual delinquent lessee's interest above other beneficiaries. Commissioners have also made decisions without considering the impact on all beneficiaries, thus calling into question the prudence of such decisions. Beneficiaries of the HHCA include: 1) about 9,900 homestead lessees; 2) nearly 26,200 applicants are seeking leases; and 3) an unknown number of people who have yet to apply for a lease.

We also found that neither state law nor administrative rules adequately clarifies how the commission is to fulfill its responsibilities regarding the Hawaiian Home Lands Trust. Although the HHCA establishes the commission as the head of the department, the act neither defines the commission's role nor delineates its authority and oversight responsibility; the department's administrative rules and functional statements also are silent on this issue. The act and rules provide broadly that commissioners are bound by fundamental fiduciary duties, which include administering the trust prudently and in the interest of all beneficiaries; protecting the trust; and adhering to trust terms. Under administrative rules, department policies, and best practices, the commission and its chairman have broad responsibilities that require exercising judgment or discretion when establishing policies to guide departmental programs and activities, as well as when ratifying loans; cancelling leases; and adjudicating contested cases.

This vague and general statement of the commission's responsibilities contrasts with the explicit powers and responsibilities provided to other state boards and commissions. For example, the Board of Trustees of the Office of Hawaiian Affairs (OHA)—another set of trustees that serves Hawaiian beneficiaries—has specifically articulated statutory powers to contract; provide grants and other types of financial assistance; and collect, receive, deposit, withdraw, and invest money and property on

behalf of the office. The OHA board is also empowered to manage, invest, and administer land trust funds, exercise control of property transferred to OHA, and perform its statutory duties, including developing and updating a strategic plan; developing and reviewing models for comprehensive native Hawaiian and Hawaiian programs; and applying for, accepting, and administering federal funds allotted to native Hawaiians and Hawaiians.

According to Cyril O. Houle's *Governing Boards* published by the National Center for Nonprofit Boards, the best way for boards to achieve their goals is to define functions and relationships very clearly—and in writing—and to keep careful records of board decisions. A board should at least have bylaws, a statement of policies, board and committee minutes, and a board manual. By contrast, we found that the department has not compiled the Hawaiian Homes Commission's policy decisions; in fact, the department has provided few written documents to support and guide commissioners in setting policies and overseeing the department's programs and the trust. Commission members need more support and written guidance if they are to fulfill their role as an executive board and administer the trust properly. The commission's lack of written policies as also identified in our 1993 audit of the department.

The commission lacks strategic perspective on loan risk

Managing loan risk is a key function of the Hawaiian Homes Commission, yet we found the commission lacks strategic perspective on loan risk. According to best practices, those in governance roles should explicitly understand and consider risk appetite when defining and pursuing objectives, formulating strategy, and allocating resources. *Risk appetite* refers to the level of risk that is deemed acceptable in order to accomplish an organization's objectives. In this case, it means articulating how much potential liability for defaulted mortgages the commission allows the department to assume. Boards should also consider risk appetite when approving management actions, especially budgets and strategic plans. According to the U.S. Department of the Treasury's Office of the Comptroller of the Currency's *Loan Portfolio Management—Comptroller's Handbook*, boards must clearly communicate, among other things, the range of risk an organization is willing to assume in pursuing its objectives.

In addition to considering and articulating risk appetite as a method of mitigating risk generally, organizations also use policies and procedures to control risks related to individual loans. For example, a bank's first defense against excessive credit risk is its initial credit-granting process, consisting of sound underwriting standards, an efficient, balanced approval process, and a competent lending staff.

We found the commission has neither articulated nor even considered risk appetite in formulating loan risk policies for the department. The department's documented policies and procedures show, and our interviews confirm, that the commission lacks strategic perspective on loan risk by having neither articulated a risk appetite nor adopted loan underwriting or policies for analyzing direct, guaranteed, and insured loan obligations, or monitoring loans. Five commissioners whom we interviewed reported the commission has not discussed the potential effect its higher-risk loans of last resort will have on the department's loan losses, its allowance for loan losses, or the availability of money for future loans. Of ten past and present commissioners whom we interviewed, nine reported the commission did not look at risk management of its loan programs. All ten said they had not developed or documented an overall loan risk appetite for the department, and that they do not monitor statistical trends in the department's loan portfolio.

Nor is the identification of risk, risk management, or risk assessment part of the department's strategic planning process. There was no mention of risk, risk appetite, risk management, or risk tolerance in the department's strategic plans covering 2003 through 2017. In fact, we found the commission's role in the department's strategic planning process has been limited to giving approvals rather than setting strategy, goals, and objectives. Five commissioners reported that risk management is not considered in formulating the department's strategic goals, objectives, or performance measures. As a result, the commission has not exercised appropriate leadership and oversight of the department's loan programs. Instead, it has assumed loan liabilities without understanding the risk associated with the department's direct loans, or that higher loan losses put the amount of money available for future loans at risk.

Monitoring and analysis of loan risks are given short shrift

The department's delinquent loans are increasing in number and amount, posing a solvency risk for the department. However, the extent of delinquent loan risk is not reflected in department reports to the commission. The Homestead Services Division's Loan Services Branch does not provide sufficient monthly delinquent loan totals or other data to the commission and it has done no meaningful analysis of direct loan program profitability and other current and upcoming obligations. With little information on the department's more than \$588 million in direct loans, loan guarantees, and insurance obligations, the commission is unaware of the potential impact of its decision making and is unable to meet its fiduciary duty to mitigate loan risk exposure.

Incomplete and lacking context, loan delinquency reports do not support commission's fiduciary responsibilities

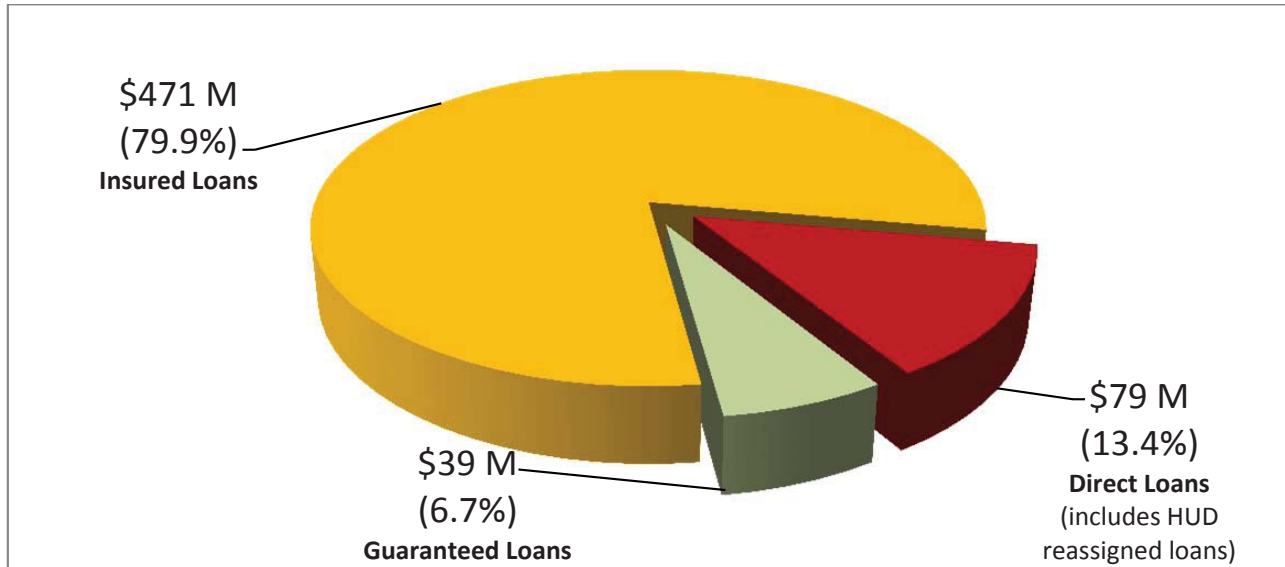
The department's residential lessee loans fall into three categories:

- *Direct loans*, which are approved, serviced and financed entirely by the department;
- *Guaranteed loans*, which are serviced and administered by other state, federal, and private organizations and are guaranteed for repayment by the department in the event of a default. In such cases the loan is assumed by the department, which is then directly responsible for collecting the delinquent amount; and
- *Insured loans*, which provide lenders with protection against losses, financed by borrower insurance premiums. Under the Federal Housing Administration (FHA) Section 247 insurance program, the department is liable for shortfalls in claims payments. The FHA loans assigned by the U.S. Department of Housing and Urban Development (HUD) fall under the direct loans category in DHHL's delinquency reports.

We found there are no guidelines for reporting on loan risk and delinquencies for any of the above loan types. As a result, commissioners do not receive enough information to gauge the scope of the department's loan risk.

As of June 2012, the combined outstanding amount for all 4,897 loans reported by the department was \$589 million. Insured loans constituted the largest single category of loans, accounting for 3,135 loans totaling \$471 million—almost 80 percent of the outstanding amount. Direct loans (including reassigned loans) totaled \$79 million, and guaranteed loans totaled \$39 million. Exhibit 2.1 illustrates the department's loan types by amount.

Exhibit 2.1
Loan Types by Amount, as of June 2012



Source: Department of Hawaiian Home Lands Delinquency Report

Direct loans were the focus of our testing because they pose the highest and most immediate financial risk to the department. During the last decade, total loans to lessees almost doubled, from \$309 million in FY2003 to almost \$590 million in FY2012. However, risk monitoring, particularly loan delinquency reporting, inadequately accounted for the increased risk exposure accompanying the rise in lending. In the limited instances where the commission assessed delinquency performance, it used sub-standard tools.

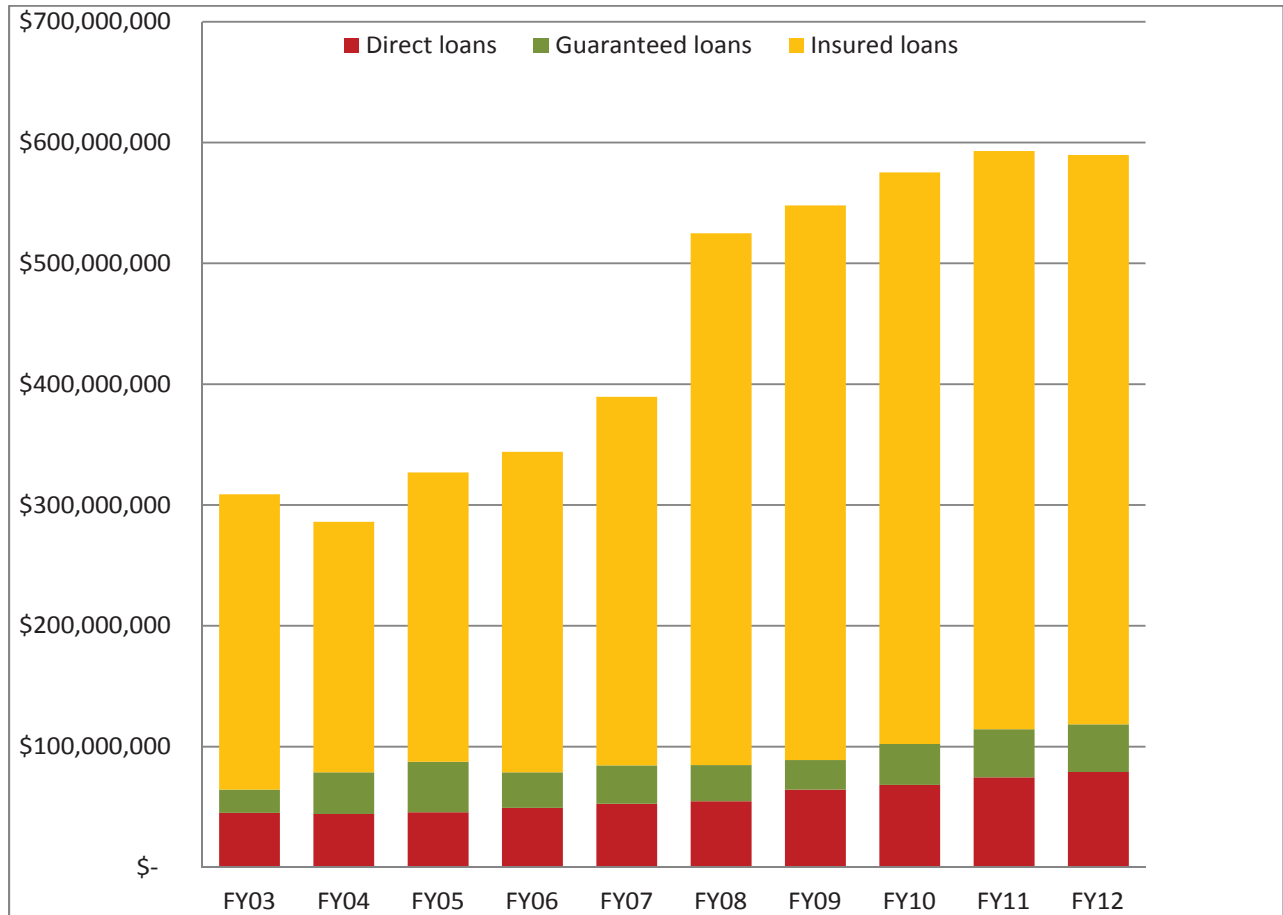
According to the federal Office of the Comptroller of the Currency, an agency that oversees national banks and federal savings associations, a lending institution's board needs concise, accurate, and timely reports if it is to make good decisions and perform its fiduciary duties. Directors should ensure that management provides timely and adequate financial and performance information, since ineffective, inaccurate, or incomplete information may lead to board decisions that increase risk. Contrary to this federal guidance, however, we found the department's main tool for tracking loans and delinquencies—the monthly delinquency report—does not report all delinquencies, lacks context, and does not include typical industry delinquency metrics. For example:

- **\$6.3 million in delinquencies not reported.** Delinquencies in June 2012 related to advances made to outside lenders and institutions, including those for property taxes, were not reported;

- **Departmental loan total not reported.** Although the department's portfolio of loans includes those it issued to lessees and those it received from HUD after lessees defaulted on loans, an overall department portfolio total is not included on the delinquency report;
- **No industry metrics included in reports.** There is no department report on cure rates, re-default rates, or summaries of loans restructured more than once, such as is found in industry reports; and
- **Delinquency rates not measured against established benchmarks.** The department and commission use past delinquency rates and a 13 percent delinquency rate goal to assess its delinquency performance, as opposed to measuring against established benchmarks. The department's loan portfolio is unique because it includes loans made as a lender of last resort, but a comparison with an external benchmark, such as Hawai'i subprime mortgage delinquency rates, would help commission members spot department delinquency trends that are significantly different than the rest of the market. A subprime loan is a loan with less stringent lending and underwriting terms and conditions that carries a higher risk.

Given such sparse departmental reporting, commissioners were not aware that the department's loan portfolio delinquency rate, which includes defaulted insured and guaranteed loans, was almost 32 percent at the end of FY2012. They also lacked the data to compare with local industry rates. Exhibit 2.2 shows the rise in the department's loan portfolio and accompanying liability over the past ten years.

Exhibit 2.2
Increase in Department’s Loan Portfolio, FY2003–FY2012



Source: Department of Hawaiian Home Lands’ annual reports and delinquency reports

We also found that the duration of delinquencies is not reported to the commission. It appears lessees can be chronically delinquent—sometimes for years—because they never fully pay off their delinquency.

An analysis of delinquencies provided by a Fiscal Office accountant noted:

- 145 accounts delinquent between one and five years;
- 56 accounts delinquent between five and ten years; and
- 57 accounts delinquent ten or more years; the longest delinquency was more than 22 years.

Loans that remain delinquent for an extended period of time should be brought to the commission’s attention by the Loan Services Branch and

Fiscal Office. Unless the commission receives more effective and timely reporting, it cannot understand the true position of the department's direct loan exposure and provide leadership by mitigating those risks through informed decision making.

Department does not analyze direct loan program costs

Despite direct loan delinquency rates increasing during the past four years, the department has done little to highlight the problem to the commission with individual reports on financial subjects. For example, commission members would have to dig through and compare the department's audited financial reports to learn of a nearly 50 percent increase in the department's loan loss allowance to \$15.1 million from FY2009 to FY2011, or that in FY2011 it reported that it may owe HUD \$23.7 million in future mortgage insurance claims. Managing risk prospectively involves understanding risk implications, and ensuring proper control and reporting systems are in place. Without more information, the commission does not have full insight into the department's loan risks and is unable to have informed discussions about loan issues.

At the time of our fieldwork, the department's deputy to the chair said there has been no detailed analysis done on the direct loan program regarding its profitability. The program requires significant department resources for reviewing loan applications, seeking manager and chair approvals, forwarding loans to the commission for ratification, drafting loan documents, monitoring delinquent loans, and seeking contested case hearings for problem loans. The fiscal management officer told us he believes the program is profitable. However, he added that providing native Hawaiians an opportunity at home ownership is an obligation the department must fulfill, even if the program operates at a loss. The fiscal management officer admitted no detailed analysis has been performed to determine whether the program is profitable, operates at a loss, or breaks even. Without an analysis that takes into account all of the loan program's costs, the commission and department do not know whether the program is adding to or eroding the trust's finances.

Little analysis of loan exposure takes place at commission level

The department's exposure for loan risks extends to its guaranteed and insured loans. The department maintains lending agreements with outside lenders that result in varying levels of department obligation, which are necessary because outside lenders cannot foreclose on Hawaiian home lands. During our fieldwork we could not find detailed analyses of the department's mounting loan risk exposure and delinquency issues; these issues were rarely if ever elevated to the commission level. For example, from FY2009 to FY2011, the total amount of loans at least 30 days delinquent more than doubled,

from \$35.2 million to \$72 million and rose by another \$11.1 million in FY2012. However, in our review of commission meeting minutes, we found no evidence of the review of this significant increase in delinquencies. Exhibit 2.3 provides a breakdown of delinquencies by loan program type. Among the reports that directors of lending institutions should receive are summaries of loans more than 120 days past due, problem loans, and trends in risk ratings.

**Exhibit 2.3
Loan Delinquencies by Type and Amount, FY2012**

Loan category	Number of loans			Amount of loans		
	Total	Delinquent at least 30 days		Total	Delinquent at least 30 days	
Department loans (includes direct and HUD reassigned)	1,170	277	23.7%	\$79,042,000	\$24,645,000	31.2%
Guaranteed loans	592	64	10.8%	\$39,346,000	\$4,075,000	10.4%
Insured loans	3,135	383	12.2%	\$470,514,000	\$54,252,000	11.5%
Total	4,897	724	14.8%	\$588,902,000	\$82,972,000	14.1%

Source: Department of Hawaiian Home Lands, June 2012 Delinquency Report

According to the U.S. Government Accountability Office (GAO), managers have a responsibility to use resources in an effective and efficient manner and to provide appropriate reports to those who oversee their actions. Per GAO standards, internal controls that are an integral component of an organization’s management provide reasonable assurance of the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Internal control is a major part of managing an organization. It comprises the plans, methods, and procedures used to meet mission, goals, and objectives. Controls serve as the first line of defense in safeguarding assets and preventing and detecting errors and fraud, and help government program managers achieve desired results through effective stewardship of public resources. There are five standards for internal control: control environment; risk assessment; control activities; information and communications; and monitoring. In implementing these standards, management is responsible for developing detailed policies, procedures, and practices to fit their agency’s operations and ensure they are an integral part of operations. Internal controls should be designed to assure that ongoing monitoring occurs in the course of normal operations, is performed continually, and is ingrained in an agency’s operations.

We asked the department what would happen under a worst-case scenario in which \$45.7 million of delinquent FHA loans are assigned back to the department in the next year. The department said it would not have

enough in reserves to pay off this amount and would have to access \$26.2 million from the Hawaiian Home Land Trust Fund—the fund through which the department receives \$30 million in annual claims payments from the State and which it uses for home and infrastructure development. The \$30 million annual payment is scheduled to end in FY2015, according to the department’s administrative services officer.

Our review of commission meeting agendas and minutes for meetings from January 2009 through December 2011 showed there were no substantive reports regarding the risk posed by loan delinquencies and that these issues were not communicated to the commission. We also did not find detailed discussions on delinquent loan assignments. We note, however, that the chair lists loan risks and delinquencies as a top priority and the deputy at the time of our fieldwork was planning to conduct commission workshops discussing loan issues.

Concerns about the department’s growing risk exposure were noted by a Hawaiian Homes Commission chair as early as 2001 in a consultant’s report, which observed risk exposure was growing and could result in a cash-flow problem should the department have to pay for defaults. A 2001 department letter to HUD within that report said the department must maintain reserves to pay for potential HUD claims and then seek to re-award the lease to recover its moneys. The department’s funds are therefore tied up in two ways: first, while the property is held in reserve; and second, while re-award of funds are sought. The length of time in re-awarding leases or allowing delinquent lessees to remain on a property was mentioned by several department staff as potentially posing a financial problem.

Department’s Lax Management of Lessee Loans Undermines Accountability to Beneficiaries As a Whole

The department has vague policies and few standards governing its direct loans, including loans it underwrites directly as well as insured and guaranteed loans that have been reassigned to the department for delinquent collection. Neither the department’s loan issuance nor its collection efforts take into account the high-risk nature of these loans. The department also has weak internal controls governing loan collections and monitoring compliance with commission orders, and does not coordinate the oversight of either, resulting in a lack of accountability for chronically delinquent lessees.

The department has not brought the severity of these delinquency issues to the attention of the commission. The commission, in turn—which lacks data on the magnitude of delinquency issues—has inappropriately applied its discretion by not canceling leases of chronically or seriously delinquent homesteaders. By not canceling such leases, the commission is providing long-term tenancy to beneficiaries but is undermining other

goals of the HHCA, such as providing for self-sufficiency and placing native Hawaiians on the land in a prompt and efficient manner.

Vague policies and procedures result in a lenient, discretionary approach to loan issuance

The Loan Services Branch's loan policies and procedures are vague. In contrast to best practices, loan specialists have few strict criteria when determining whether the department should issue a direct loan, which is by nature the highest risk to the department since it poses the most immediate financial risk should the borrower fail to pay. Consequently, loan specialists have broad discretion when conducting their analysis and may be recommending loan approval for financially incapable lessees.

The department's lack of leadership appears to contribute to this problem. The department and commission have not reassessed loan interest rates since 1995. In addition, an estimate used to calculate household expenses for determining loan eligibility has not been updated in a decade, meaning the branch may be underestimating the cost of living and miscalculating lessees' ability to pay off loans. As a result, the department may be making loans to borrowers who cannot afford to make their payments.

Problems go beyond a lack of clear guidance from management. Loan specialists do not always follow the branch's few existing rules, guidelines, and procedures concerning direct loan applications, income analysis, credit standing analysis, and filing of documents. Also, the branch does not follow administrative rules governing the submission of applicants' financial data to the commission for review, ratification, and approval. Finally, loan specialists frequently fail to flag loans that do not meet the department's residual income or other credit requirements, which means the commission may not have adequate information with which to assess loan risk before approval.

Few formal, written policies and procedures guide branch loan specialists when qualifying loan applicants

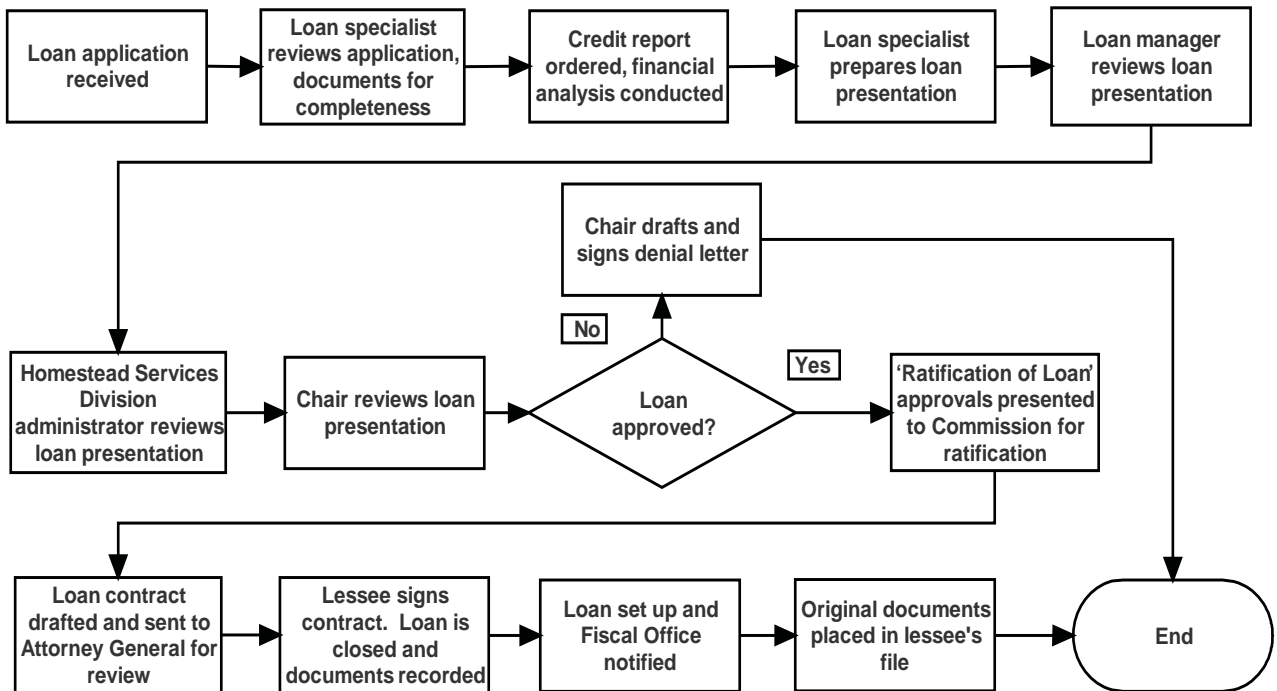
The department provides lessees with direct loans, which are by their nature higher risk than insured or guaranteed loans. Procedures for assessing whether to recommend a direct loan for approval are outlined in the department's Loans Policies and Procedures Manual, and are meant to determine whether an applicant will be able to repay a loan.

The loans manual, however, lacks detail and direction to guide loan specialists in determining whether an applicant can repay a loan. Although loan specialists must determine whether an applicant's income and credit are *satisfactory*, the manual does not define the term and loan specialists are left to determine this for themselves. Furthermore, administrative rules require that applicants have *satisfactory credit*

standing in the community, yet the branch’s loans manual does not define what this means either. As vague as these rules are, we found that loan specialists often use their own judgement.

When processing a loan, loan specialists review packets for completeness; obtain applicants’ credit reports; and review applicants’ income, and employment history. If applicants’ income and credit are satisfactory, loan specialists prepare a loan presentation for review by the branch manager and Homestead Services Division administrator and approval by the commission chair. If the chair approves a loan presentation, it is forwarded to the commission for ratification. Exhibit 2.4 illustrates the direct loan process.

Exhibit 2.4
Direct Loan Process



- HSD - Homestead Services Division
- LSB - Loan Services Branch
- HHC - Hawaiian Homes Commission
- DHHL - Department of Hawaiian Home Lands
- E Team - Enforcement Team
- CCH - Contested Case Hearing

Note: This is the process as detailed in the department’s Loan Policies and Procedures manual that was in effect during our test period.

Source: Office of the Auditor

Contrary to administrative rules, we found the commission ratifies loans without required information. Rules require applications be submitted to the commission with a summary of an applicant's financial qualifications, including gross and net monthly income, outstanding indebtedness, and number of dependents. However, our testing of loan application documents from FY2009 to FY2011 revealed no indications that loan specialists consistently prepared this information for commission review. In fact, none of the 16 applications we reviewed were submitted to the commission with a summary, making it unclear how the commission was able to make a determination. Without a summary, the commission lacks key information necessary to analyze loan requests, which impacts its ability to recognize and mitigate loan risk.

According to GAO internal control standards, management should set a tone that provides adequate discipline and structure. Loan specialists consistently told us they believe their principal mission is to help beneficiaries obtain mortgage loans, even as the specialists said they sought to protect the trust's assets. One specialist said, "When I first came here, I denied everything and got scolded."

Branch's loose adherence to rules, policies, and procedures results in loan awards to financially incapable lessees

We reviewed 16 direct loans issued between FY2009 and FY2011 and found that files were frequently missing required documents even though they are kept in a secure file room. The branch's loose adherence or inability to follow its rules, policies, and procedures exposes the department to potentially greater risks resulting from providing loans to financially incapable lessees.

For example, two of the 16 files we reviewed were missing loan applications. In one case, there was no evidence the commission had ever approved the loan. Half the files we reviewed (eight of 16) were missing key loan application documents, such as tax returns or proof of employment. Three were missing a required analysis of the applicant's financial ability and credit standing, and two were missing the original loan agreements, which were later located in the loan specialist's cubicle.

These oversights appear to be caused by weak internal controls. One specialist said he keeps files in his office because there is only one clerk in the secure file room, which makes accessing files inconvenient. After we noted that the documents from a 2009 loan were not in the secured filing area, a specialist later found them in a different location and commented, "I know it's been years, but out of sight, out of mind." This approach toward safe-guarding loan documents exemplifies deficient internal controls.

Branch applies outdated estimates and rates when qualifying potential borrowers

Best practices call for separate evaluations of the effectiveness of internal controls with the scope and frequency of evaluations determined by an assessment of risks. However, we found the Homestead Services Division and its Loan Services Branch rarely reassess their policies. For example, household expense estimates established ten years ago are now out of date. Additionally, the department has not reassessed its 6 percent loan interest rate since 1995.

The branch also does not follow best practices when documenting results produced by its outdated income analysis formula. According to GAO internal control standards, all transactions and significant events should be clearly documented. We found that in seven of 16 cases we reviewed, applicants failed to meet the 15 percent reserve standard; yet in six of those seven cases, loan specialists did not record the failure. The standard, which is not part of a written policy, is based on net monthly income minus monthly household expenses, existing debt payments, and prospective monthly loan payments. Remaining income is considered residual (or reserve) income. The standard requires a reserve of at least 15 percent of net monthly income; otherwise, loan specialists attempt to find compensating factors. Yet, in those six cases, loan specialists listed the applicants as qualified. In effect, the loan specialists failed to alert the Loan Services Branch manager, Homestead Services Division acting administrator, commission chair—and ultimately the commission as a whole—of the higher risk assumed in issuing these loans.

The branch could improve identifying and managing loan risk by following the best practices of Community Development Financial Institutions (CDFIs). These institutions provide loans and financial services to underserved communities, such as native Americans and native Hawaiians. A best practice cited by the U.S. Treasury Department calls for using a maximum housing expense ratio and total debt ratio to determine whether to award a loan. Potential borrowers may be required to undergo personal finance education or attend credit counseling programs. In addition, CDFI loan specialists should rate loans according to risk. Loan Services Branch workers told us they do not follow these practices.

Chronically delinquent accounts tie up resources to the detriment of beneficiaries as a whole

We found that the Homestead Services Division lacks a system for coordinated oversight of chronic and serious loan delinquencies. Loan collection policies and procedures are vague and responsibilities are unclear. One office responsible for collections—the division’s East Hawai‘i District Office (EHDO)—neither supervises nor performs its responsibilities for delinquent loans. In addition, misleading departmental reporting of delinquent loans conceals the actual duration and severity of delinquencies. For example, one loan classified as more than 120 days delinquent had not been current in more than 16 years.

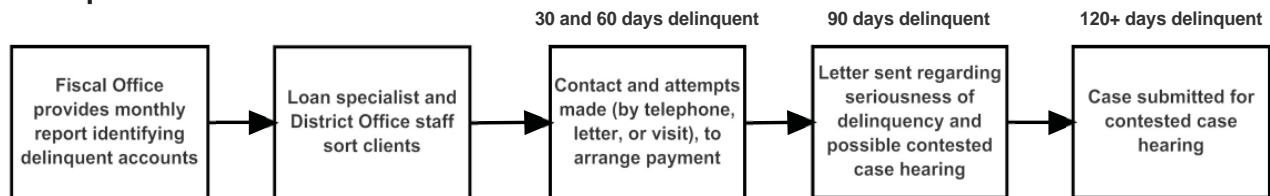
Loan repayments are supposed to be timely so that funds can be used to make more loans. Loans that are not repaid reduce the amount of funds available to other native Hawaiians and the department.

Misleading departmental reporting conceals actual duration and severity of delinquencies

Loan delinquencies are monitored monthly on a spreadsheet generated by the department’s Fiscal Office that classifies loans as 30, 60, 90, or 120 days or more past due. We found these categories do not indicate the number of *days* a loan is past due; rather, they indicate the number of *payment installments* missed. For example, a *30-day delinquency* means that one installment is overdue; a *60-day delinquency* means that two payments are overdue.

For each category, the Loan Services Branch and the East Hawai‘i District Office are supposed to contact delinquent lessees, seek payment, and notify them of possible departmental action if their delinquency is not resolved. Follow-up actions depend on the category of delinquency. For example, at 120-days past due, loan personnel can request the commission schedule a contested case hearing, which is the department’s administrative process for resolving lessee issues. Rules give the commission discretion to initiate proceedings and set matters for hearing. Exhibit 2.5 summarizes the delinquent loan collection process.

**Exhibit 2.5
Delinquent Loan Collection Process**



Source: Office of the Auditor based on Department of Hawaiian Home Lands information

The Fiscal Office accountant, who compiles the delinquency report, agreed that the metric can be misinterpreted that the lessee in the *30-day* category is only one month late, when in actuality the lessee may have been one payment behind for ten years.

We reviewed collection activities for 40 loans that were delinquent as of May 2012 and found that delinquencies are generally older than the department’s categories indicate. For example, one loan categorized as *30-days delinquent* was last current more than three years ago. A loan categorized as *60-days delinquent* was last current in 2005. A *90-day delinquency* was last current in 2008; and one *120-day delinquency* was last current in 1995. Exhibit 2.6 shows the number of days and years since the loans in our sample were last current (as of May 19, 2012) compared with the department’s categorization of those loans.

Exhibit 2.6
Duration of Delinquencies, as of May 2012

Item	Department’s delinquency category	Date loan was last current*	Number of days past due as of testing	Number of years past due as of testing (rounded)
1	30 days	03/19/12	61	0.2
2	30 days	01/19/12	121	0.3
3	30 days	12/19/11	152	0.4
4	30 days	11/19/11	182	0.5
5	30 days	11/19/11	182	0.5
6	30 days	10/19/11	213	0.6
7	30 days	09/19/11	243	0.7
8	30 days	03/19/11	427	1.2
9	30 days	06/19/10	700	1.9
10	30 days	04/19/09	1,126	3.1
11	60 days	03/19/12	61	0.2
12	60 days	06/19/10	700	1.9
13	60 days	06/19/10	700	1.9
14	60 days	05/19/10	731	2.0
15	60 days	12/19/09	882	2.4
16	60 days	11/19/09	912	2.5
17	60 days	10/19/09	943	2.6
18	60 days	06/19/09	1,065	2.9
19	60 days	09/19/08	1,338	3.7
20	60 days	06/19/05	2,526	6.9
21	90 days	01/19/12	121	0.3
22	90 days	08/19/11	274	0.8
23	90 days	06/19/11	335	0.9
24	90 days	03/19/11	427	1.2
25	90 days	03/19/11	427	1.2
26	90 days	09/19/10	608	1.7
27	90 days	06/19/10	700	1.9
28	90 days	06/19/09	1,065	2.9
29	90 days	02/19/09	1,185	3.3
30	90 days	12/19/08	1,247	3.4

Item	Department's delinquency category	Date loan was last current*	Number of days past due as of testing	Number of years past due as of testing (rounded)
31	120+ days	07/19/11	305	0.8
32	120+ days	06/19/11	335	0.9
33	120+ days	11/19/09	912	2.5
34	120+ days	08/19/09	1,004	2.8
35	120+ days	05/19/08*	1,371**	3.8*
36	120+ days	06/19/08	1,430	3.9
37	120+ days	12/19/07	1,613	4.4
38	120+ days	10/19/06	2,039	5.6
39	120+ days	08/19/06	2,100	5.8
40	120+ days	10/19/95	6,057	16.6

* Monthly payments are due on the 19th of each month.

**The ledger for this loan did not include transaction history after February 29, 2012. This calculation is therefore based on February 19, 2012 instead of May 19, 2012.

Source: Office of the Auditor analysis of Department of Hawaiian Home Lands data

Exhibit 2.7 shows the total past due balance by delinquency category for the period ending May 19, 2012.

**Exhibit 2.7
Past Due Balances by Delinquency Category, as of May 2012**

Delinquency category	Delinquent amount
30 Days	\$5,413.70
60 Days	\$8,566.10
90 Days	\$13,372.90
120 Days	\$106,725.79*
Total	\$134,078.49

*One loan did not include transaction history after February 29, 2012. Although the lease related to the loan was cancelled, the department could not provide the current status of the loan. The outstanding balance remains and is included in our calculations.

Source: Office of the Auditor analysis of Department of Hawaiian Home Lands' data

The Fiscal Office accountant told us that the department's computer system was not designed to handle a loan collection function. The Loan Services Branch uses the Fiscal Office's report to compile a monthly delinquency report, which it presents to the commission. The commission chair likewise acknowledged that the department's way of reporting delinquencies does not give the commission an accurate picture of the duration and severity of delinquencies.

Best practices state that the early detection of and intervention in delinquent and problem loans help in resolving delinquencies by allowing borrowers and agencies to arrange acceptable methods to bring loans up to date. Additionally, efforts should be made to prevent loans from becoming even 30 days past due. The commission chair acknowledged that the department needs to reduce the total amount of delinquencies and address delinquencies earlier.

Loan Services Branch loan personnel acknowledged the number and problems associated with chronic delinquencies; however, said they felt powerless to cancel leases. According to the Homestead Services Division acting administrator, actions taken by loan personnel have “no teeth” because only the commission can take official action. Although loans we reviewed provided for cancellation of leases or for accelerated payment, some lessees pay just enough to keep from becoming 120 days past due, thereby avoiding a contested case hearing. The Homestead Services Division acting administrator admitted that some lessees take advantage of the system because they know loan personnel have no power to cancel leases.

At one time, the department’s loan policies and procedures recognized that the longer an account remains past due, the less likely payments will be recovered. According to the acting administrator, this guidance still applies, but it is no longer in the department’s loans manual. Department agreements with outside lenders for other loan programs calculate the time of delinquency from the due date of the missed payment. For example, in an agreement with First Hawaiian Bank, the bank defines delinquency as occurring on the first day following the 30th complete day the loan is past due. The department should adopt a definition of delinquency that provides a standard for addressing delinquencies in a timelier manner.

Vague management instructions and lax oversight of delinquent loans benefit chronically delinquent homesteaders

Division statewide collection efforts are centralized at the Loan Services Branch on O’ahu, except for the East Hawai’i District Office (EDHO), which performs its own collections because of the area’s historically high delinquency rate, according to department personnel. However, the EDHO supervisor position (in Hilo) was abolished in 2009 and the acting administrator (on O’ahu) does not oversee EDHO’s collection efforts. Instead, the EDHO’s loan collection specialist reports directly to the District Office supervisor (in Hilo), who acknowledged that he, too, does not supervise the collection activities. This leaves EDHO, which accounts for 45 percent of the department’s delinquent direct loans, with unsupervised collection activities. Indeed, 16 of the 40 delinquent loans we reviewed (40 percent) were the responsibility of this office.

All 16 of the EDHO loans we reviewed lacked current documentation on collection efforts and account status. According to department procedures, collection activities are to be recorded on a *collection card* on the department's computer system. There were no collection cards for two of EDHO's loans. The EDHO loan collection assistant told us her lack of documentation did not mean she is contacting lessees but not recording it; she said she is simply not making any contacts. For one loan, the last documented collection activity was in March 2007. Although payments of varying amounts were made on that loan in 2012, there was a past due balance of more than \$2,600 as of June 19, 2012. The collection EDHO loan specialist said that the loan is still delinquent, yet she has not submitted it for a contested case hearing; she also admitted that her loans are "out of control."

Furthermore, the East Hawai'i District Office is short-staffed. Of seven positions, only two are filled (a delinquent loan collection assistant and a general laborer), as well as a temporary supervisor. The permanent supervisor position was abolished in 2009, but was scheduled to be restored in FY2013. Both the temporary supervisor and the collection assistant said that due to the staff shortage they are performing other duties. The collection assistant said she has had no time for loan collection efforts.

According to the U.S. Comptroller of the Currency, managing problem loans is time-consuming and requires special knowledge. Additionally, the comptroller states that an important part of the collection process is to review and understand how problem loans develop. The collection assistant said she would welcome a monthly review of her delinquencies by the Loans Services Branch manager.

For 24 of the 40 loans we reviewed, lessee files and collection cards did not provide the current status of the loans or whether lessees are making efforts to pay past amounts due; nor are the cards uniformly maintained. For example, the last documented collection activity on one loan was July 13, 2010. By not recording all collection activity on collection cards, the division risks not having documented evidence for contested case hearings and other legal proceedings. In addition, recording all collection activity would provide others handling the account with a detailed history. One loan specialist said that once a *Decision and Order* is issued, loan specialists no longer contact lessees. He said that the Enforcement Team (E Team) is supposed to monitor and follow-up on that account. According to the acting administrator, the E Team has access to collection cards on the computer system and should be noting collection efforts.

Best practices for collections state that all communications with a borrower should be documented in writing. Furthermore, according

to the GAO's standards for internal control, proper documentation of events and transactions are integral to an agency's accountability for the stewardship of government resources. Best practices also say that when working with a delinquent borrower, collections personnel should determine why a borrower is late; when the borrower is going to pay; how the borrower will pay; and how the borrower intends to stay current.

Contrary to best practices, the department's current loans manual has only vague instructions on dealing with delinquencies. The department's prior loans manual provided more detailed guidance on planning a collection approach, such as documents to review and factors to consider. In addition, the prior manual gave follow-up actions for chronic and serious delinquents. When asked why the current manual only gives general instructions, the acting administrator said the manual now gives loan specialists flexibility to perform their collection duties. He added that due to limited time and staff and increasing workloads, loan specialists are not able to perform the former processes and procedures as written.

The chair said that the kinds of loans the department makes are inherently higher risk. Knowing this, the department should have stronger, more specific instructions on delinquent direct loan collections to ensure it collects amounts past due.

Failure to monitor commission's orders benefits delinquent lessees

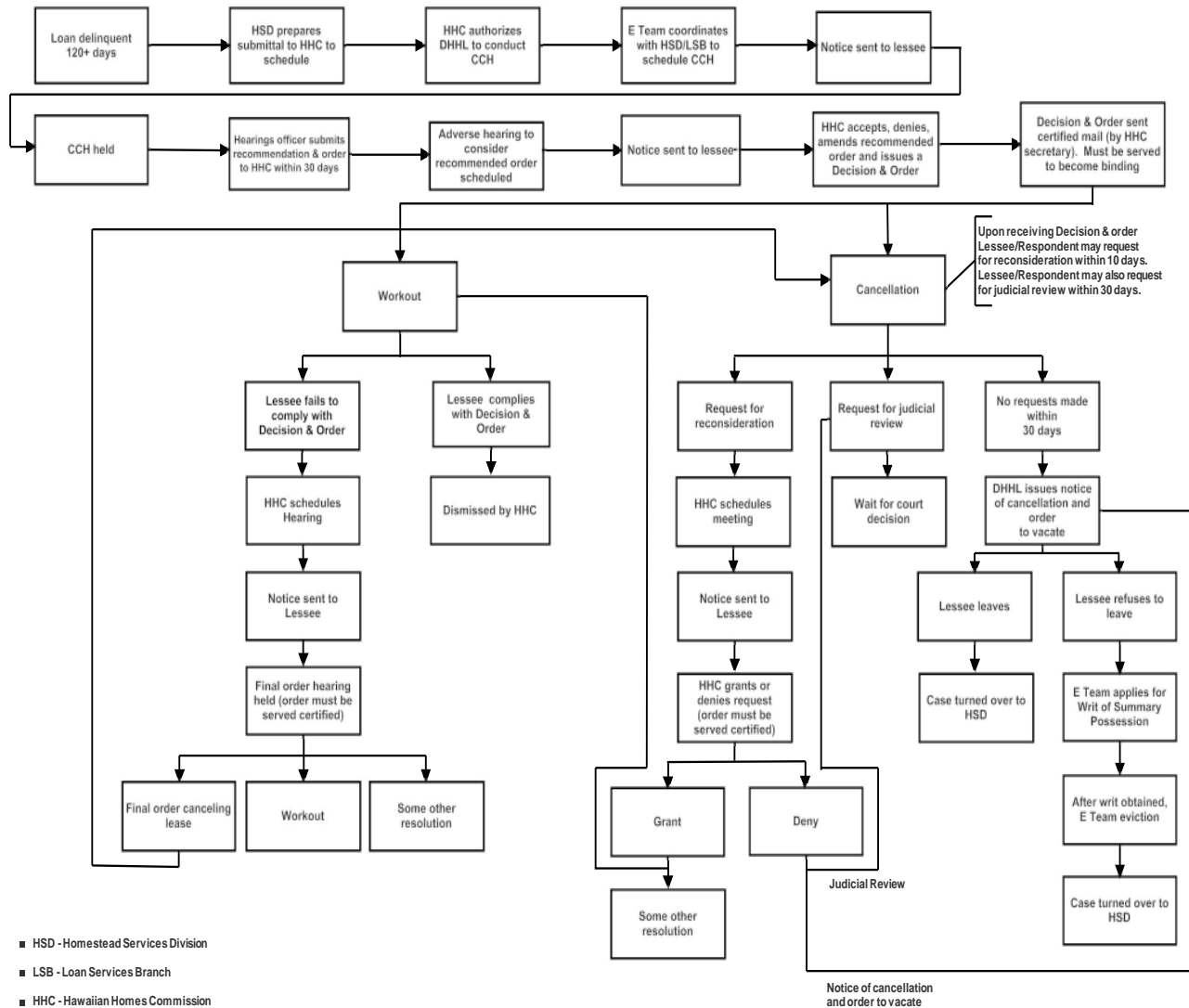
The department lacks a tracking system to monitor contested cases and therefore is not monitoring delinquent lessees' compliance with the commission's orders. Furthermore, there are no policies and procedures for monitoring compliance. As a result, the department cannot assure compliance with commission orders. Our review of 25 contested case files and account ledgers identified 21 lessees who were not in compliance with commission orders; however, only seven had their leases cancelled. The remaining delinquent lessees were allowed to keep their leases and remain on the land, to the detriment of beneficiaries as a whole.

Lessees are afforded the opportunity for *workouts* prior to lease cancellation, a process that can last years

Administrative rules provide that homestead leases may not be cancelled without first affording lessees the right to a hearing. Once a loan becomes 120 days past due, the Loan Services Branch may request the commission schedule a contested case hearing. Hearings afford borrowers an opportunity to protect their interests in their leases. Settlements are allowed, and encouraged, at any time before or during contested case hearings. After a hearing is held, the commission accepts, denies, or amends the hearings officer's recommendations, and issues an

official order. Exhibit 2.8 illustrates the contested case hearing process. The term *workout* is used when the commission issues an order that includes a payment plan.

Exhibit 2.8
Contested Case Hearing Process for Delinquent Loans



- HSD - Homestead Services Division
- LSB - Loan Services Branch
- HHC - Hawaiian Homes Commission
- DHHL - Department of Hawaiian Home Lands
- E Team - Enforcement Team
- CCH - Contested Case Hearing

Source: Department of Hawaiian Home Lands, Enforcement Team; and Office of the Auditor

Upon approval by the commission, the E Team coordinates with the Loan Services Branch to schedule a hearing. The E Team contacts a hearings officer, sends out notices to lessees, and prepares a docket for the hearing consisting of the mortgage note, lease agreement, and collection card.

The hearing is held either before a hearings officer or the commission and on the island where the lessee resides. After the hearing, the hearings officer makes a recommendation to the commission, which accepts, denies, or amends it and issues an order, or the commission issues its own order. After the order is signed by the chair, it is served on the lessee and copies are given to the E Team and the Loan Services Branch.

Upon receiving the order, the lessee has ten days to request reconsideration. Should the commission grant such a request, according to the contested case hearing flowchart, the lessee will go back to another workout.

We found that the commission is reluctant to cancel leases. In fact, staff told us the commission rarely cancels leases, and that 85 to 95 percent of contested cases result in an order with a workout plan. Moreover, the hearing and workout process can last years. For example, in one case, the hearing was held in February 2008, but as of October 2012, the case remained unresolved, as shown by this timetable of events:

<u>Date</u>	<u>Event</u>
February 2008	Contested case hearing held
June 2008	Commission Decision and Order, including workout plan
March 2009	Commission amended Decision and Order, including workout plan
October 2011	Lessee notified of default
March 2012	Commission Decision and Order to cancel lease
April 2012	Lessee requested reconsideration
September 2012	Commission accepted request for reconsideration, but again decided to cancel lease
September 2012	Lessee requested another reconsideration
October 2012	Case remains unresolved

In another example, a contested case was originally heard in February 2010 but had yet to be resolved as of October 2012:

<u>Date</u>	<u>Event</u>
February 2010	Contested case hearing held
September 2010	Commission Decision and Order to cancel lease
October 2010	Lessee requested reconsideration
February 2011	Commission amended Decision and Order, including workout plan

<u>Date</u>	<u>Event</u>
June 2012	Sent notice of default for failure to comply with workout plan
September 2012	Commission decided to cancel lease
October 2012	Decision and Order has yet to be prepared; case remains unresolved

Both the department’s administrative rules and its loans manual include the contested case hearing process, but neither contains procedures to monitor and enforce the commission’s orders. We noted that for calendar years 2009–2011, approximately 300 contested case hearings were scheduled, including those relating to other types of lease violations.

No one at the department takes responsibility for monitoring compliance with commission’s orders

We found that no one takes responsibility for monitoring compliance with the commission’s orders—in fact, department staff are unclear as to who is responsible for this function. The loans manual’s contested case hearing procedures state that the E Team is responsible for monitoring orders. The Homestead Services Division acting administrator concurred that monitoring orders is the E Team’s responsibility. Members of the E Team, however, asserted that the Loan Services Branch is responsible for monitoring compliance with orders because branch loan officers know the lessees better. The chair believes that both the E Team and the Homestead Services Division are responsible for monitoring those orders. The net result of these conflicting views, as confirmed by the acting administrator, is that no one is monitoring compliance with the commission’s orders, reflecting another serious lapse in internal controls.

According to GAO standards, internal controls are an integral component of an organization’s management that provide reasonable assurance of the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Internal controls should be designed to assure that ongoing monitoring occurs in the course of normal operations, is performed continually, and is ingrained in an agency’s operations. By not tracking compliance with commission orders, the Homestead Services Division, E Team, and commission chair are not aware of and therefore cannot bring loan delinquency issues to the attention of the commission. Without policies and procedures outlining staff responsibilities and how they should carry out their monitoring function, the department and the commission do not know whether lessees are in compliance with commission orders nor the rate of that compliance.

We also found that the department does not maintain a complete docket of contested cases. The acting administrator keeps a list of contested

cases. After each commission meeting, the acting administrator adds the names of lessees who were approved for scheduling of contested case hearings. The acting administrator also tracks when hearings are held; however, the acting administrator's list is incomplete as it does not track lessees' compliance with commission's orders. Also, the acting administrator's list is not current. Likewise, E Team members told us they keep track of all contested cases scheduled for hearing on a calendar and a white board, but they do not track orders relating to loan delinquencies. The only way to determine the status of a contested case, they told us, is to look through its case file.

The acting administrator told us the division started to build a database in 2010 to track delinquent loan contested cases. However, the employee who created the system is no longer with the department and the system is not accessible by the division. Department information technology staff recommended that the division create a new database.

In the past, a former employee manually prepared a report of contested case hearings for the commission's monthly meetings. The report contained cases approved to be heard; cases scheduled for hearing; the status of compliance with orders for cases already heard; and cases set for final decisions and lease cancellations. The acting administrator said the branch used this report to track contested cases. However, this report has not been prepared since August 2011, nor has the commission requested it. The acting administrator knows the report needs to be resurrected and revamped, but said the process is on hold until the chair provides direction on how to proceed.

Lack of enforcement of commission orders enables non-compliant lessees to remain on the land

Many lessees are not complying with the terms and conditions of their orders. Some have missed monthly payments, paid less than the amount required, or have no proof of homeowner's insurance policies on file. For example, of the 25 leases we reviewed, we found that nine lessees had missed monthly payments. Four lessees made additional payments in months following missed payments. In one case, however, a lessee missed 11 payments without any consequence. We also found that five lessees paid less than what their order required. The terms and conditions of orders state that if a lessee fails to make a monthly payment, the entire delinquent amount must be paid in full within 60 days and/or the lease must be transferred to another qualified Hawaiian; but this is not consistently enforced, if ever. We also found that 13 of 25 lessees were directed to provide proof they had obtained homeowner's insurance policies, but only three had current policies on file.

According to the E Team and Loan Services Branch, cases involving missed payments are not brought to the commission for non-compliance of their orders. This dysfunctional environment in which no one takes responsibility for tracking compliance with commission orders results in non-compliant lessees remaining on the land. Further, by not enforcing home insurance requirements, the department increases its risk exposure for insuring loan collateral against loss.

Conclusion

The Hawaiian Homes Commission's policy decision to issue direct, high-risk loans of last resort does not absolve it from prudently administering those loans. Nor should the Hawaiian Homes Commission Act's goal of providing long-term tenancy to native Hawaiians justify keeping chronically delinquent lessees on Hawaiian home lands while the list of beneficiaries waiting for such leases grows. By failing to identify and mitigate loan risk, and by allowing lessees to remain chronically delinquent, the commission ties up both loan and land resources that could be provided to other beneficiaries, and creates a solvency risk for the Hawaiian home lands trust fund.

Furthermore, the Homestead Services Division's administration of loans is inadequate. Policies and procedures governing direct loan issuance and collection of delinquent loans are lenient and vague. No one at the department monitors severely delinquent lessee compliance with commission orders. Monitoring and analysis of loan risk and mitigation are insufficient; as a result, delinquent loans are not resolved via collection or lease cancellation. Ultimately, the Hawaiian Homes Commission Act is being administered in favor of delinquent lessees over all other beneficiaries.

The commission and the division cannot continue to operate in this way. Rising loan obligations, the impending loss of annual \$30 million in settlement payments, and a growing list of beneficiaries waiting for leases pose imminent challenges. The commission would benefit from embracing a broader perspective of how it allocates resources and serves beneficiaries as a whole, including adopting a system to deal with delinquencies that takes into account the act's goal of promoting Hawaiian self-sufficiency and meeting the needs of all beneficiaries—not just those with leases.

Recommendations

1. The Hawaiian Homes Commission should:
 - a. Fulfill its role as fiduciary by acknowledging and mitigating loan risk. Specifically, the commission should:

- i. Adopt and communicate a risk management plan. This includes developing an appropriate risk appetite that can support a sustainable direct loan program. Risk appetite should be considered when approving all loan requests;
 - ii. Adopt and disseminate guidance in the form of policies, procedures, and performance goals relating to direct loan issuance, delinquent loan collections, and monitoring contested case hearing orders; and
 - iii. Comply with administrative rules requiring “the exercise of such care and skill as a person of ordinary prudence would exercise in dealing with one’s own property in the management of Hawaiian home lands.” This includes cancelling leases where loans are not in compliance with commission orders.
2. The Department of Hawaiian Home Lands should:
 - a. Adopt and implement reporting methods that bring loan delinquency issues to the attention of the commission. Specifically, the department should:
 - i. Coordinate resources of the Loan Services Branch and Fiscal Office to provide the commission with adequate information to make informed decisions on loan risk exposure; and
 - ii. Require the Fiscal Office and Homestead Services Division to create a more effective report that would allow commissioners to quickly understand the true position of the department’s direct loans. More financial information should be provided so that commissioners have a more complete picture of the status of delinquencies in the contested case process, including the status of each contested case.
 - b. Develop policies and procedures outlining the contested case hearing process, including procedures on how the department carries out the commission’s orders to ensure lessees comply with their terms and conditions;

- c. Require the Homestead Services Division's Loan Services Branch to:
 - i. Equip loan officers to properly administer loans by:
 - 1. Adopting a manual that provides firm criteria for reviewing and approving loan applications, including policies and procedures requiring a risk rating and credit counseling for each loan applicant;
 - 2. Establishing policies, procedures, and enforcement action for chronically delinquent lessees;
 - 3. Clearly outlining the responsibilities of branch staff in collecting on delinquent loan-related contested cases; and
 - 4. Re-instituting clear written collection procedures for each phase of delinquency in order to avoid inconsistent practices among collection staff.
 - ii. Ensure that loan officers adhere to trust responsibilities by adequately analyzing applications and only recommending loans for applicants who are financially capable;
 - iii. Adopt a system of internal controls relating to:
 - 1. Documenting standards and objectives with respect to delinquent loan collections;
 - 2. Requiring complete and accurate documentation of all collection activity. Loan officers should properly file and maintain loan files in accordance with best practices; and
 - 3. Periodically reviewing policies that govern income analysis and interest rates to determine whether they meet program goals.
 - iv. Address delinquent loans in a timely manner, recognizing that loans of last resort are inherently risky. This should include:
 - 1. Redefining how delinquent loans are characterized as 30, 60, 90, and 120 days delinquent; and

2. Customizing automated delinquency reports to ensure management and the commission receives critical information necessary for identifying deficiencies and weaknesses in delinquent loan collections and to take prompt action to remedy them.
- v. Adopt strategies or plans to address chronically delinquent accounts. Specifically, the Homestead Services Branch should:
 1. Formalize current unwritten payment plans and use salary assignments and garnishments; and
 2. Consider debt restructurings when repayment under current terms and conditions is doubtful. Concessions could include: reducing the interest rate on the original loan, extending the loan's maturity date and re-amortization, and/or reducing accrued interest.
- d. Require the Office of the Chairman's Compliance and Community Relations Section's Enforcement Team to:
 - i. Clearly outline the responsibilities of the Enforcement Team in the monitoring of delinquent loan-related contested cases; and
 - ii. Ensure that information needed to obtain the status of each contested case is available and readily obtainable.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Hawaiian Homes Commission and the Department of Hawaiian Home Lands on April 3, 2013. A copy of the transmittal letter to the commission is included as attachment 1. The department's response, received on April 11, 2013, is included as attachment 2.

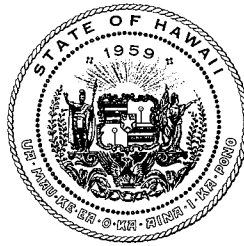
The department agreed that much can be done to enhance its performance. The department concurred with our recommendation that its higher-risk portfolio requires active loan monitoring and collection policy enforcement to control delinquent loan levels. The department further recognized our concern that lax management of lessee loans undermines its ability to serve all beneficiaries. The department said it will aggressively and comprehensively look at loan delinquency issues and that actions will be taken against the most chronic delinquent borrowers. The department also reported that it will review best practices to improve loan program internal controls and look to provide adequate staffing to improve loan effectiveness. Many of these items are addressed in the report.

The department said that following a May 2012 change in administration and leadership it improved reporting efforts, briefed the commission on fiduciary duties, and trained staff and commission members on loan risk and contested cases. The department also said that as of March of this year, it started reporting to the commission on department advances made on behalf of lessees.

The department disagreed that an external benchmark such as Hawai'i's subprime mortgage delinquency rates would help commissioners identify whether department delinquency trends diverged from the rest of the market. The department said it was unfair to judge the department's performance solely on standards established by for-profit, commercial lenders. The department misunderstands our point that an external benchmark of subprime loans would provide commissioners with perspective on performance trends of other loans provided to less creditworthy borrowers and whether the department's performance trends run counter to the market. Accordingly, we stand by our findings.

We made minor technical changes to correct an error of fact.

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



JAN K. YAMANE
Acting State Auditor

(808) 587-0800
FAX: (808) 587-0830

April 3, 2013

COPY

Ms. Jobie Masagatani
Chair-Designate
Hawaiian Homes Commission
Department of Hawaiian Home Lands
Hale Kalaniana'ole
91-5420 Kapolei Parkway
Kapolei, Hawai'i 96707

Dear Ms. Masagatani:

Enclosed for your information are nine copies, numbered 6 to 14, of our confidential draft report, *Management Audit of the Department of Hawaiian Home Lands' Homestead Services Division*. We ask that you telephone us by Friday, April 5, 2013, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Wednesday, April 10, 2013.

The Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

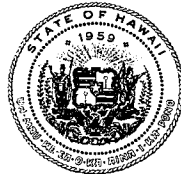
Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Jan K. Yamane
Acting State Auditor

Enclosures

NEIL ABERCROMBIE
GOVERNOR
STATE OF HAWAII



JOBIE M. K. MASAGATANI
CHAIRMAN
HAWAIIAN HOMES COMMISSION

STATE OF HAWAII
DEPARTMENT OF HAWAIIAN HOME LANDS

P. O. BOX 1879
HONOLULU, HAWAII 96805

RECEIVED

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April 10, 2013

OFF. OF THE AUDITOR
STATE OF HAWAII

Ms. Jan K. Yamane
Acting State Auditor
465 South King Street, Room 500
Honolulu, HI 96813-2917

Dear Ms. Yamane:

Thank you for the opportunity to comment on the State Auditor's draft report, *Management Audit of the Department of Hawaiian Home Lands' Homestead Services Division*. The Department of Hawaiian Home Lands ("DHHL"/"department") views audits as a valuable tool to improve operational efficiency and program effectiveness.

The challenge of the department and the Hawaiian Homes Commission ("Commission") is to strike a balance between addressing the management of its loan portfolio and addressing the needs of its beneficiaries for mortgage loan financing so that they can be placed on Hawaiian home lands.

DHHL loans are, by design, intended to serve those with no other financing options. Section 10-3-46 subsection (5) of the DHHL Administrative Rules indicates that "if the loan applicant is found by the department to have sufficient resources or credit to secure financing from non-departmental sources to undertake the purpose for which the loan is sought, no departmental loan shall be made." This is intended to preserve DHHL resources for those families most in need. While DHHL loans are therefore inherently riskier, in many cases, the alternative of not extending the loan to the family is to deny the family the opportunity to reside on Hawaiian home lands or the opportunity to repair their existing home. That said, addressing the risks associated with loan portfolios is a high priority for this administration.

In the audit report's discussion of the department's management of its loan portfolio, it was noted that DHHL's delinquency rates were not measured against established benchmarks. It was suggested that an external benchmark, such as Hawaii's sub-prime rate, be used as a comparison with DHHL's delinquency rate. The audit report also drew many comparisons between DHHL and a commercial lender. While the comparison appears reasonable on the surface, upon closer inspection the differences between the two entities render the comparison useless.

Commercial lenders, as private for-profit entities, are focused on generating assets (mortgages) that perform well. To achieve this outcome, they minimize their risk by lending to families with sufficient income and good credit. Lenders are judged based on how well their portfolio is performing, including maintaining a low delinquency rate.

DHHL, on the other hand, is judged not only on how well its loan portfolio is performing, but also on the number of families assisted by the department's programs. While the delinquency rate for commercial lenders may outperform DHHL's loan portfolio, DHHL's performance in terms of assisting families with no financial alternatives outperforms the record for the commercial lenders. Since denial of a loan application by a commercial lender is a criterion needed to qualify for a DHHL loan, the majority, if not all, of DHHL loans are given to families that did not qualify to receive assistance from a commercial lender. Although it may not be fair to base the performance of the commercial lenders on standards that are inconsistent with its core purpose as a for-profit entity, it is also not fair to judge DHHL's performance solely on standards that are established for the for-profit world.

In addition, the delinquency rate overstates the true delinquency situation for DHHL since many of the lessees that are delinquent are on a repayment plan and are actually paying as required. These loans are not considered current until the Commission authorizes a refinancing of the entire loan, including the delinquent balances. This usually occurs after the lessee has demonstrated a consistent payment history on his or her payment plan for at least one year.

Ms. Jan K. Yamane

April 10, 2013

Page 3

DHHL concurs with the audit report's comments that it needs to actively monitor loans and enforce collection policies to control the level of delinquent loans, given DHHL's higher risk portfolio. DHHL also concurs that more and better training for the staff and the Commission would improve DHHL's ability to effectively manage its loan portfolio. Improvements through technology could assist staff, and, follow-up on delinquent loans and compliance to existing collection policies and procedures could be improved.

While DHHL concurs that much can be done to enhance DHHL's performance, we would like to note the following efforts that have been completed since the change of administration and leadership in May 2012:

- Improved Reporting Efforts - As of March 2013, DHHL improved its reporting to the Hawaiian Homes Commission by including a report on advances made by the department on behalf of its lessees in addition to its direct and indirect loans portfolio.
- Briefing the Commission on Fiduciary Responsibilities - In both June and in August 2012, the Deputy Attorney General assigned to the Hawaiian Homes Commission provided a briefing of the roles and responsibilities to the members of the Commission. The Attorney General also provided a written memo addressing the same as a follow-up to the briefings in June and August.
- Training of Staff and Commission Members on Loans - Workshops regarding the U.S. Department of Housing and Urban Development (HUD) FHA 247 insured loan program and the Contested Case Hearing process were presented to the Commission in October 2012 and March 2013, respectively. The workshops are meant to educate and inform the Commissioners and staff of the process and inherent risks posed by loan delinquencies.

Ms. Jan K. Yamane
April 10, 2013
Page 4

Your report will be of great interest to our beneficiaries, the general public, and the media. It is for this reason that any inaccuracies or misunderstandings be corrected. A discussion of our concerns is attached and made a part of this letter.

Again, we appreciate the opportunity to comment on the draft audit report. We would be pleased to meet with you or your staff if any of the comments need further clarification.

Aloha,

A handwritten signature in black ink, appearing to read "Jobie M. K. Masagatani". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Jobie M. K. Masagatani, Chairman
Hawaiian Homes Commission

Attach.

Attachment

DHHL COMMENTS ON AUDITOR'S DRAFT REPORT OF April 10, 2013
As Recapped From the Summary of Findings (Page 13)

Background Information:

Page 1, Paragraph 2:

Ceded lands - Hawaiian home lands is a special class of public lands. Income derived from Hawaiian home lands can only be used for the purposes of the Hawaiian Homes Commission Act, 1920, (HHCA) as amended. DHHL also receives revenues from the public land trust described in the report, pursuant to §5(f) of the Hawaii Admissions Act.

Page 1, Paragraph 3:

Act 349, SLH 1990 - was enacted to incorporate a purpose statement in the HHCA. That purpose is much broader than the interpretation given the Act by the Attorney General and the courts. Act 349 takes effect upon consent of the U.S. Congress, and to date that consent has not been given.

Page 7, Paragraph 3:

Insured mortgage loans - The U.S. Department of Housing and Urban Development (HUD), not the State, insures mortgages through its FHA 247 Insured Loan program. FHA insured financing requires payment of an insurance premium by the borrowers. HUD consented to an agreement between HUD and DHHL in which FHA insured loans would be made available for DHHL homestead lessees.

Page 8, Paragraph 3:

"sufficient" - Although the 1978 Constitutional Convention expanded the department's entitlement to include "sufficient" funding, appropriations to finance the department's operations did not occur until FY 1989 and discontinued in FY 2010.

Findings and Responses

1. **"The Hawaiian Home Commission fails to meet its fiduciary obligations through its inattention to loan risk guidance."**

The high delinquency rate in loans is recognized and staff is aware of the need to step up collection efforts. Monthly status reports on loans are required by the Commission. The Commission's actions not to automatically cancel the leases of all lessees with delinquent loans should not be construed as "inattention" to loan risk. In recent months, DHHL has provided the Commission and staff with training in the loan risk and contested case areas.

DHHL has already implemented improving its loan delinquency reporting to the Commission by including "advances" made on behalf of lessees on its delinquency report and separating delinquencies by separate distinct categories for better analysis. DHHL is planning additional workshops with the Commission to provide training to read and interpret the reports.

2. **"The department's lax management of lessee loans undermines its ability to serve all its beneficiaries."**

The department recognizes that this is an area of concern and will aggressively be looking at issues affecting the loan delinquencies comprehensively. DHHL is concerned about adding to the growing population of homeless native Hawaiians. However, actions will be taken against the most chronic delinquent borrowers.

In the area of internal controls, DHHL will be reviewing with other State agencies on best practices to improve internal controls relating to the loan program. DHHL will be looking at staffing issues to provide adequate staffing to improve program effectiveness.