Audit of the Office of Hawaiian Affairs

A Report to the Governor
and the Legislature of the State of Hawaii

Report No. 01-06
March 2001

THE AUDITOR
STATE OF HAWAII

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds are existing funds meet legislative criteria.

7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.

8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.

9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

THE AUDITOR

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OVERVIEW

Audit of the Office of Hawaiian Affairs

Report No. 01-06, March 2001

Summary

The Office of Hawaiian Affairs (OHA) is a state agency responsible for improving the conditions of all persons of Hawaiian ancestry. During FY1998-99 OHA received nearly $5 million in general and federal funding to be used for this purpose. Its share of ceded land revenues paid in that year totaled $15 million. It also earned $11 million in dividends and interest. In addition, OHA's investment portfolio was valued at approximately $350 million at the close of that fiscal year. This audit assesses the adequacy of OHA's management of these resources, its efforts to improve the conditions of all Hawaiians, and the efficiency of the agency's organizational structure.

We found the Board of Trustees has not adequately planned to improve the conditions of Hawaiians. The board has allowed OHA's master and functional plans to remain outdated and has inefficiently planned for program expenditures. For example, during FY1998-99 the trustees spent approximately $13 million on unplanned expenses—exceeding OHA's budget by 100 percent. Although the board recently adopted a spending policy to balance spending for current beneficiaries while reserving assets for future generations, it failed to coordinate this policy with other plans that are intricately related to spending.

The board also failed to uphold its fiduciary duties and inefficiently managed OHA's public land trust funds. We found certain trustees misused funds for personal needs. Two trustees used over $8,000 in personal expense allowances to make interest-free loans to themselves and family members, while another trustee spent over $1,000 on beauty salon services over a three-year period. The board did not invest in international equities for many years although required to do so by OHA's investment policy. In fact, Morgan Stanley Dean Witter, OHA's former investment consultant, estimated that OHA could have earned approximately $2 million if the former board chair and the agency's administrator had not delayed hiring two international money managers selected by the board. Moreover, the board failed to terminate under-performing fund managers in a timely manner which further decreased the overall value of OHA's investment portfolio by approximately $1 million.

OHA did not ensure that funds disbursed from its grant and Native Hawaiian Revolving Loan Fund programs were well spent. OHA awarded over $900,000 in grants during FY1998-99 without ensuring that the recipient agencies indeed provided services to Hawaiians. We also found that loan funds were disbursed to beneficiaries without assessing whether these individuals would be able to repay. Moreover, funds were disbursed prior to receipt of loan-closing documents, and staff failed to implement collection controls for accounts in arrears. Consequently,

the solvency of this fund was jeopardized. As of June 30, 2000, 158 loans with a combined balance of $4.6 million were outstanding. Approximately half of this amount was past 90 days due.

We reviewed OHA's organizational effectiveness and concluded that OHA's on-going reorganization has led to a state of crisis. Staff are unsure of their duties and responsibilities because the administrator hastily reassigned staff to new positions for which approved position descriptions were lacking. In fact, some of these staff do not appear to be qualified for their positions. An exodus of knowledgeable staff has also hurt OHA. The reorganization has led other staff to resign who were not afforded the opportunity to grieve the administrator's actions.

Recommendations and Response

We recommended that the board direct its attention to identifying OHA's role in improving the conditions of all Hawaiians, and fulfill its fiduciary duties and improve its management of OHA's investments. We recommended that OHA improve its management of its grant and Native Hawaiian Revolving Loan Fund programs. We also recommended that the board develop clear policies and procedures for effecting organizational change that requires careful planning prior to implementation.

The board did not dispute any of our audit recommendations and responded that it has much to accomplish. The board described steps it has already taken as well as timeframes for implementing changes to address our audit findings and recommendations. The board disagreed with some of our findings and agreed with others. Specifically, the board agreed that it needs to update key planning documents; however, the board disagrees that it lacks the leadership and direction needed to improve the conditions of Hawaiians. The board agrees that improvements are needed in trustee expense accounts and that it failed to comply with the guidelines established in its investment policy. Although these guidelines were developed to ensure superior return rates, the board responded that its non-compliance did not result in any *overall* losses during 1999. This response does not sufficiently address the long-term effect of non-compliance. In fact, the board's own written response indicates that it did not meet the policy benchmark in three of the past four years.

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Audit of the Office of Hawaiian Affairs

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Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 01-06
March 2001

Foreword

This audit of the Office of Hawaiian Affairs (OHA) was conducted pursuant to Section 10-14.55, Hawaii Revised Statutes (HRS), which requires the State Auditor to conduct an audit of OHA at least once every four years.

We wish to express our appreciation for the cooperation and assistance extended to us by the Board of Trustees and the staff of the Office of Hawaiian Affairs.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

Background

The Office of Hawaiian Affairs (OHA) is a state agency established by the State Constitution. OHA is the principal public agency in Hawaii responsible for the performance, development, and coordination of programs and activities relating to native Hawaiians, people with at least 50 percent Hawaiian blood, and Hawaiians. Significant revenues are committed to OHA to enable it to accomplish its mission of improving the conditions of all persons of Hawaiian ancestry.

This is our second audit of OHA pursuant to Section 10-14.55, Hawaii Revised Statutes (HRS), which requires the State Auditor to conduct an audit of the agency at least once every four years. Our first audit pursuant to Section 10-14.55 was issued in February 1997. We have issued other audit reports on OHA in 1990 and 1993 pursuant to other legislative directives.

The Admission Act established a public land trust to benefit the general public and native Hawaiians

Hawaii was granted statehood through the Admission Act of 1959. The Act required that Hawaii hold certain lands in public trust as a condition of statehood. The public trust included 1.2 million acres of crown and government lands formerly ceded to the United States after Queen Liliuokalani, the last reigning monarch of the Kingdom of Hawaii, was overthrown in January 1893.

Section 5(f) of the Admission Act limits use of these public lands and any proceeds from their sale or disposition to specific purposes for two beneficiary classes: native Hawaiians and the general public. The lands and their proceeds may be used to support public schools and other public educational institutions, improve the conditions of native Hawaiians, develop farm and home ownership on as widespread a basis as possible, make public improvements, and provide lands for public use. The Act authorizes the United States to bring suit against the State for failure to limit the use of these lands to the five established purposes.

Article XII of the State Constitution Established OHA

To fulfill its obligation to native Hawaiians and the general public, the State's past practice was to generally direct proceeds of the public land trust to the Department of Education. However, delegates to the 1978 Constitutional Convention were concerned with this practice since the State did not earmark ceded lands or ceded land proceeds *specifically* for the betterment of native Hawaiians. During the convention, the Committee on Hawaiian Affairs supported a proposal that addressed the needs of Hawaiians regardless of blood quantum separately from those of the general public.

The convention delegates proposed amending the State's constitution to establish OHA which the electorate then ratified. The newly ratified Article XII, Section 5 of the State Constitution established the Office of Hawaiian Affairs. The Legislature passed Act 196 in 1979, now codified as Chapter 10, HRS, that implemented this constitutional amendment.

Ceded land revenues comprise the majority of OHA's revenues

OHA accounts for its revenues in separate trusts—one for native Hawaiians and another for Hawaiians. Three major funding sources provide revenues for these two beneficiary groups. As shown in Exhibit 1.1, almost half of these revenues comes from the Public Land Trust Fund. This fund, under the Department of Land and Natural Resources, receives its revenues from the sale of ceded public lands and from lease rents, licenses, and permits of ceded lands (less the required 30 percent of sugar cane lease land revenues that are transferred to the Department of Hawaiian Home Lands). Twenty percent of the Public Land Trust Fund's revenues are paid to OHA's trust for native Hawaiians. During FY1998-99, OHA received approximately $15 million in ceded land revenues.

Although the Admission Act restricts OHA's use of ceded land revenues to programs that benefit native Hawaiians, the State's general fund, federal funds, and other private donations support all Hawaiians. During FY1998-99, OHA received $2.7 million in general funds and $2.2 million in federal funds and other grants.

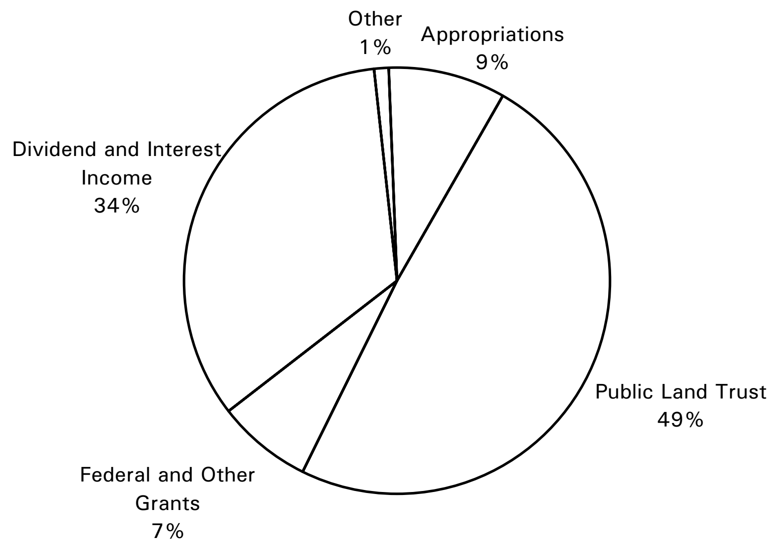
Exhibit 1.1 shows that public land trust revenues and investment income from these funds comprised the majority of OHA's revenues during FY1998-99. OHA received approximately $11 million in dividend and interest income during that year. At the close of FY1998-99 OHA's investment portfolio was valued at approximately $350 million.

OHA's revenues have decreased

In recent years, OHA's ceded land and general fund revenues have decreased. During FY1996-97 the governor withheld ceded land revenue proceeds from airports situated on ceded lands, resulting in a revenue decrease of approximately $5 million. However, ceded land revenues increased from $7 to $15.1 million when Act 329, Session Laws of Hawaii (SLH) 1997, provided OHA with interim revenues while outstanding issues among the Legislature, the executive branch, and OHA were being addressed. OHA reported that ceded land revenue income decreased during recent years, as the governor continued to withhold proceeds derived from the airports.

The decrease in OHA's ceded land revenues was coupled with a decrease of approximately $60,000 in general fund appropriations during

Exhibit 1.1
Office of Hawaiian Affairs Revenue Sources, FY1998-99



FY1998-99. Legislative appropriations further decreased from $2.7 million during FY1998-99 to $2.5 million during FY1999-00 and FY2000-01.

Organizational structure

The State Constitution requires that OHA be governed by a Board of Trustees of at least nine members who are Hawaiian and are elected by Hawaiians. However, the U.S. Supreme Court recently ruled that denying non-Hawaiians the right to vote in OHA elections violated the U.S. Constitution's Fifteenth Amendment, which prohibits states from denying individuals voting rights on account of their race. As a result of this ruling, the status of the trustees was to be determined by the Hawaii Supreme Court. While this matter was being considered by the court, the trustees continued to maintain responsibility over OHA's real and personal property and formulated policies relating to the affairs of native Hawaiians and Hawaiians. The trustees maintained these responsibilities during the period of our audit fieldwork. However in September 2000, all elected trustees resigned after the governor threatened to petition the courts to remove the eight trustees whom the Hawaii Supreme Court ruled had been elected in an unconstitutional process. They were replaced by interim trustees appointed by the governor. Three of the trustees who resigned were appointed by the governor to serve as interim trustees. The interim trustees served until the general public elected new trustees in November 2000. Five of nine trustees who resigned were reelected by the general public.

As required by law, OHA's policymaking board appoints an administrator who serves as the agency's principal executive. The Office of the Administrator is responsible for executing board policies, carrying out OHA's goals and objectives, and managing agency operations. The administrator has direct supervisory control over all OHA personnel excluding the aides and secretaries assigned to the trustees. As of June 30, 1999, OHA employed 88 staff who reported to the administrator and 22 staff who reported to the trustees. Five authorized positions in the administrator's office were vacant at that time. All other positions were filled.

OHA's trustees are bound by fiduciary duties

OHA's trustees are bound by fundamental fiduciary duties that include marshaling OHA's resources, loyalty, and prudence. The duty of undivided loyalty requires that the trust be administered solely in the interest of the beneficiaries. Furthermore, Chapter 554A, HRS, Uniform Trustees' Powers Act, defines a prudent person as one who, in exercising trust powers, is reasonable and equitable from the viewpoint of the beneficiaries' interests and acts with the same diligence, discretion, and judgment as would be expected in managing the trustee's own affairs.

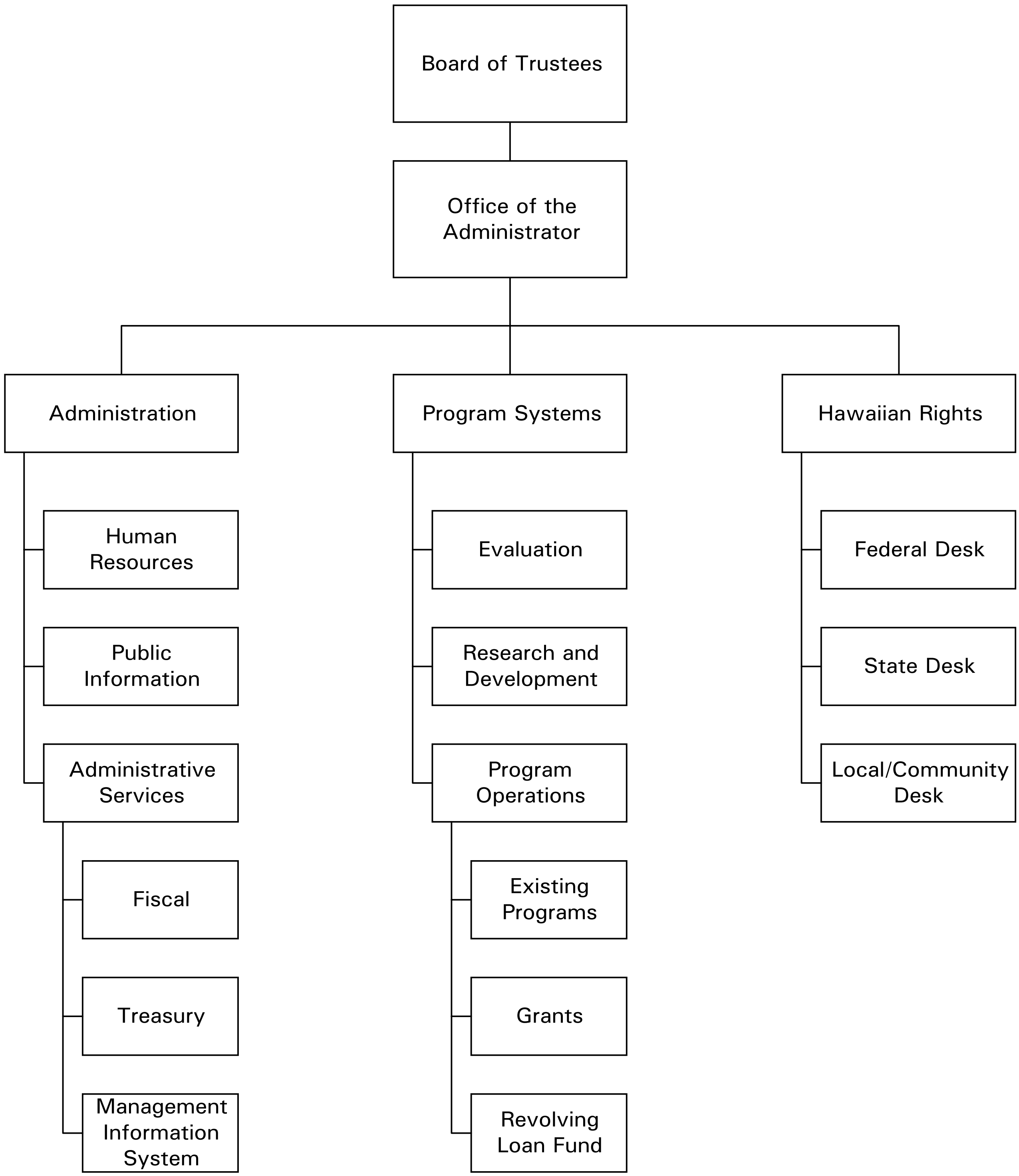
OHA is reorganizing

In FY1998-99, OHA's administrator initiated a staff reorganization. As reported in OHA's 1999 Annual Report, this reorganization was intended to better serve its beneficiaries by consolidating ten program divisions within the office into the following three functional operating centers: 1) Administration, 2) Program Systems, and 3) Hawaiian Rights. Exhibit 1.2 displays the current organizational structure of the administrator's office.

Previous audit reports

OHA's inability to adequately plan for beneficiary needs was first identified in our 1990 audit report, *Management and Financial Audit of the Office of Hawaiian Affairs* (Report 90-11). This finding was again noted in our 1993 and 1997 audit reports. Report 93-28, *Management and Financial Audits of the Office of Hawaiian Affairs*, recommended that OHA update its master and functional plans. Report 97-7, *Audit of the Office of Hawaiian Affairs*, reported that these key plans remained outdated although OHA's written response to our 1993 audit indicated that by July 1, 1994 it would update its master plan, and that by June 30, 1994 it would develop a comprehensive master plan to include other

Exhibit 1.2
Office of Hawaiian Affairs' Current Organization Structure



agencies dealing with Hawaiians. Our 1997 audit also identified problems with OHA's budgetary process and found that OHA could improve its management of its short-term investment funds.

Our earlier audits also found that OHA's financial controls were inadequate. For example, in 1990 we reported that OHA did not have loan closing information for loans provided through the Native Hawaiian Revolving Loan Fund program. We also found poor record keeping and evaluation of grant awards. In our 1997 audit, we reported that OHA inadequately monitored grants and recommended that OHA develop an evaluation system. OHA's own independent financial auditors also confirmed many of these earlier audit findings.

Our most recent audit also recognized the need for OHA's trustees and staff to rise above internal discontent and discord that could compromise OHA's mission. During 1990 we recommended that the board clearly distinguish its policymaking and oversight functions from the administrator's executive role.

Objectives of the Audit

1. Assess whether the Office of Hawaiian Affairs has adequately planned to improve the conditions of native Hawaiians and Hawaiians.

2. Assess whether the Board of Trustees has fulfilled its fiduciary duties to safeguard the resources of the Office of Hawaiian Affairs and to ensure fiscal accountability.

3. Assess whether the Office of Hawaiian Affairs' organizational structure and human resource practices ensure organizational effectiveness.

4. Make recommendations as appropriate.

Scope and Methodology

Our audit focused on the Office of Hawaiian Affairs' management of its program services, financial operations, and staff primarily during FY1998-99. However, our review of OHA's efforts to identify and plan for the needs of native Hawaiians and Hawaiians included board and staff action since our last audit in 1997. Our review of OHA's reorganization included both its implementation during 1998 and earlier planning efforts.

We reviewed pertinent state and federal laws and rules, operation manuals, selected expenditure reports, investment reports, and financial statements for grant and Native Hawaiian Revolving Loan Fund disbursements. We attended board meetings, and interviewed each trustee, the administrator, and staff. We also surveyed 600 randomly selected beneficiaries to identify their understanding of OHA's role and their opinion of OHA's effectiveness in meeting the needs of native Hawaiians and Hawaiians in specific areas. We also surveyed all staff employed by OHA between 1997 and 2000 to assess employee morale and identify whether employees were given adequate direction for carrying out their duties.

Our audit was performed from January 1999 through November 2000 in accordance with generally accepted government auditing standards.

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Chapter 2

The Office of Hawaiian Affairs Needs Much Improvement to Ensure that It Fulfills Its Fiduciary and Trust Obligations

The Office of Hawaiian Affairs (OHA) is responsible for improving the conditions of all Hawaiians. The Legislature provides OHA with general funds and ceded land revenues to assist in this endeavor. However, OHA has failed to ensure that these funds are spent for the betterment of Hawaiians. Instead, certain trustees have chosen to ignore their fiduciary and leadership roles, resulting in poor planning, budgeting, and investment practices. This lack of leadership coupled with staff's ineffective management of the grant and Native Hawaiian Revolving Loan Fund has resulted in the loss of millions of dollars. Meanwhile, the administrator's poorly planned reorganization has resulted in an internal organizational crisis that threatens to undermine OHA's ability to serve Hawaiians.

Summary of Findings

1. The Board of Trustees of the Office of Hawaiian Affairs has failed to adequately plan to improve the conditions of native Hawaiians and Hawaiians.

2. The Board of Trustees failed to uphold its fiduciary duties and ineffectively managed nearly $345 million in public land trust funds.

3. Inadequate oversight of the Office of Hawaiian Affairs' grants program and Native Hawaiian Revolving Loan Fund allows for waste and misuse of funds.

4. The hasty reorganization of the administrator's staff has led to a state of organizational crisis, demanding the immediate attention of the trustees.

The Board of Trustees Has Not Adequately Planned for the Improvement of Beneficiary Conditions

Chapter 10, HRS, broadly establishes OHA's purpose to include the betterment of the conditions of native Hawaiians and Hawaiians. In order to ensure that OHA's efforts towards this goal are productive, Chapter 10 also directs the trustees to formulate policy and to implement a comprehensive master plan. However, the trustees have failed to provide OHA with the leadership and direction needed to improve the conditions of native Hawaiians and Hawaiians.

Specifically, the board neglected to update key planning documents despite repeated promises to do so. Moreover, the board did not adequately plan for expenditures. Although the trustees' recent recognition of the need to adopt a spending policy is commendable, their failure to coordinate this policy with other key planning documents does not ensure the betterment of the conditions of native Hawaiians and Hawaiians.

Consequently, native Hawaiians and Hawaiians are unclear about OHA's role and believe that its programs are ineffective. Approximately 40 percent of the 162 beneficiaries who responded to our survey indicated that they do not understand OHA's purpose. One beneficiary responded, "I don't understand their (OHA's) whole purpose. If they are for the Hawaiian people, I haven't seen much results. It seems like it (OHA) is just for a select few." Of further concern, about 30 percent of the survey respondents also believe that OHA has been "very ineffective" in meeting the educational, healthcare, housing, employment, and job training needs of native Hawaiians and Hawaiians. Another beneficiary wrote, "Trustees act for the betterment of themselves rather than the Hawaiian community. They are too busy positioning themselves and flaunting rather than making actual efforts to identify issues and solve problems."

The Board of Trustees has failed to establish priorities

The Board of Trustees has not provided OHA with sufficient direction to ensure efficiency in meeting OHA's broad mandate to improve the conditions of native Hawaiians and Hawaiians. Although Section 10-6, HRS, requires that the trustees develop, implement, and *continually update* a comprehensive master plan that identifies the needs of native Hawaiians and Hawaiians, the board allowed OHA's master plan to remain outdated.

Section 10-6, HRS, also requires that the trustees assist state and county agencies in planning for services and in coordinating federal, state, and county activities for native Hawaiians and Hawaiians. Act 147, SLH 1999, the OHA appropriation act, specified that OHA address this need by spending $62,517 to develop a comprehensive master plan. However, OHA has not made adequate progress in developing a comprehensive master Hawaiian plan as specified in Act 147.

OHA's master and functional plans are outdated

OHA's Master Plan was developed as the blueprint to guide OHA in fulfilling its basic responsibility of improving the conditions of all Hawaiians. The master plan contains a mission statement and prioritized goals and objectives for at least a ten-year time frame. Although OHA intended that the plan be revised as objectives were met and new opportunities arose, the plan has not been updated for 12 years. Consequently, the objectives then deemed the most urgent by the master plan are now deficient.

Trustees serving during 1988 established building OHA's financial resources as a high priority in the master plan. However, the trustees failed to update the master plan after receiving $136.5 million during 1993 for back payments and interest on OHA's share of previously collected public land trust revenues. This significant increase in revenues provided the trustees with the opportunity to focus on substantive programs to benefit Hawaiians. Our 1997 audit urged OHA to account for the increased funding in its long range (master) and short range (functional) plans. However, the trustees have not addressed this recommendation. Consequently, OHA has expended considerable funds on programs and goals that may no longer be relevant. Outdated functional plans (also referred to as divisional plans) failed to provide staff with direction. These archaic plans cover the period between 1991 to 1997 and refer to divisions that are currently obsolete.

OHA's trustees recognize the need to update key planning documents. This is evidenced by the recent authorization by the trustees to hire a facilitator to update OHA's master plan. However, there is little assurance that the entire board is committed to this task since OHA promised over seven years ago to address this pressing need.

OHA is unlikely to fulfill the legislative mandate for the development of a comprehensive master plan

OHA first developed its master plan to address its internal objectives, although it recognized that ultimately it needed to coordinate this plan with those of other agencies servicing Hawaiians. Section 10-6, HRS, makes OHA responsible for assisting state and county agencies in developing plans and activities for native Hawaiian and Hawaiian services. Although there have been past efforts among Hawaiian organizations to coordinate services to Hawaiians, a statewide comprehensive Hawaiian master plan still does not exist.

The Legislature's commitment to coordinating the public and private services available for Hawaiians has been long-standing. The 1989 Legislature requested the establishment of a governor-appointed task force for the purpose of inventorying available services, identifying critical needs of Hawaiians, and making recommendations to improve service accessibility and coordination. The task force, Hui Imi, is neither part of nor attached to OHA. The Legislature commended the task force for its work and formally reauthorized Hui Imi in 1997. The Legislature more recently directed OHA to collaboratively develop a comprehensive master plan with other agencies servicing Hawaiians in Act 147, SLH 1999.

Act 147 establishes specific timeframes to ensure that a master plan would be ready for public distribution by December 31, 2000. The Act also requires OHA to submit status reports to the 2000 and 2001 Legislatures. During the 2000 legislative session, OHA's administrator appears to have misled the Legislature by reporting that significant progress had been made, and that the work group tasked with the development of a comprehensive master plan anticipated meeting the timeline set forth by the Legislature. This was even after the administrator informed the task force work group that he did not believe it was realistic for the group to formulate a master plan. He believed that the terms of Act 147 were unrealistic. We noted very little progress towards compliance with Act 147 at the time of our fieldwork.

Our review of the work group's minutes also indicates that tasks were not completed within the timeframes set by Act 147. For example, many of the organizations represented on the work group spent several months providing an overview of their purpose. As a result, the work group did not contract an independent consultant to provide an objective analysis of the strengths and weaknesses of existing related master plans by the mandated October 1999 deadline. This is of concern since several group members questioned the status of Hui Imi's earlier collaborative planning efforts, and indicated that they were uncertain of their role. Furthermore, the Hawaiian master plan has not been completed although Act 147 specified that it be distributed to the public by December 31, 2000.

The Board of Trustees has not adequately planned for expenditures

OHA's budget should represent the policy statements of the trustees and function as the vehicle by which plans are realized. However, the absence of trustee leadership has reduced OHA's budget to a meaningless document. Trustees spent additional funds from the public land trust irrespective of the limits that a budget ordinarily imposes. The magnitude of unplanned expenses is fiscally irresponsible and reflects insufficient planning and control over spending. Moreover, OHA's failure to adopt a spending policy to address current beneficiary needs while preserving the trust for future generations further exacerbates this situation.

Thirteen million dollars spent on unbudgeted items

During FY1998-99 OHA spent approximately $13 million on unplanned expenses—exceeding its budget by 100 percent. Funding for these unplanned expenses, referred to as "parachutes," was appropriated by the trustees from OHA's public trust funds.

OHA only recently contracted a consultant to provide alternative spending policies that would help determine funding ceilings for current programs and investments. Our 1997 audit warned OHA that substantial "parachute" appropriations could result in a deficit. Although OHA recognizes the merit of establishing a spending policy to guide spending decisions, it has failed to coordinate the development of this policy with other key plans that also drive funding decisions.

The development of a spending policy lacks coordination with other key plans and policies

OHA is a perpetual trust, meaning it must serve all current and future Hawaiians. Therefore, a spending policy is necessary to ensure a balance between spending for current beneficiaries' needs while reserving assets for future generations. OHA contracted with Cambridge Associates, Inc., to assess its current spending policy and to present an analysis of alternative spending rules that would balance the need to preserve the corpus and to fund current programs. Cambridge Associates is being paid $24,500 to develop policy alternatives to be reviewed by OHA's trust attorney who will determine whether the proposals comply with OHA's fiduciary and public trust duties.

Current assets, organizational priorities, expected future funding, and potential future costs including litigation, are all considered when formulating a spending policy. An organization's asset allocation, the various asset classes in which funds are invested, is also intricately related to its spending plan. Consequently, investment and spending policies should be developed concurrently.

Although OHA's contract with Cambridge Associates recognizes the close relationship between asset allocation and spending policies, it does not include the analysis of alternative portfolio asset allocations under the scope of services. At the time of our audit fieldwork, OHA's investment consultant, Morgan Stanley Dean Witter, filled this role. Morgan Stanley informed the board's budget committee that OHA's spending plan would dictate its asset allocation. However, there was no collaboration between Cambridge and Morgan Stanley. This was largely due to Cambridge's requirement that it work independently from OHA's investment consultant since it considers its work proprietary and confidential.

The lack of coordination in developing these essential policies is indicative of OHA's disjointed approach to planning. First, OHA trustees must update its master plan to identify priorities and goals for its beneficiaries. The trustees must then decide what OHA's role will be before developing a spending policy to support that role.

The Board of Trustees Failed to Uphold Its Fiduciary Duties and Poorly Managed the Public Land Trust

OHA's Policies and Procedures Manual requires that the trustees act reasonably and prudently in accordance with the highest fiduciary standards applicable to private trustees. Undivided loyalty, a fundamental fiduciary duty, also requires that the trust be administered solely in the beneficiaries' interests. To assist the trustees in meeting these obligations, OHA's Administrative and Financial Manual of Guides establishes management controls for safekeeping the trust's assets. However, inadequate controls and certain trustees' disregard for the fundamental fiduciary duty of loyalty has resulted in the misuse of funds.

Trustees are also obligated to invest any trust property not required for the immediate future in income-producing assets. Furthermore, the Uniform Prudent Investor Act requires that the trustees manage the trust assets solely for the beneficiaries' interest. Trustee management and investment decisions must be evaluated in the context of the trust portfolio as a whole, and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. OHA's trustees adopted an investment policy to establish asset mix requirements and specific market cycle benchmarks for each of OHA's money managers. However, the trustees' failure to ensure compliance with this policy has cost OHA millions of dollars.

Certain trustees misused funds

Incidental costs incurred in daily operations may be covered by trustee expense accounts, the protocol fund, or petty cash. Management controls limit disbursements from these funds to prevent their misuse. However, inadequate controls have resulted in the loss of funds through gross misuse by some trustees.

Trustee expense account funds are used for personal gain

Each trustee receives an annual allowance of $7,200 at the start of each calendar year to develop and maintain an ongoing communication network with beneficiaries, promote an understanding of Hawaiian issues, and encourage participation in resolution of these issues. This annual allowance is apart from and in addition to each trustee's annual salary of $32,000 and the chair's salary of $37,000. Although trustees are responsible for submitting quarterly expenditure reports to the board's chair, trustees are able to use these funds for purposes other than intended because trustees receive their entire year's allowance in advance and before ever incurring any costs. Furthermore, one trustee co-mingled the annual allowance with the trustee's personal funds, which increased the opportunity for misuse.

We reviewed trustee expense reports for calendar years 1996 through 1999 and found numerous questionable transactions that did not appear to meet the purpose of the trustee expense account. For example, two trustees used their allowances to make interest-free personal loans exceeding a combined total of $8,000 to themselves and family members. Another trustee spent over $1,000 on beauty salon services over a three-year period. These trustees appear to have failed to uphold their responsibility of loyalty, and may have instead spent funds for personal needs and interests.

We also found that certain trustees did not always return unspent annual allowances to OHA, although policy requires that they do so. These trustees returned only half of the $24,250 in unspent allowances between calendar years 1996 and 1999. This is after spending $231,171 in annual allowances over those four years.

Inaccurate income reporting could violate Internal Revenue Code. Since annual trustee allowances are not intended as additional compensation or salary for OHA trustees, these funds are not taxed as personal income. However, when trustees fail to return unspent expense funds at the end of the calendar year, one recourse is to report the amount due as income on the trustee's wage and tax statement (W-2 Form).

Failure to accurately report a trustee's earnings could violate the Internal Revenue Code, which requires OHA to report all earnings of employees on the W-2 Form to the Internal Revenue Service. The penalty for each incorrect form is $50 with a maximum penalty of $100,000 for all errors in a calendar year. OHA's fiscal staff began reporting unspent expense funds as taxable income only during 1999.

OHA should consider disbursing trustee expense funds on an actual expenditure reimbursement basis. This would help to ensure that these funds are used only for allowable purposes, and reduce the opportunity to use such funds for personal expenses.

Protocol funds are inappropriately used

OHA's protocol fund is used to cover the cost of social occasions hosted by OHA, the observance of Hawaiian culture at social and business conventions, and other social occasions authorized by the board's chair. We reviewed all disbursements from this account during FY1998-99 and found that 16 percent of the total amount disbursed were for questionable purposes. Questionable expenses included over $1,000 in payments for a beneficiary's dentures, $200 to pay for a former trustee's legal fees, and other payments that would have more appropriately been reviewed under OHA's grant, donations, subsidies, and purchase of service program.

Petty cash funds are inappropriately parceled

OHA's Administrative and Financial Manual of Guides limits single cash disbursements from the petty cash fund to $250. The board's chair may authorize disbursements to trustees not to exceed $400 only in the event of hardship. A former chairperson violated the intent of one-time disbursements of $250 by allowing the board's staff to parcel requests for funding. For example, the chair approved two separate requests, each for $250 made on the same day, to pay for a beneficiary's shipping crates. These crates were used to enable the beneficiary to transport his woodwork to an art show. This former chair also approved these separate requests all made on the same day to purchase refreshments for community meetings. As a result the requisitioner received $300 in petty cash, or $50 more than authorized by the Administrative and Financial Manual of Guides.

The Board of Trustees did not ensure compliance with OHA's investment policy

The Uniform Prudent Investor Act requires the trustees to invest and manage OHA's assets by considering the purpose, terms, distribution requirements, and other circumstances of the trust. Trustees must also diversify the investments, unless the trustees determine that the trust is better served without diversification. OHA's investment policy was developed to provide superior investment returns to sustain the trust fund for beneficiaries and uphold OHA's mission.

In order to achieve greater investment returns, OHA's investment policy established an asset mix designed to obtain higher long-term rates of return while limiting overall fund volatility through diversification. Exhibit 2.1 illustrates the current asset allocation required by the policy. Deviation from the established asset allocation requires that the board chair be notified within five days. Equities include stocks, while fixed income includes both government and corporate bonds and other interest bearing financial instruments.

Exhibit 2.1
OHA Investment Policy on Asset Allocation

ASSET CLASS	PERCENT
EQUITIES	
U.S. Core Equities	39%
U.S. Small Cap Equities	15%
International Equities	10%
Alternative Equity Investments	0%
FIXED INCOME	
U.S. Fixed Income	35%
REAL ESTATE	
Land Investment	1%
Total	100%

Source: Investment Policy for the Office of Hawaiian Affairs Native Hawaiian Trust Fund, Board of Trustees, Office of Hawaiian Affairs, December 16, 1999, p. 3.

As of March 31, 2000, the market value of OHA's composite portfolio was $344,464,581. Although OHA's portfolio contains significant resources, the board has not ensured superior return rates. The failure to follow the policy on investing in international equities resulted in significant lost opportunities to add to the assets of the trust. Moreover, the board's lax oversight of its investment consultant and money managers has not adequately safeguarded OHA's assets.

Failure to hire international investment managers resulted in an opportunity cost of over $2 million

OHA's investment policy required that the trustees invest in international equities as early as 1995. However, the untimely implementation of this policy has resulted in a significant cost in potential earnings. Although non-compliance with this policy has been pointed out by OHA's investment consultants on at least two occasions and by some trustees as well, the board failed to implement the policy in a timely manner.

On April 6, 2000 Morgan Stanley, OHA's investment consultant, urged the board's budget and finance committee to promptly select an international investment manager in order to benefit from the great influx of capital expected from the Japanese market. Morgan Stanley recommended that an international money manager be funded from OHA's money market account, its small cap value stocks, and small cap growth stocks. This was recommended in order to increase OHA's projected return from 9.16 percent to 9.32 percent, and reduce the projected volatility from 12.53 percent to 11.83 percent.

Although the board selected Lazard Asset, International ADR, and Simms Capital, International Equity as OHA's international money managers on April 27, 2000, the chief procurement officer (also the board's chair) failed to execute a contract with these firms in a timely manner. Consequently, the two newly selected money managers were unable to provide services for the approximate 90 days that elapsed before the contracts were executed. Morgan Stanley warned the trustees of the consequences of delaying these contracts, and estimated that OHA could have earned $2.1 million had the contracts been executed earlier.

Under-performing fund managers are not identified in a timely fashion

During FY1998-99 OHA paid nine money managers approximately $1.6 million to make purchase and sale decisions in accordance with OHA's investment policy. Since decisions made by these money managers directly impact OHA's portfolio value, the timely identification of under-performing managers is crucial to minimizing potential investment losses.

OHA's investment consultant is responsible for monitoring the performance of each money manager against specific benchmarks established in OHA's investment policy. The consultant reports this information to the trustees generally in quarterly and annual reports. Merrill Lynch served as OHA's investment consultant since 1994; however, Morgan Stanley filled this role during the last quarter of calendar year 1999.

Our review of the investment consultants' reports indicated that these reports do not serve the trustees well. First, Merrill Lynch often submitted its quarterly and annual performance reports late. In some cases, the reports were issued three months after the close of the period under review. These late reports failed to identify under-performing managers in a timely manner.

Secondly, Morgan Stanley's performance report for the period ending March 31, 2000 did not provide the trustees with the data needed to assess whether the money managers complied with benchmarks for long term return rates as established in the investment policy. Although the investment policy defines a market cycle as a three- to seven-year period, Morgan Stanley's annual performance report provided rate of return data only for a two-year period. Our review of the rate of return for each of OHA's nine money managers over a three-year market cycle (12/96-12/99), found that six of nine money managers failed to meet the investment policy benchmarks. This information was not included in the investment consultant's annual report. In fact, the consultant made recommendations to improve the performance of only two of the nine managers.

Underperformance may be linked to inappropriate benchmarks. On January 31, 2000 Morgan Stanley first recommended that the board amend the money manager's guidelines established in the investment policy. In order to meet industry standards, the recommendations included updating the market cycle benchmarks for five of OHA's nine money managers. The proposed changes would affect three of the six money managers we identified as under-performing in our analysis. Morgan Stanley informed us that the investment policy's benchmarks were outdated and that comparing the performance of the money managers would result in termination of money managers that were actually performing well. Although some board members believed that the amendments would relax the guidelines in the investment policy, the board eventually agreed to the changes on August 9, 2000.

Quarterly benchmarks are needed. The board has not adopted short term or quarterly benchmarks for each of OHA's money managers. Consequently, the quarterly performance of each manager may only be compared to the long-term benchmarks established in OHA's investment policy. Merrill Lynch suggested that the trustees adopt quarterly benchmarks in order to ensure the early identification of under-performing managers. Adopting such standards would make the quarterly performance reports more meaningful because the trustees would have a measure by which to compare each manager's performance.

Under-performing managers are not terminated in a timely fashion

Certain trustees have used their leadership positions in the past to delay the termination of under-performing money managers. Although the budget and finance committee voted to recommend to the full board that it terminate one of OHA's money managers in 1997 and a second manager in 2000, these managers were not terminated in a timely manner.

In the first case, the budget and finance committee voted to terminate a money manager when Merrill Lynch pointed out the firm's poor performance. However, the committee chair failed to report the committee's recommendation to the board chair. As a result, this recommendation was not placed on the board agenda for a vote. Consequently, this firm was allowed to continue managing OHA's funds despite its poor performance. Our analysis of this firm's performance as compared to OHA's investment policy indicated that it continued to under-perform.

The budget and finance committee more recently voted to terminate a second money manager during a May 4, 2000 meeting, due to its poor performance and failure to adhere to its allowable asset allocation. Although the budget and finance committee chair and vice-chair prepared an action item 11 days later documenting the committee's recommendation, the board chair at that time did not include this item on the board agenda in a timely manner. Only when the committee wrote the chair a month later and warned that further delay in including the recommendation on the board's agenda was unacceptable, did the chair take action.

The majority of the board voted to terminate the second money manager on July 5, 2000; however, OHA's administrator further delayed the reallocation of investment funds from the poorly performing portfolio by waiting until August 8 to attempt to formally notify the money manager of the board's decision. This delay is of concern since Morgan Stanley had informed OHA on June 26, 2000 that the value of the portfolio managed by this money manager had decreased from approximately $24 to $18 million between December 1999 and May 2000. Morgan Stanley estimated that this manager's portfolio decreased by approximately $1 million between the time the budget and finance committee voted to terminate the manager and the time the funds in this portfolio were liquidated.

Investment consultant and bank custodian provided services without executed contracts

OHA's investment consultant and bank custodian play key roles in the management of OHA's portfolio. As discussed earlier, OHA's investment consultant reviews the performance of each money manager and makes recommendations to the trustees to improve the performance of its investments. OHA's bank custodian, First Hawaiian Bank, is responsible for the safekeeping and physical administration of all funds managed by all money managers. Although these are important functions, the board allowed its contracts with its investment consultant and bank custodian to expire.

Merrill Lynch's contract for consultant services expired on July 15, 1995, but it continued to serve as OHA's investment consultant until September 1999. Failure to renew the contract resulted in a disagreement over payment for services provided. As a result, OHA paid Merrill Lynch for services a former administrator had authorized but had not documented in a contractual agreement. The board chair at that time terminated Merrill Lynch on September 9, 1999, one month prior to hiring a new investment consultant.

The board also allowed its contract with First Hawaiian Bank to expire in September 1997. A new contract or extension of the original contract still had not been executed at the time of our fieldwork, although the chief financial officer informed us that she planned to renew the contract with the bank custodian. The trustees' negligence in allowing these contracts to expire while the contractors continued to provide services exposed OHA to unnecessary fiduciary risk and liability.

The Grant and Native Hawaiian Revolving Loan Fund Programs Are Poorly Managed

One of the ways in which OHA attempts to improve the conditions of Hawaiians is by making grants and business loans available to them. Grants awards are restricted to nonprofit agencies that service native Hawaiians, while business loans are available to all eligible Hawaiians regardless of blood quantum. Although OHA's grant and Native Hawaiian Revolving Loan Fund programs provide meaningful opportunities to Hawaiians, OHA's poor financial management of these programs exposes it to unnecessary financial risks and potential waste.

Grant oversight needs improvement

OHA awarded grants to agencies amounting to $935,766 during FY1998-99 for services including health care, transportation, and the promotion of Hawaiian culture. Contracts for grants describe the scope of services to be provided by the grant recipient and specify reporting requirements that allow OHA's staff to monitor each recipient's performance. After an initial installment, program performance and expenditure reports must be submitted prior to payment. However, our review of reporting requirements, grant recipient reports, and payments made to recipients indicated that payments are often made without any assurance that OHA's beneficiaries are receiving the services specified in the contract.

We reviewed 11 of the 22 grants awarded during FY1998-99, and found that 8 of the grant recipients were paid without reporting on their required performance measures. Payment was made to four recipients even when the reports they submitted revealed that they did not meet required performance measures. For example, two of these grant recipients did not provide services to the number of clients they were required to service. Moreover, OHA paid three recipients without first ensuring that they did not owe any state and federal taxes. Section 103-53, HRS, requires that state agencies obtain tax clearances from all service providers before entering into a contract. If a contractor fails to pay all taxes owed during the contract term, payment due to the contractor should first be assigned to the Department of Taxation or the Internal Revenue Service as applicable.

OHA staff also did not ensure that grant recipients used these funds to service native Hawaiians. Grant awards may be used to benefit only native Hawaiians since funding is obtained from ceded land revenues. Although OHA requires each grant recipient to provide evidence of serving native Hawaiians, we were unable to find any documentation in 90 percent of the grant files reviewed to indicate that services were in fact provided to *any* Hawaiians.

Grant program is inappropriately used to fund purchase of services and subsidies

Grants are intended to be *one time* funding awards to stimulate and support activities that improve the conditions of native Hawaiians. Grants should neither be used to fund on-going service needs nor to subsidize agency beneficiary services in order to lower cost for services than would otherwise be charged. These needs are more appropriately funded through either purchase of service agreements or subsidies.

Although OHA's trustees have adopted a formula to determine separate funding levels for grants, purchase of services, and subsidies, OHA has developed policies only for awarding grants. Consequently, grant awards are often used to purchase on-going service needs and to subsidize costs such as student transportation.

We reviewed 11 grants awarded during FY1998-99, and found that approximately half of these grants would have been more appropriately funded as either a purchase of service or subsidy. For example, two private providers were awarded several grants to provide case management to AIDS patients dating back to 1994 and 1995 respectively. Since there appears to be an on-going need for this service, it would be more appropriate to fund this through a purchase of service agreement. Furthermore, OHA's practice of funding this program as a grant does not ensure that funds for these services are awarded by the competitive purchase of service process required in Section 103F-402, HRS.

Native Hawaiian Revolving Loan Funds are disbursed without adequate review

Title 42, Section 2991b-1 of the United States Code established the Native Hawaiian Revolving Loan Fund program to promote economic development in Hawaii. OHA administers this fund to expand entrepreneurial opportunities for native Hawaiians. Loan recipients are those unable to secure conventional financing through traditional lending sources. As of May 2000, this program had disbursed 331 loans totaling approximately $14.7 million since its inception in 1989. The Native Hawaiian Revolving Loan Fund supports businesses that are registered to do business only in Hawaii. Businesses that have received funding include fishing charter services, food services, automotive services, and farms.

In order to ensure that funds will be available to Hawaiians on an on-going basis, it is the federal government's intent that loan moneys be made available expeditiously and with as much assurance of 100 percent payback as possible. The Code of Federal Regulations requires OHA to develop policies and procedures to meet these goals. However, staff have not followed established procedures in recommending loans for approval, disbursing payments, and collecting moneys owed to the fund, thereby jeopardizing the solvency of the fund. As of June 30, 2000, 158 loans with a combined balance of $4.6 million were outstanding. Approximately $2 million of this amount is past 90 days due.

Loan officers do not always complete credit checks and financial analyses

OHA approved 12 of 13 loan requests we reviewed without assessing whether these loan applicants would be able to repay their combined loan amount of $433,750. The loan approval process requires that the loan officer complete a credit check on each applicant prior to determining eligibility; however, this was not done for two loans that were approved. Furthermore, loan officers did not prepare required financial analyses to determine whether 12 of the 13 loan applicants would be able to repay borrowed amounts. Of further concern, most of the loan files did not even contain the required financial information needed to complete these analyses. As a result, OHA has not been able to identify all loans at risk of delinquency.

Funds are disbursed prior to receiving required loan closing documents

All loan closing documents must be signed and received by OHA prior to the disbursement of loan funds. These documents include promissory notes, term loan agreements, security agreements, financing statements, certificates of title, and loan commitment letters. We compared the signature dates on these loan documents to the disbursement dates of the loan funds and found that 12 of 13 recipients received funds prior to signing all required loan documents. This practice increases the risk of financial loss that must be absorbed by the Native Hawaiian Revolving Loan Fund should a borrower default.

Native Hawaiian Revolving Loan Fund losses are not minimized

As a lender of "last resort" the Native Hawaiian Revolving Loan Fund is subject to higher than average loan risks. The Code of Federal Regulations requires that management controls be established to minimize financial risks. These controls include securing collateral as necessary and monitoring loans once funds are disbursed.

Loan officers' efforts to secure loans are inadequate

Collateral security can provide the Native Hawaiian Revolving Loan Fund with reasonable protection from loss. Collateral may include liens on real or personal property, assignment of accounts receivable or proceeds from inventory sales, and hazard and life insurance policies naming OHA as the beneficiary. The Code of Federal Regulations allows OHA staff to use discretion when determining when collateral should be secured. However, the federal rules clearly state that the availability of collateral is normally an important factor when making loans and that the type and amount of loan collateral required should be governed by the strengths and weaknesses of other credit factors.

Currently, OHA staff do not require nor do they secure collateral in all possible cases. The failure to secure collateral has resulted in financial loss to OHA. In one case, OHA initially required that a loan applicant obtain life insurance with OHA named as the beneficiary. However, the applicant was denied insurance due to a pre-existing health condition so OHA waived this requirement and approved the loan. The loan recipient later died and OHA was unable to collect $63,000 owed by the recipient. Since loans disbursed through the Native Hawaiian Revolving Loan Fund are at higher risk of default than those approved through conventional lending practices, OHA should consider requiring collateral as a loan condition in all cases where collateral is available.

We also found that even when collateral is required as a condition of loan approval, OHA sometimes fails to take possession of the collateral when the loan becomes seriously delinquent. For example, although OHA could have taken possession of a tractor/tiller purchased with loan funds in the above example, OHA did not do so. OHA staff also failed to take possession of a boat purchased by a fishing charter operator although this loan recipient failed to make payments for almost two years.

Collection efforts for delinquent accounts are inadequate

In order to increase the likelihood of collecting past due payments, the Code of Federal Regulations requires that OHA send delinquent recipients late notices and that OHA establish provisions for late charges. OHA's policies require that a second notice be sent to the loan recipient if payment is not received within six days of the due date. A letter outlining possible collection alternatives is to be sent when the account is past 30 days due, and the account may be turned over to a loan collection specialist when the account is past 90 days due. Late fees for payments past 15 days due may be assessed at the rate of seven percent of the monthly loan payment due.

We reviewed 14 loans randomly selected from all active loans and found that in the majority of these cases late notices were not sent to the recipient when applicable. These recipients were also never assessed late fees although some loans had not been paid for almost two years. Instead, loan recipients were allowed to make payments at their discretion.

Of further concern, OHA consistently failed to assign accounts past 90 days due to the loan adjustment specialist. The Code of Federal Regulations requires that these delinquent accounts and OHA's recommendations for further action be reported to the federal Administration for Native Americans (ANA). Upon receiving such notice the ANA is required to instruct OHA on action to be taken including taking possession of collateral and initiating legal action. Although OHA submits quarterly and annual reports to the ANA, these reports only identify the aggregate amount of loans past due; they do not identify specific delinquent accounts and recommendations for action. The ANA is only informed about specific delinquencies when OHA requests authorization to write loan losses off that are already past 90 days due.

The failure to pursue delinquent accounts in a timely manner may be due in part to OHA's flawed monthly reports that fail to identify all delinquent accounts. In one case an account was not reported as delinquent until it was five months past due.

OHA's failure to implement these collection controls has significantly impacted the Native Hawaiian Revolving Loan Fund. The average delinquency rate increased 12.6 percentage points between federal fiscal year 1998 and 1999. OHA has recently assigned a collection specialist to reduce the high rate of loan delinquencies.

The Administration for Native Americans could demand that federal funds be refunded. OHA has disbursed approximately $14 million in Native Hawaiian Revolving Loan Funds between 1989 and September 30, 1999. Federal funds comprise $11.6 million or 81 percent of the disbursed funds. The Code of Federal Regulations allows the Administration for Native Americans (ANA) to recover federal funds when a loan recipient defaults and OHA has failed to implement certain management controls. These controls include performing a proper check of an applicant's credit, securing collateral when collateral is a condition of a loan, maintaining accurate records, and notifying the ANA of loans past 90 days due. Although the ANA has not initiated the recovery of federal funds under this provision, OHA's failure to routinely implement the required controls puts OHA at risk of being required to cover the loss of federal funds with either general funds or ceded land revenues.

The On-going Reorganization By the Administrator Has Led to a State of Crisis

OHA's functional plans make the administrator responsible for the development and oversight of OHA's organizational structure. The current administrator recently reorganized OHA's ten program divisions into three functional areas in order to promote teamwork and efficiency. However, inadequate planning for organizational change has resulted in hasty decisions, which have negatively impacted employee morale and resulted in assigning staff to positions for which they may not be qualified. Moreover, the lack of an employee grievance process to address employee concerns resulting from the poorly planned reorganization provides employees with few options besides resignation or civil action.

The reorganization was inadequately planned

Organizational change is managed by assessing the current organizational situation, determining the desired future, and planning ways to reach that desired future. Although this approach required that the administrator involve the trustees since they are responsible for determining OHA's future, the board was not formally involved. Furthermore, the lack of policies and procedures for effecting organizational change resulted in a poorly planned reorganization. Many staff were reassigned to positions for which no position description had been approved. Furthermore, some of these staff do not appear to be qualified for these newly created positions.

Policies and procedures for effecting organizational change are needed

Executive branch departments are required to follow Administrative Directives No. 90-01 and 95-06 when planning organizational change. These directives require change at the branch level and above to be reviewed by the director of finance and the Department of Human

Resources Development in order to assure organizational efficiency and effectiveness. Proposed changes may be implemented only after receiving approval from the governor.

Although OHA is not required to follow these executive directives, they are based on sound management principles. OHA should similarly plan for, document, and review its proposed organization *prior* to actual implementation. For example, a timeframe for completing the reorganization should be clearly established. Furthermore, position descriptions and reorganization charts should be updated and reviewed prior to implementation.

OHA's administrator failed to complete these key documents prior to reassigning staff to new positions. In fact about 90 percent of the reassigned staff did not have approved position descriptions. Approximately 45 percent of the reassigned staff who responded to our employee survey indicated their responsibilities have changed significantly. Moreover, some staff were unsure of their position titles. These uncertainties leave staff vulnerable and create a condition of organizational crisis within OHA.

Not all staff may be qualified for newly assigned positions

We reviewed draft position descriptions for staff reassigned to new positions and found that some staff may not be qualified for their new positions. For example, several staff working in clerical type positions were reclassified as evaluation assistants although they did not meet the educational (college degree) or work experience requirements for the new position. Furthermore, we were unable to determine whether 25 percent of the reassigned staff met the qualifications in their draft position descriptions since the personnel files for these employees did not contain the information necessary to make this determination.

The administrator's failure to approve position descriptions prior to filling these positions resulted in detrimental organizational practices. Not only are staff placed in positions for which they may not be qualified but also the opportunity is created for job descriptions to be written to match the qualifications of the selected staff. We found one case in which this appears to have occurred. This practice is contradictory to the spirit and integrity of public sector employment that promotes merit and fairness.

An exodus of key staff plagues OHA

Institutional knowledge is important to all organizations; however, OHA has lost staff who held key positions prior to the reorganization. At the time of our audit fieldwork approximately half of the former division officers had resigned. The reorganization eliminated most division officers' positions and reassigned them to newly created positions. For example, the education officer became the research and development manager, and the planning officer became the procurement and contracts attorney.

The reorganization has led other staff to resign. A resignation letter of one former employee stated OHA has become ineffective because of the loss of good personnel. This employee expressed concern that "capable people (were) thrown, tossed or forced out because their skill and ability did not fit new plans."

Lack of grievance process places OHA at risk of litigation

Organizations provide employees with due process by establishing procedures for handling employee grievances by unbiased or neutral parties. A grievance process that ensures due process allows employees to object to management action without fear of retaliation.

OHA did not afford this opportunity to its employees who disagreed with the reorganization because it lacks policies and procedures for filing a grievance. Failure to adopt a grievance policy to assure employees due process can result in costly litigation.

Conclusion

The board's failure to plan adequately is a recurring obstacle to bettering the conditions of Hawaiians. Although some trustees have attempted to improve OHA's planning, budgeting, spending, and investment policies there is little assurance that their intentions will be met with success. Past attempts to improve accountability have met with resistance from board members then in control.

In the middle of this conflict, the State is ultimately responsible for ensuring that the trust obligations established in the Admission Act are fulfilled. Should the Board of Trustees continue to overlook it's fiduciary responsibilities, the Legislature will need to ensure that the State upholds the duties of loyalty, prudence and the marshaling of the public land trust funds earmarked for the betterment of native Hawaiians. If the Office of Hawaiian Affairs fails to improve within a reasonable time period, the Legislature may need to consider options to increase its oversight of the agency.

Recommendations

1. The Board of Trustees should direct its immediate attention towards identifying OHA's role in improving the condition of all Hawaiians. Specifically, the trustees should:

- Identify and prioritize goals and objectives for the Office of Hawaiian Affairs. These goals and objectives should be developed within the context of a comprehensive master plan that clearly identifies OHA's role in relation to other agencies providing services to Hawaiians;

- Update OHA's master and functional plans and ensure that these plans account for increased revenues that should be used to expand services to Hawaiians, while at the same time preserving the corpus for future generations. The trustees should also coordinate these key planning documents with OHA's spending and investment plans; and

- Prepare a budget that reflects the board's priorities as established in OHA's master plan, and limits expenditures to budgeted programs and services. Cash reserves set aside in money market accounts should be limited to quarterly budgets and emergency appropriations. An appropriation that would cause OHA to exceed its expenditure ceiling should be justified and reported to the Legislature within 20 days prior to the commencement of each legislative session.

2. The board should fulfill its fiduciary duties and improve its management of OHA's investments by:

   - Complying with policies regarding the use of expense, protocol, and petty cash funds. The fiscal staff should audit these records and refer all incidents of gross misuse to the attorney general for further review;

   - Disbursing trustee expense funds on a cash reimbursable basis;

   - Ensuring compliance with OHA's investment policy;

   - Carefully considering the recommendations of OHA's investment consultants and documenting in public record the reason for choosing not to implement any of these recommendations;

   - Adopting quarterly benchmarks for each money manager and requiring OHA's investment consultants to compare each manager's quarterly performance to these benchmarks in order to improve the timeliness in identifying under-performing managers. Similarly, the board should require that OHA's investment consultants annually report the data needed to identify whether each money manager complied with market cycle performance measures;

- Terminating under-performing money managers in a timely manner; and

- Immediately contracting for bank custodian services for OHA's investments.

3. The board should clarify its bylaws to require the board chair to place all items on the board agenda within a reasonable number of days once a committee recommendation is received.

4. OHA should improve the management of its grants program by:

   - Improving its oversight of grant awards. Grant monitors should verify whether the grantees meet performance measures prior to disbursing quarterly payments to the grantees;

   - Developing policies and procedures for awarding subsidies and purchase of services in accordance with board priorities. The practice of using the grant program to fund these services should be discontinued immediately and necessary health care services should be identified and procured in accordance with the competitive purchase of service process established in Chapter 103F; and

   - Ensuring that services are provided and tax clearances received from grant recipients prior to disbursing any grant funds.

5. OHA should reduce the financial losses incurred by the Native Hawaiian Revolving Loan Fund by:

   - Completing loan applicant credit reviews and analyzing each applicant's market and financial plan prior to OHA's approval of loan requests;

   - Disbursing loan funds only after receiving all required loan-closing documents;

   - Developing clear guidelines for determining when collateral is a loan condition. Furthermore, OHA should take possession of secured collateral when accounts are past 90 days due and other collection efforts have been unsuccessful;

   - Improving collection efforts by notifying borrowers in writing of outstanding monthly payments and consequences of failure to pay. Late fees should be assessed as authorized by the Native Hawaiian and Revolving Loan Fund Operation Manual;

- Promptly notifying the Administration for Native Americans (ANA) of all loans 90 days in arrears. Notification to the ANA should include OHA's recommendations for further action as required by Title 45, Section 1336.68 of the Code of Federal Regulations; and

- Ensuring that monthly delinquency loan reports are accurate.

6. The board should adopt clear policies and procedures for effecting organizational change that require careful planning prior to actual implementation of any change. These policies should require the following:

    - An assessment of the current organization's strengths and weaknesses. The purpose of a reorganization being considered by the board or administrator should be clearly documented and available for public review;

    - A detailed timeframe for implementation;

    - A revised organization chart (to be reviewed and approved by the board) that identifies all position titles and position numbers; and

    - Accurate position descriptions and qualification statements for each position prepared by OHA's personnel office.

7. The administrator should immediately develop an employee grievance process for board review and approval. Once adopted, copies of the policy should be distributed to all employees.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the chair of the Board of Trustees of the Office of Hawaiian Affairs on January 30, 2001. A copy of the transmittal letter to the chair is included as Attachment 1. The official board response is included as Attachment 2.

Attachment 3 includes the individual comments of some trustees that were transmitted through the board chair. Attachment 3 also includes duplicates of documents submitted directly to our office by one or more trustees before the response deadline. One of those documents was covered by a letter that stated, "The following members of the Board of Trustees hereby submits its response to the audit report on the Office of Hawaiian Affairs for the year 2000." The document was signed by five trustees, but not the same trustees who signed the duplicate document included in Attachment 3. Attachment 4 is a memo from Trustee Stender stating that he does not endorse an unofficial response to our audit. We included only those documents that were submitted to our office by the February 12, 2001 deadline. Our comments are limited to the board's official response.

The Board of Trustees responded that OHA is far stronger than it was during our initial (1990) audit. However, the board acknowledges that it has much to accomplish. The board did not dispute any of our audit recommendations and in fact reports that it has already taken steps to address some of those audit recommendations. The board also described timeframes it has established for implementing changes to address other audit recommendations. The board agrees with the specifics of some of our audit findings and disagrees with others.

Specifically, the board concurred that key planning documents are outdated and it reported that extensive work is needed. Nevertheless, the board disagrees that the trustees lacked the leadership and direction needed to improve the conditions of all Hawaiians. This response is inconsistent with the board's agreement that it inadequately planned for expenditures. Although the board reports that it has developed a spending policy since the completion of our audit fieldwork, it does not acknowledge any efforts to coordinate this policy with the development of other key plans (OHA's Master Plan and investment policy).

The board agrees that improvements can be made in the use of trustee expense accounts. The board alleges that the trustee who improperly used these funds for beauty salon services was "ill advised" and that upon receipt of our draft report this trustee reimbursed OHA for these personal expenses. The board also informed us that the year-end balance of approximately $90 of one trustee was not subject to income tax provisions since the trustee had deposited $1,500 of her personal funds into her trustee expense account. We deleted reference to this balance not being reported as income from our draft report after confirming that the trustee had deposited $2,000 to her account during calendar year 1999. We adjusted the total amount of unspent allowances that was not returned to OHA between calendar years 1996 and 1999 to reflect this information.

The trustees also indicated that they would review their policies and procedures for protocol fund and petty cash disbursements, even though they deny that a former chair allowed the parceling of petty cash funds. However, the board's response fails to address the parceling of these funds to pay for a beneficiary's shipping crates. Furthermore, the board incorrectly cites two refreshment check requests paid on separate days for different community meetings "held between August 6, August 11, and 25 in Honolulu." The example referred to in our report was for three requests all made on the same day to purchase refreshments for three community meetings held on Oahu and a neighbor island on August 24 and 25, 1998. We believe that staff should have requested a purchase order since the purchases were for the same purpose (refreshments) and covered a very close period of time (two meetings were held on the same day and the third a day later). Instead, staff appear to have inappropriately circumvented OHA's petty cash fund policies for convenience.

In its response the board acknowledges that it did not comply with OHA's investment policy. However, the board's response that OHA's processes were flawed and have since been corrected is obscure. The board referred to a 5.1 percent unrealized investment gain during 1999 despite its failure to hire an international money manager as required by OHA's investment policy. However, we point out that this 5.1 percent is not a real gain in its investment portfolio but merely the difference between the rate of return and its benchmark percentage for a one year period (1999). The board's response is an attempt to minimize its failure to comply with its own investment policy. OHA's investment policy establishes an asset allocation to achieve superior return rates over the *long term*, not in any one given year. In fact, OHA's investment policy states that the asset mix was designed to increase long-term rates of return while limiting volatility through diversification. The board's written response indicates that this did not occur since OHA failed to meet the policy benchmark in three of the past four years.

The board further contends that its failure to hire an international money manager did not result in any *overall* losses. However, the board acknowledges that it lost the opportunity to add assets to the OHA trust when it delayed executing the contracts with two international money managers. The board states that the former chair delayed the contracts due to “dissatisfaction with the contractual agreement,” resulting in a $330,000 “opportunity loss.” The board disputes Morgan Stanley’s estimate that OHA could have earned $2.1 million, and incorrectly calculated the $330,000 in potential income had the contracts been executed earlier. We found two computation errors in the board’s response.

The board also disputes Morgan Stanley’s estimate that the value of a fund manager’s portfolio was reduced by approximately $1.3 million when the termination of the manager was delayed by the previous board chair. The board responded that other accounts handled by this firm that were similar to OHA’s account in style were up during July 2000. Morgan Stanley calculated the estimated loss by comparing the portfolio’s value at the time the budget and finance committee voted to terminate the money manager and the portfolio’s decreased value at the close of July 2000. We have since learned that although OHA sent the money manager the notification of termination via certified mail on August 8, 2000, the termination was further delayed because OHA sent the notice to an incorrect mail address. Based on current information, we have updated our report to reflect the loss of approximately $1 million in this money manager’s portfolio value between the initial board vote and the actual liquidation during late August 2000. The value of the portfolio was determined from monthly balances reported by First Hawaiian Bank, OHA’s custodian of funds.

The board agrees that a second money manager was not terminated when recommended by the budget and finance committee, and blames its failure to take action on “flawed processes” that it has since corrected. The board did not elaborate on these “flawed processes.”

The board acknowledges that it allowed its contracts with a former investment consultant and its current bank custodian to expire. The board reports that it will finalize its investment custodian contract with First Hawaiian Bank by March 31, 2001.

In response to our finding that grant recipients were paid without reporting on their required performance measures, the board stated it has implemented a comprehensive evaluation program since our on-site visit. The board also reports that it has developed a legal checklist to ensure that all grantees submit tax clearances before being paid.

The board disagrees that the grant program may only be used to serve native Hawaiians. The board reports that the *GSPD Program Guidelines for Funding* specify that the grant recipient must secure other funds prior to receiving a grant award. Reference to this requirement is irrelevant since it does not address the fact that OHA’s grant funds are restricted to native Hawaiians. The policy the board references clearly specifies that “funding appropriations are made from ceded land trust revenues and are restricted to use for the betterment of conditions of Native Hawaiians (those with at least 50 percent blood quantum, Hawaiian ancestry), as defined in Chapter 10-2, Hawaii Revised Statutes."

The board agrees with our finding that some grants could be considered purchases of service and subsidies; however, it disagrees with funding these under purchase of service and subsidy programs. Rather, the board reports that "maintaining responsiveness to community needs is very difficult under competitive procurement processes."

The board acknowledges that improvements can be made in the area of credit checks and financial analysis of the Native Hawaiian Revolving Loan Fund (NHRLF) program. The board responded that financial losses to the NHRLF will be reduced by following existing policies and by continuing efforts to improve collection processes. OHA will provide standard notification to all accounts 30 days in arrears beginning April 1, 2001 and enforce the option of charging late fees by June 2001.

The board disagreed with our finding that NHRLF loans were disbursed to recipients prior to executing all required loan closing documents. The board erroneously assumed that we compared the date on the loan checks to the date on the loan closing documents. We reached our conclusion after finding numerous cases in which the loan closing documents were signed *after* the borrower certified *receiving* the funds.

The board acknowledges that the administrator's reorganization created instability; however, it contends that OHA planned for the reorganization and ensured staff were qualified for the new positions they were reassigned to. The board stated that the clerical staff reassigned to evaluation assistant positions are not required to have a college degree. We reviewed OHA's budget journal tables for 2001 to identify the position numbers and new position titles for each of these staff. The position numbers and new titles were traced to draft position descriptions. In each case, the position description was clearly titled "evaluation assistant" and identified a college degree as a minimum qualification. As noted in our report, although these position descriptions were in draft form, the staff referred to were already working in these new positions.

The board's response to our finding that an exodus of key staff has harmed OHA's institutional knowledge is misleading. The board reports it reviewed 12 staff vacancies between November 1998 and December 1999; however, it does not address many of the vacancies that occurred after our audit fieldwork began in January 2000. The board responded that it plans to explore the development of an employee grievance procedure; however, it expects this process to take four to six months. We encourage the board to make this a priority to reduce the risk of litigation resulting from the absence of such a policy.

The board's willingness to address our audit recommendations is encouraging. However as noted in our report's conclusion, the efforts of some trustees have been stifled by other trustees in the past. Given the seriousness of our audit findings and recommendations, the board must not allow itself to resort to the internal discontent, suspicion, and discord reported in our previous audit. If the Office of Hawaiian Affairs fails to improve within a reasonable time period, the Legislature may need to consider options to increase its oversight of the agency.

Finally, we made some minor changes to the draft report for the purposes of accuracy and clarity.

ATTACHMENT 1

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

MARION M. HIGA
State Auditor

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

January 30, 2001

COPY

The Honorable Haunani Apoliona, Chair
Board of Trustees
Office of Hawaiian Affairs
711 Kapiolani Boulevard, Suite 1250
Honolulu, Hawaii 96813

Dear Ms. Apoliona

Enclosed for your information are 10 copies, numbered 6 to 15 of our draft report, *Audit of the Office of Hawaiian Affairs*. Please distribute the copies to the members of the board and to the administrator. We ask that you telephone us by Thursday, February 1, 2001, 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 Thursday, February 8, 2001.

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

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

PHONE (808) 594-1888

FAX (808) 594-1865

STATE OF HAWAI'I
OFFICE OF HAWAIIAN AFFAIRS
711 KAPI'OLANI BOULEVARD, SUITE 500
HONOLULU, HAWAI'I 96813

February 12, 2001

RECEIVED
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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawai`i 96813-2917

Dear Ms. Higa:

We are pleased to respond to your fourth audit of the Office of Hawaiian Affairs after previous audits by your office performed in 1990, 1993, and 1997. Although our ceded land revenues flowing to the agency have decreased (see page 2, Audit of the Office of Hawaiian Affairs, State Auditor, 2001) and threats to the organizational structure and existence of OHA continue in the wake of *Rice v. Cayatano* case (supra, page 4), our agency is far stronger than during our first audit.

- The Native Hawaiian Trust Fund has increased from June, 1993 ($152,409,637 market value) to $330,710,564 in June, 2000, a 117% increase;

- The home loan program has disbursed $11.5 million to needy Hawaiians in calendar year 2000.

- OHA's partnership in the Individual Development Account (IDA) has proven the value and viability of partnering with other State, Hawaiian and private organizations.

- The Solicitor General of the United States acknowledged a trust responsibility to Hawaiian in their brief in support of *Rice v. Cayatano*. This position was consistent with the position of the Office of Hawaiian Affairs.

We do agree, however, that despite our many successes, there is much yet to be accomplished. We have reviewed your most recent audit and would offer the following clarifications and updates on our progress on those items you have identified. Responses to your Recommendations and Findings follow, in that order:

RECOMMENDATIONS:

Our comments to the Report's recommendations are as follows:

Recommendation #1

OHA's Role in Improving Conditions of all Hawaiians

OHA's Response

In January 2001, the Office of Hawaiian Affairs ("OHA") Board of Trustees declared strategic planning as an urgent priority for the year. They convened their first planning session on February 5, 2001. Through this entire process the needs of the Hawaiian community will have been identified and prioritized. Programs will be developed to meet those needs and budgets will be developed within the OHA Spending Policy limits. OHA will assume its clearinghouse role in the Native Hawaiian Comprehensive Master Plan. A report regarding the status of the Native Hawaiian Comprehensive Master Plan was submitted to the Legislature in January 2001. The report notes that Native Hawaiian Comprehensive Master Plan working group was convened on July 23, 1999. A total of twenty organizations, agencies, and or individuals participated in the first meeting. The working group met 17 times between July 23, 1999 to December 1, 2000. The group agreed to "intensive information gathering" which led to the creation of an "infrastructure for communications". The working group stated:

> "We will provide services to the Hawaiian community in a coordinated way by creating an infrastructure to combine data, integrate the work of agencies and communities to better pursue referrals to the community and coordinate communication."

Recommendation #2

Fiduciary Duties and Management of OHA's Investments

OHA's Response

All issues related to investment and fiscal management and financial controls mentioned in this audit indicate a necessity for an internal auditor to ensure compliance to existing policies and the further development of appropriate policies to assist Trustees in fulfilling fiduciary duties and proper management of OHA's operations. Therefore, the following actions will occur:

- OHA Trustees are considering the creation of an internal auditor position during the first quarter of fiscal year 2002.

  Referral to the respective Board Committees will occur as it relates to policies and procedures that need to be amended.

- OHA's Investment Custodian contract with First Hawaiian Bank will be finalized before March 31, 2001.

Recommendation #3

Items on Board Agenda

<u>OHA's Response</u>

By March 2001, the Board of Trustees will request the Committee on Policy and Planning to promulgate policies to:

Adopt time limits within which the Board of Trustee Chair must place a committee's recommendation to the board on the full board's meeting agenda, no later than two board meetings after the chair receives the recommendation, and adopt a formal re-referral process that includes written notice to all trustees of the re-referral and its reasons, and time guidelines.

Recommendation #4

Management of Grants Program

<u>OHA's Response</u>

- OHA has requested through its budget bill four provisos to create grants. These grants, if approved, will meet the definition of a legislative grant set forth in HRS section 42F-101. OHA will take steps to add provisos to its budget bill for subsidies as recommended by this report and in compliance with HRS section 42F-102.

- To ensure that services are provided to the Hawaiian community, OHA has established an internal monitoring process for grants. With this monitoring process enacted, OHA shall obtain all information via quarterly reports, interviews, and/or site visits that services are provided to native Hawaiians and Hawaiians before disbursement of funds.

Recommendation # 5

Native Hawaiian Revolving Loan Fund

OHA's Response

OHA should reduce the financial losses incurred by NHRLF by:

- Loan applicant credit reports will continue to be reviewed upon receipt of each application, by the Loan Officer. A comprehensive write-up includes analysis of financial statements, projections, and market/business plans. The write-up will continue to be prepared by the Loan Officer, and reviewed by the NHRLF Advisory Board Loan Approval Committee in determining loan approval.

- Loan funds will continue to be disbursed only after all closing documents are executed. Currently, checklists are utilized by the Loan Officers to ensure that documents are in place. A designated staff member then reviews the file for completeness prior to any loan closing or disbursement.

- The NHRLF Operations Manual section 6.H. provides adequate guidelines for the securing of collateral. The Loan Officer and Loan Approval Committee considers all available collateral in making loan decisions, however, such security or lack thereof should not be used as the primary basis for deciding whether a loan is approved. Possession of secured collateral for accounts past 90 days due, is taken on a case by case basis by the Loan Officer or Credit and Collections Specialist whenever all other collection efforts have been exhausted.

- Continuing efforts will be made to improve collection processes. Late notices plan to be in place by March 2001 and standard written notification for accounts 30 days past due plan to be implemented by April 2001. We are planning to enforce the option to charge late fees and will work on an implementation plan by June 2001.

- NHRLF will resume sending notification to the ANA of all loans 90 days in arrears, along with recommendations for further action, with the next quarterly reporting package.

- With designated staff and a new loan servicing software currently in place, accurate monthly delinquency reports will continue to be produced.

Recommendation #6

Policies and Procedures for Effecting Organizational Change

OHA's Response

We have reviewed the State's Administrative Directives 90-01 and 95-06 and the four items noted in this recommendation. The Board of Trustees intends to discuss the administrative directives and the audit recommendation, and adopt guidelines on reorganization during 2001.

Recommendation #7

Employee Grievance Process

OHA's Response

We employ the complaint process contained in the OHA Policy Against Sexual and Other Forms of Harassment in response to employee grievances. The Board of Trustees approved this policy on July 14, 1998. We will, however, explore the development of an employee grievance procedure for review and discussion by the Board of Trustees. This process may take four to six months to complete.

FINDINGS:

Our comments as to the Report's findings are as follows:

Finding #1

Board of Trustees Priorities

Pages 10 to 12

OHA's Response

The OHA concurs with the Legislative Auditor that OHA's planning documents are outdated and need extensive work. OHA does, however, disagree that "the Trustees have failed to provide OHA with the leadership and direction needed to improve the conditions of native Hawaiians and Hawaiians".

Discussion

In 1998, there was an informal assessment by the Administration of the planning functions and capabilities of the OHA administration. That assessment revealed the inadequacy of planning skills and the ability to coordinate an administration-wide plan. Previously, all planning, research and development activities were the responsibilities of the Administrator and eleven OHA administrative divisions. The Planning and Research Office was to assist divisions in their efforts and to coordinate the full agency plans. A shortcoming of this working format did not lend to a collective vision - development of which must be initiated by Trustees. The first steps in addressing the recommendations of the 1993 and 1997 Legislative Audit on the OHA planning failures, was the reorganization of the agency in 1999 into functional work divisions and units.

A reorganization occurred in order to decentralize decision making and foster teamwork; provide the board with more information relating to data collection and reporting; consider the relationship between programs and its delivery system; improve results and outcome measurements; and to define OHA's role in legal, legislative and governance issues. This decision to reorganize was consistent with addressing the recommendations of the 1990, 1993, and 1997 Legislative Audit.

The auditor's report refers to three different plans, the native Hawaiian comprehensive master plan, OHA master plan, and OHA functional plans. Discussion of the two master plans is necessary for clarity.

OHA's Master Plan

<u>OHA's Response</u>

OHA acknowledges that our master and functional plans must be updated and corrective action is underway.

The OHA master plan is a Trustee initiated document for the OHA as described in its Policy and Procedures Manual (Section 2.7). The OHA master plan was last revised in 1988.

<u>Discussion</u>

The OHA Functional Plans, I Luna A'e (1991-1997) developed and approved by the Board of Trustees in 1991 represented an agency wide effort to establish short and midrange goals, objectives, and implementing actions to functionally carry out the OHA Master Plan.

In January, the OHA Board of Trustees declared strategic planning as an urgent priority for the year 2001. They convened their first planning session on February 5, 2001. The Trustees expect to have a strategic plan that will address its collaborative effort with other Hawaiian agencies and the native Hawaiian comprehensive master plan, OHA's master plan, and OHA's functional plan.

Native Hawaiian Comprehensive Master Plan

<u>OHA's Response</u>

We agree that OHA must work hard to fulfill the legislative mandate to develop a comprehensive master plan. Although the report expresses some doubts that OHA will fulfill the Legislative mandate for the development of a comprehensive master plan, OHA is committed to completing this task in behalf of its beneficiaries.

The comprehensive master plan for native Hawaiians and Hawaiians is a plan involving all agencies serving Hawaiians and is mandated by HRS section 10-6.

<u>Discussion</u>

A report regarding the status of the Native Hawaiian Comprehensive Master Plan was submitted to the Legislature in January 2001. The report notes that the Native Hawaiian Comprehensive Master Plan working group was convened on July 23, 1999. A total of twenty organizations, agencies, and/or individuals participated in the first meeting. The working group met 17 times between July 23, 1999 to December 1, 2000. The group agreed to "intensive information gathering" which led to the creation of an "infrastructure for communications". The working group stated:

> "We will provide services to the Hawaiian community in a coordinated way by creating an infrastructure to combine data, integrate the work of agencies and communities to better pursue referrals to the community and coordinate communication."

Completion of a comprehensive master plan for Hawaiians is being built much in the Hawaiian fashion with attention to detail while securing resources, cooperation and commitment—a collaborative process. There is a deliberate effort to respect the autonomy of each of the participating organizations. The OHA is serving as facilitator in this effort. A date or time line to finalize the master plan with the assistance of independent consultants has not yet been agreed upon.

The report also refers to Hui 'Imi, a taskforce reauthorized by the Legislature in 1997 (Act 376, Session Laws of Hawai'i , 1997). In the fall of 2000, the Hui 'Imi Advisory Council concluded a round of discussions about their role. The Council agreed to maintain its status as Hui 'Imi and meet as part of the Comprehensive Master Plan working Group. Many of the working group participants also sit on the Hui 'Imi

Council. These efforts bring the state departments directly into the working group, allowing OHA to also meet, in part, HRS section 10-6's mandate:

> 1. To assist in the development of state and county agency plans for native Hawaiian and Hawaiian programs and services;
>
> 2. To maintain an inventory of federal, state, county, and private programs and services for Hawaiians and native Hawaiians and act as a clearinghouse and referral agency;
>
> 3. To advise and inform federal, state, and county officials about native Hawaiian and Hawaiian programs, and

coordinate federal, state, and county activities relating to native Hawaiians and Hawaiians.

Expenditure Planning

Page 12, paragraphs 2 – 3

OHA's Response

We agree that expenditures must be planned and have taken bold steps to accomplish this end.

- On November 3, 2000, OHA adopted the practice of a Total Budget Approach, which requires all funds received by OHA to be accounted and budgeted for.[1]

- On October 31, 2000, OHA adopted a Spending Policy for all of its ceded land revenues (the Native Hawaiian Trust Fund), which protects OHA's funds in perpetuity for future generations of native Hawaiian beneficiaries .[2]

Discussion

Currently, all of OHA's expenditures are subject to OHA Spending Policy and are reflected in the fiscal year operating budget. This practice requires that all expenditures be enumerated during the initial development of the budget. The net effect of this action will be to minimize the number of "unbudgeted" appropriation requests and ensure the protection of OHA's corpus for future generations.

Spending Policy

Page 12, paragraph 4

OHA's Response

The Spending Policy was created to adjust to changed circumstances and was coordinated with OHA's existing plans and policies.

OHA developed a Spending Policy while the State withheld approximately 40% of OHA's ceded land revenues in FY:00. OHA created a Spending Policy to protect the corpus for future generations and scale down expenses to meet our reduced levels of ceded land payments.

The criticism that OHA's Investment Policy should be completed concurrent with the Spending Policy is not well founded, given that the investment policy was fully activated prior to the development of the Spending Policy and was determined by our consultant, Cambridge & Associates LLP, to be fully harmonious with one another.

OHA's Investment Policy was last amended on August 1, 2000, therefore, Cambridge Associates LLP did not comment on it within their report.[3] A thorough review of all OHA policies was conducted by Cambridge.

A formal Board of Trustee "Strategic Planning Training Meeting" on February 5, 2001 is scheduled[4] and the Trustees have committed to completing the process by December 31, 2001.

Page 13, paragraphs 2 - 3

The information flow from OHA's Investment Policy[5] was incorporated in the development of the Spending Policy.[6]

Alternative Asset Allocation

<u>OHA's Response</u>

Page 13, paragraph 3

Although the contract did not specifically identify the "analysis of alternative portfolio asset allocation," Cambridge & Associates did analyze and provide the Board with that information it their report.

<u>Discussion</u>

On page 6 of the Cambridge & Associates report, they informed the Board that a variety of alternative portfolio asset allocations exist and further elaborated on what such allocations would have yielded in historical terms.

Finding #2

Expense Accounts

Page 14, paragraph 4

<u>OHA's Response</u>

We recognize improvements can be made in the use of the trustee expense accounts.

<u>Discussion</u>

Since 1999, OHA's administrative staff has implemented tighter fiscal controls to ensure that the trustee expense account (trustee allowance) expenditures are in fact used to develop and maintain an ongoing communication network with beneficiaries; to promote a broader understanding of Hawaiian issues within the

Hawaiian community and among the general public; and encourage participation in the resolution of those issues.

OHA staff will be recommending a reimbursable allowance plan as opposed to the existing policy of a prepayment at the beginning of the year. Thus, a reimbursement plan would allow for greater scrutiny of expenditures.

The Chair of the Board of Trustees will refer the policy and procedures relating to Trustee Allowance to the respective committee to propose new guidelines for reimbursable business expense controls.

Page 15, paragraph 3 and 4

Regarding the finding relating to the beauty salon services, the respective Trustee has reimbursed OHA of all related costs. It was reported by the respective Trustee that clarification on Trustee allowance expenditures was sought and the Trustee was ill advised. Upon receipt of the state auditor's report, immediate reimbursement occurred.

The finding of OHA's failure to report approximately $90 of a trustee's unspent allowance is erroneous. This trustee had made a personal contribution to her allowance fund of $1,500 during the year. Therefore, the year-end balance of approximately $90 represents a balance of personal funds rather than a balance of the annual allowance.

Protocol Funds

Page 15, paragraph 5

<u>OHA's Response</u>

The Chair of the Board of Trustees will refer the policies and procedures on OHA's protocol funds to the respective committee to propose new guidelines.

Petty Cash

Page 16, paragraph 1

<u>OHA's Response</u>

The auditor is incorrect.

All petty cash transactions are thoroughly reviewed to ensure proper fiscal management. Two refreshment check requests were prepared, paid on two separate days, and for two different community meetings held between August 6th, 11th, and 25th in Honolulu.

Discussion

Upon review of the related check request documentation, the finding regarding parceling of disbursements for refreshments is erroneous. We found that the two refreshment check requests were prepared and paid on two separate days, and were made for different community meetings. Therefore, there was no intention on the part of the requestor to circumvent the $250 disbursement policy.

The Chair of the Board of Trustees will refer the policy and procedures relating to petty cash to the respective committee to propose new guidelines.

Investment Policy Compliance

Page 17, paragraphs 1 and 4

OHA's Response

OHA's processes were flawed and since have been corrected.

Discussion

"Superior return rates" is a goal for any organization including OHA. While OHA cannot ensure "superior return rates," OHA believes that the returns achieved by OHA for the audit period are within acceptable ranges.

OHA's Native Hawaiian Trust Fund returned the following overall rate of return from 1997 to 2000:

	OHA's (%)	**POLICY BENCHMARK (%)**
1997	18.7	19.6
1998	13.0	17.7
1999	**18.4**	**13.3**
2000	–3.3	-0.6

While OHA had not hired an international money manager at the time cited, OHA did not suffer any overall losses and in fact, achieved a 5.1% unrealized gain during the audit period (1999).

Money Managers-Hire, Performance and Termination

Page 17, paragraph 4

OHA's Response

OHA disagrees with some of the findings.

Discussion

As to the delay of approximately 90 days OHA's chief procurement officer (calendar year 2000) indicated dissatisfaction with the contractual arrangement proposed by the respective money managers because the contract exposed OHA to undue liability and a lack of accountability on the part of the proposed contract.

Page 17, paragraph 5, and page 19, paragraph 4

The Board of Trustee's processes, for follow-up action on Budget & Finance Committee recommendations and the money managers reports, were flawed and processes have since been corrected.

International investments (as measured by Morgan Stanley Dean Witter's own Europe Australia Far East (EAFE) international index) performed exceptionally poorly from 1995 through 2000. Not only did international investments have more risk than our other investments they returned less than bonds during this six-year period.[7]

Salomon Smith Barney, OHA's current investment consultant, noted that accounts they "have with Bidwell in a similar strategy as OHA, were up in the month of July 2000 of approximately 1% vs. the Russell 2000 at –3.2%. Therefore, it seems difficult to see how Morgan Stanley Dean Witter and the auditor estimated a $1.3 million dollar loss."

Page 18, paragraph 5

OHA's long-term spending policy goal is considered to be OHA's long term benchmark in contrast to market relatives identified in OHA's investment policy.

Quarterly benchmarks as identified in the investment policy are currently matched with money manager's performance results and hereafter, the practice is to adjust benchmarks when warranted considering the advice of OHA's investment consultant.

The auditor claims that OHA's failure to hire international managers resulted in a loss of over $2.1 million had the contracts been executed earlier. We would suggest that the auditor's assumptions are retrospective. Lazard International's results show that from May through July, 2000 they returned 9.3% while Simms lost 4.09%. The combined income would have been a profit of 4.21% or approximately $885,000. This assumes that both managers would have invested

$34 million dollars in one day only. This does not equal $2.1 million in lost earnings on $34 million nor does it answer the question about what we actually did earn on our monies during that time. For example, the $34 million dollars in cash returned approximately 7% in interest for a total of $570,000 at no risk to the trust assets. The difference, therefore, is $330,000 in opportunity loss and not $2.1 million.

Furthermore, the auditor assumes that OHA could have executed their advisory agreements immediately without any adequate legal review whatsoever

Investment Consultant and Bank Custodian

Page 20, paragraph 1

<u>OHA's Response</u>

It is correct that the Merrill Lynch contract (former investment consultant) lapsed. However, all subsequent OHA investment consultants have executed contracts.

OHA's Investment Custodian contract with First Hawaiian Bank will be finalized before March 31, 2001.

Finding #3

Grants (GSPD)

Page 21, paragraph 2

<u>OHA's Response</u>

OHA has taken affirmative measures to address the issue of fulfillment of performance measures by grantees.

<u>Discussion</u>

Over the last eighteen months there have been significant improvements in OHA's management of the Native Hawaiian Revolving Loan Fund program and the audit report relating to the Grant program do not take into account the unique nature of the Office of Hawaiian Affairs and the applicability of certain statutes. However, we acknowledge that some of your comments have merit and in some cases we have already implemented appropriate changes.

Since the Auditor's onsite visit, a comprehensive evaluation program has been implemented. The first phase of the program was the creation of an evaluation unit within the OHA. This new unit was a fundamental change to evaluation processes in

OHA. Previously, the primary method of contract evaluation was through outsourcing of the expertise for evaluation of OHA programs. The shortcomings of such an approach are obvious and most important being the lack of a uniform process for selecting which program was to be evaluated.

As mandated by HRS section 10-3(3), the OHA is required to serve as "...the principal public agency in this State responsible for the performance, development, and coordination of programs and activities relating to Native Hawaiians and Hawaiians."

To fulfill this mandate, OHA created an Evaluation Unit in May 1999. As of December 2000, the Evaluation Unit has expanded its services to include the monitoring of OHA's grants and contracts. Monitoring ensures the proper utilization of OHA funds as agreed to by OHA and the contractor/grantee.

Monitors review progress reports and gather data as necessary to ensure that the activities of the contractor/grantee meet the agreed scope of services as specified in the contract agreement. The scope of activities/services are reviewed by their deliverables and timeline as stated in the contract. Monitors shall identify whether the contractor/grantee has fulfilled the scope of activities/services in the contract agreement and draft a report of their findings. The Evaluation Unit recommends appropriate action to the Administrator.

Furthermore, OHA tracks all grants in a centralized database that is located and administered by the Evaluation Unit.

Page 21, paragraph 2

It has been the past and current practice of OHA to require all grantees and contractors to submit a tax clearance certificate before payment is made. A legal checklist has been developed by OHA to ensure that all applicable legal and financial documents are submitted prior to contract execution.

Page 21, paragraph 3

OHA disagrees with the point that the GSPD Program can only serve native Hawaiians, that is, Hawaiians with 50% or more blood quantum because the funding source are ceded land revenues. The GSPD Program requirements[8] clearly specify that grant applicants must document the fact that funds with which to match OHA's grant funds have been secured prior to the OHA grant award.

The GSPD grant review process consists of intake, internal staff review, external community review, assessment of both reviews by staff, preparation of action items to the Board of Trustees, the Board action, and preparation of approved grant award. OHA requires that all grant proposals include a signed statement assuring services to native Hawaiians[9]. Certain assumptions are applied also. For example: Grant requests for funds for programs that perpetuate Hawaiian language and culture by their nature are deemed to provide benefits to Hawaiians.

Purchase of Services and Subsidies

Page 21, paragraphs 4, 5, and 6

OHA's Response

OHA acknowledges that some grants could be considered a purchase of services and subsidies. OHA disagrees that purchases of services or subsidies are more appropriate than GSPD grants.

Discussion

As is discussed earlier, GSPD is a community based grant process which allows OHA to serve a wide variety of grant requests and at the same time promote heavy beneficiary interaction. To illustrate the possible diversity within a grant request, and to link that with the case management for AIDS patients project mentioned in the report, it is often the case that budget proposals that are submitted by a grant applicant include a mixture of salary for staff, transportation for patients, and office equipment. It would be highly inefficient and disadvantageous to all for OHA to use a separate grant process for the salary component, a separate competitive purchase of services process for the patient transportation component, and a separate subsidy process for rent of office space and equipment for the organization.

In addition, OHA has a clear constitutional mandate in Article XII of the State Constitution and HRS Chapter 10 to better the conditions of Hawaiians through grants and financial assistance. The challenge it faces is negotiating the myriad of regulatory limitations including those recommended by the report.

For example, in studying its options, OHA had reviewed the various purchases of services methods specified HRS section 42F-401 which are described as follows:

> Section 103F-401. Methods of selection.
>
> Unless otherwise provided by law, all contracts for purchases of health and human services shall be awarded by competitive purchase of services pursuant to section 103F-402, except as provided in:
>
> (1) Section 103F-403 (restrictive purchase of services);
> (2) Section 103F-404 (Treatment purchase of services);
> (3) Section 103F-405 (Small purchases); and
> (4) Section 103F-406 (Crisis purchase of services).

Maintaining responsiveness to community needs is very difficult under competitive procurement processes listed above.

Similarly, OHA had reviewed the subsidy process required by HRS section 42F-101 and section 42F-102.

> "Subsidy" means an award of state funds by the legislature, by an appropriation to a recipient specified in the appropriation, to reduce the costs incurred by the organization or individual in providing a service available to some or all members of the public.
>
> Section 42F-102. Applications for grants and subsidies.
>
> Requests for grants and subsidies shall be submitted to the appropriate standing committees of the legislature at the start of each regular session of the legislature. Each request shall state:
>
> (1) The name of the requesting organization;
> (2) The public purpose for the grant or subsidy;
> (3) The services to be supported by the grant or subsidy;
> (4) The target group; and
> (5) The cost of the grant or subsidy and the budget.

Because subsidies have legislative origins, subsidies can be awarded annually and only if funds are appropriated by the legislature.

Page 22, paragraph 1

OHA disagrees that GSPD grants should be purchased competitively. The GSPD program is designed as community based grant program where community needs are expressed through a grant application process established.

The GSPD Program created by the Board of Trustees, in fulfillment of its constitutional mandate, is designed to be more responsive to community needs. OHA's constitutional mandate with respect to grants and financial assistance are enabled by HRS section 10-5 provided below for your information:

> Section 10-5. Board of trustees; powers and duties.
>
> The board shall have the power in accordance with law to:

(7) Provide grants to public or private agencies for pilot projects, demonstrations, or both, where those projects or demonstrations fulfill criteria established by the board;

(8) Make available technical and financial assistance and advisory services to any agency or private organization for native Hawaiian and Hawaiian programs, and for other functions pertinent to the purposes of the office of Hawaiian affairs. Financial assistance may be rendered through contractual arrangements as may be agreed upon by the board and any such agency or organization; and . .

Native Hawaiian Revolving Loan Fund

Page 22, paragraph 3

OHA's Response

Native Hawaiian Revolving Loan Fund ("NHFLF") is recognized nationally by the federal government. However, we acknowledge that improvements can be made in the area of credit checks and financial analysis.

As part of the standard loan application and approval process, loan officers do always complete credit checks and prepare financial analysis. Sections 6.A.2-8 & 6.A.2-9 of the NHRLF Operations Manual[10] requires that business information be obtained from each loan applicant, to include financial statements and a business plan, and Sections 6.A.4 through 6.A.8 describe procedures for analyzing the data and preparing a write-up for the NHRLF Loan Approval Committee. The Loan Committee, which consists of outside professionals in related fields, has the responsibility for considering the merits of each loan via written and oral presentation by the loan officer. Such presentations must and do include a financial analysis of repayment ability based on financial statements, tax returns, and projections provided by the borrower. Upon careful consideration, each loan request is approved or denied by the Committee. Section 6.A.2-4 of the NHRLF Operations Manual requires a credit check to be performed on each applicant upon verification of his Hawaiian ethnicity. OHA realizes the importance credit checks and financial analyses and will continue to insure that proper loan processing and evaluation procedures are followed.

Page 23, paragraph 1

All loan closing documents are signed by both OHA and the borrower prior to the disbursement of the loan funds. Chapter 6 of the NHRLF Operations Manual provides procedures for loan processing and closing. Section 6.A.9-5 of these procedures state that the request for the loan check is submitted to the fiscal department upon signing of the commitment letter, indicating the borrower's agreement with the loan terms and conditions. Once the NHRLF staff receives the check, the loan documents are prepared for loan closing (section 6.A.9-6). Loan officers will schedule the loan closing meeting to include both the signing of the documents along with the disbursement of the loan check and opening of a bank account for the loan proceeds. These activities are scheduled together because interest begins accruing at the loan closing date and it has proven more efficient in saving travel cost. Also, the Operations Manual states that upon signing and submission of loan documents, the NHRLF will disburse the funds within two working days (section 6.C.3). If we are to meet this requirement, the check needs to be requested prior to document signing in order to accommodate our fiscal turnaround time for producing checks. Therefore, although the check date will in most cases be prior to the date on the documents, the loan proceeds are not disbursed to the borrower until all necessary documents are executed. This is necessary in order for the NHRLF to be in compliance with its operating manual procedure for loan closings as well as to service its borrowers efficiently.

Page 23, paragraphs 3 and 4

As part of the standard loan write-up and approval process, available collateral is identified and secured §1336.67 of 45 CFR Part 1336 which states, "The taking of collateral as security should be considered with respect to each loan. Collateral security should be sufficient to provide the lender reasonable protection from loss in the case of adversity, but such security or lack thereof should not be used as the primary basis for deciding whether to extend credit" leaves determination of loan collateral requirements to the discretion of the Loan Administrator. NHRLF borrowers usually lack sufficient assets to fully collateralize their loans and is one reason they do not qualify for conventional financing. Existing procedures provide for blanket security agreements on all loans covering all of the borrower's business assets and, when available, real property is taken as additional collateral as are assets already owned by the borrower such as vehicles and heavy equipment. Key man life insurance policies are an optional requirement that may be waived by the NHRLF Loan Approval Committee under certain circumstances.

Page 23, paragraph 3

When collateral is not repossessed in a seemingly timely manner, it is usually because it has been determined that it is not in OHA's best interest, or it may be due to extenuating circumstances as in the case of the charter boat owner who was involved in a lengthy dispute with the county over the height of a bridge that prevented him from plying his trade. Efforts will continue, however, to insure collateral is recovered in an expeditious manner whenever appropriate.

Page 24, paragraphs 1 and 2

Given the nature of this program for borrowers unable to obtain financing from conventional sources, delinquencies will occur at a comparatively higher rate and collection efforts will be an integral part of loan servicing. In addition, the Federal Register states that it is not the intent to actively seek the sale or takeover of assets of a business in a loan default, but rather to encourage OHA to provide competent loan servicing and technical assistance to minimize loan defaults.[11] In order to improve servicing efficiency, in early 2000 the NHRLF completed the conversion to a new loan servicing computer software that was needed due to "Y2K" issues. The system software has a module for generating late notices, which we expect to install and set up this current fiscal year. In addition to sending late notices, the loan officers are expected to contact their delinquent borrowers for payment. The NHRLF is also currently revising its Operations Manual based on the experience obtained administering the loan fund over the past years. Chapter 7 of the NHRLF Operations Manual outlines loan collection procedures, and calls for a letter outlining possible collection alternatives be sent if payment is not received within 30 days[12]. Based on prior experiences and the nature of this unique portfolio of loans, we feel that 30 days is too soon to send a letter regarding collection procedures and are proposing a revision to the manual that will make this timing requirement more feasible. The loan officers are currently required to work with their delinquent borrowers in setting a plan to obtain payments. When all efforts are exhausted on their level, the loan is sent over to OHA's collections specialist for more extreme collection measures; this may not automatically be at the point that the account is 90-days past due. The enforcement of loan repayment is of utmost importance; however the unique nature of this program requires the loan officers to work more closely with their delinquent borrowers rather than routinely sending them to collection and taking over assets that could ultimately shut down their businesses.

Page 24, paragraph 3

Obtaining approval from the Administration for Native Americans ("ANA") on all actions to be taken on accounts over 90 days delinquent proved to be a hindrance to NHRLF collection efforts during the start-up period of the program in that valuable time was lost waiting for a response. Without objection from ANA, the NHRLF takes whatever action is necessary to handle delinquent accounts which is more efficient and meets the goal of addressing problem accounts in a timely manner. When monthly delinquency reports were initiated in 1994, copies were sent to ANA in lieu of quarterly reports as the information was more detailed and timely.

Page 24, paragraph 4

While we are uncertain which of OHA's monthly reports were "flawed and failed to identify all delinquent accounts", it may have been during the period in March 1999 when the old Loan Fund software system went down and was not restored for two months. A new loan servicing program has since replaced the old system and should prove to be more reliable.

Page 24, paragraph 5

Regarding the delinquency rate increase between fiscal years 1998 and 1999, this was a transition period during which the Loan Adjustment Specialist position, which duties include "problem" loans, was vacant for a number of months. The NHRLF has implemented tighter collection procedures and a Credit and Collections Specialist has been added in the fiscal office to assist in the handling of non-performing and "problem" loans.

Page 25

Since 1989, we have received annual funding from ANA, most recently approved for fiscal year 2001 on September 15, 2000.[13] Although ANA has the option to recover costs for losses incurred by the Loan Fund,[14] ANA must carefully review required annual audit reports along with program progress reports in order to grant annual funding. NHRLF is a federally funded program and is required to have an outside single audit performed each year. Since inception, we have passed all single audits and are compliant with federal regulations and requirements, the most recent completed on December 21, 2000.[15] We have made significant progress on our latest single audit report as compared to the previous year audit as evident by the lessor amount of citations noted. In addition, quarterly and annual ANA program progress reports are required. These annual reports are reviewed by ANA and submitted to Congress for approval of continual funding each year. All reports include specific program updates on items such as overall program highlights/impact, summary of all 90 days past due loans outstanding, Financial Status Reports, summary of loan collateral values, and measures to address total portfolio delinquency rate.[16] Since fiscal year 1999, some of the program improvements to date include a 23% decrease in our delinquency ratio, a 46% increase in disbursed loans, and the milestone approval of 400 loans totaling $17,218,227 (since inception). The combination of satisfactory annual audit reports and the major accomplishments achieved reported in our progress reports indicate to ANA the major impact the program has and will continue to make on the Native Hawaiians and to the state economy. We are confident that ANA will continue to support this program and plan to apply for continual funding via reauthorization this year.

Reorganization

Pages 25 and 26

<u>OHA's Response</u>

The reorganization of OHA initially commenced in early 1997, but was curtailed later that year. This process, however, was revived in 1999 and is still evolving.

Discussion

The reorganization of OHA was implemented to meet the needs of the beneficiaries and the goals set forth in HRS Chapter 10. An analysis of the scope of responsibility of each of the original ten divisions clearly indicated that they were severely understaffed. For example, one should not expect a division of three employees to address the Health and Human Service needs of the Hawaiian people. In addition, OHA needed to place more efforts in gathering data and information to improve planning and funding decisions.

Planning for the reorganization included an analysis of the strengths and weaknesses of each employee, goals and resources of the organization, goals and objectives of the reorganization, and management controls and reporting. While Administrative Directive 90-01 was not followed in its totality, the five-item criteria employed by the Director of Finance to review and assess organization and position organization charts and functional statements was consulted and incorporated into the reorganization planning process.

This criteria posed the five following questions:[17]

1. Does the proposed organization clearly address the needs for change identified by the department?

2. Does the organization structure provide for clear lines of communication and command?

3. Is it evident how responsibility, authority and accountability are delegated for accomplishing major program objectives assigned to the segment(s)?

4. Is there a logical division of work presented in how program objectives will be achieved?

5. Does the organization and the assignment of functions to each segment represent a reasonably efficient use of personnel?

On January 4, 1999, the Administrator communicated to the Chairperson of the Board of Trustees regarding the proposed reorganization of the agency. It was noted that this proposal represented the concept of the new structure, which essentially grouped the ten existing division into three administration divisions under the Office of the Administrator.

In addition, the recommendations for the proposed OHA reorganization presented six main concepts/desirable outcomes.[18] Of particular significance was concept five, which sought to leave the reorganization process open-ended, so that we are flexible to meet the changing conditions, needs, and trends of our beneficiaries.

The reorganization while a controversial point at all OHA levels is the key for meeting OHA's broader mandates of bettering the conditions of Hawaiians. HRS section 10-6 (Board of trustees; powers and duties) was revisited and several assumptions were made.

1. Planning would be done by OHA and at all levels, not only at management;

2. All programs and projects for Hawaiians must be evaluated;

3. An assessment of all available data on Hawaiians must be undertaken;

4. All requests, inquiries and information about and for Hawaiians needed centralization;

5. All new initiatives need to be collaborative, prioritized and part of a total plan.

The agency was organized into functional units to develop and provide the resources needed to meet OHA's mandates.

1. A planning process for all staff was developed and introduced. The process was used at all levels.

2. An evaluation Unit was established. Personnel were given extensive training in evaluation and research methodologies. A contractor formerly with the Auditor's Office remained with the Unit in the first year of evaluations.

3. A central Information and Referral Unit is being developed in the Public Information Unit.

4. A Research and Development Group was also established. The purview includes:

   a. The development of the Native Hawaiian Well-Being Model. Current plans are to take the model to community for review and comment and return to Trustees for adoption.

   b. A review of available data on Hawaiians showed only comparative data to other ethnic groups. There is no data on Hawaiians compared to other Hawaiians. Requests are in the budget process for the establishment of a Native Hawaiian relational database.

   c. A review of current research on Hawaiians is planned. It is currently in the procurement process.

   d. A review of OHA's ancestry validation program found the need to coordinate efforts with other like organizations in the problems of ancestry validation. The

Native Hawaiian Comprehensive Master Plan working group has made this one of its collaborative problem solving efforts.

On March 19, 1999, the Board of Trustees discussed whether to provide the administrator with the authority "to delineate the structure, functions, duties and responsibilities performed by each program area and define the lines of authority between program areas."[19]. This authority, in conjunction with three other areas, was granted to the administrator by a majority vote of the Board.

On April 19, 1999, the Administrator informally met with several managers on the process of placing employees into the reorganized structure of the three new divisions. The objective of this process was to provide employees with the opportunity to choose their future positions and to gain their support for the new structure and functions.

This process involved two steps:

1. Officers and employees had the opportunity to make three choices on the yellow form titled "Employment Opportunity Form"[20] and attach resumes for positions they were interested in the new offices and divisions. This form was due to the Administrator by April 12, 1999.

a. If they were accepted, the supervisor or manager of that office notified them and made a recommendation to the Administrator for approval; and,

b. If they were not accepted, they were then asked to re-apply or add other positions that were interested in.

2. If the employees were not placed in the new offices and divisions, they were retained in their current positions or asked to consider moving to an available opening with no loss of pay and benefits.

In addition, meetings were held with the reorganization planning team and the employees with the Administrator during the first six month of 1999 regarding the reorganization and its related activities.

On May 28, 1999, the Programs Systems Director informed nine program managers via the Administrator on the need to prepare Staff Transition and Training plans[21] prior to the implementation of the reorganization. The Transition Plan sought to assure current assignments were not being set aside. The Training Plan sought to provide the new employee to the new position with the knowledge, skills and abilities to effectively carry out the new assignments.

While this memorandum principally focused on the new staff coming into the Programs Systems Group, these guidelines were also applicable to other managers as well.

On June 22, 1999, the Administrator made the Staff Reorganization Presentation[22] to the Board of Trustees and the Budget and Finance Committee. This presentation discussed the present situation and the objectives of the reorganization.

Subsequent to this meeting, the new OHA reorganization was implemented on July 1, 1999 and continues to evolve based on internal operational changes and external forces.

The reorganization effort has enhanced the capabilities of staff and we believe it will continue to strengthen the organization. However, we agree that policies and procedures for effecting organizational change would be helpful. In addition, because the current organizational change began its implementation in July of 1999, the comment made by the Legislative Auditor in its report to OHA in 1990 is applicable:

> *"As can be expected in any reorganization effort, the changes created concerns among some trustees and staff. Not everyone agreed with the new structure, nor were all changes popular. Nevertheless, time is needed before their success can be measured. It would benefit the office for the trustees and staff to give these actions sufficient support in the interim."*

With regard to position descriptions and reorganization charts to be updated and reviewed prior to implementation, we believe that these comments are relevant:

The organization charts that indicated the location of new positions in the three new divisions (Administration, Programs Systems, and Hawaiian Rights) have been completed.[23]

At the time of the State Auditor's review at the end of Fiscal Year 1999, about 10% of the position descriptions were approved, as these positions were not significantly affected by the reorganization. These positions were principally in the Administration Division.

As noted in the Administrator's memorandum of January 4, 1999, one of the six main concepts/desirable outcomes was concept five, which sought to leave the reorganization process open-ended, so that we are flexible to meet the changing conditions, needs, and trends of our beneficiaries. As the reorganization process remained open-ended, position descriptions were developed and revised as new program functions were added and existing functions were amended or revised.

While 75% of the position descriptions are currently in their final stages or have been finalized in the Administration and the Hawaiian Rights divisions, about 40% of the position descriptions in the Programs Systems Division have also been completed. The 75% figure translates to 48 of a total of 63 positions and the 40% figure amounts to 11 of a total of 27 positions.

Among the three divisions, however, Program Systems has been subjected to the greatest change both from a programmatic and an operational standpoint. This division consisted of Existing Programs, Native Hawaiian Revolving Loan Fund (NHRLF), Research and Development, Economic Development, and Evaluations. These operating programs between 1999 and 2000, consisting of about 30 employees, suffered from about nine resignations and transfers of key managerial employees (4) in the Economic Development, NHRLF, and Evaluations programs, as well as the re-assignment of Research and Development Program (5) to Administration. These changes have created a situation of instability due to difficulty in securing replacements for these resignations and transfers; the need to carry on existing services, respond to new challenges; and continue to develop new knowledge, skills and abilities to meet and address these challenges. These difficulties have delayed the preparation of position descriptions due to the revision of program functions and the introductions of new functions where the need to service existing projects and programs and develop new programs and services.

We will continue our efforts to achieve stability in these programs and finalize the position descriptions for affected employees within the next six months barring unforeseen circumstances.

Page 26

As noted in our earlier response, as the reorganization process remained open-ended, position descriptions were developed and revised as new program functions were added and existing functions were amended or revised.

Major improvements to our Human Resource management practices have been recently made to further improve the capabilities of OHA. Some of these include:

- A system for the review of employee's job description and salary range,
- An employee development report program with a focus on improving work performance, teamwork, and communication,
- A merit review or pay for performance system to recognize an employee's work accomplishments, conduct and related activities,
- A means to provide across-the-board salary adjustments,
- Provided unprecedented levels of training for managers and employees,
- A system to address declining work performance at an early stage, and

Strengthened processes relating to the filling of vacancies and position action requests.

Newly Assigned Positions

OHA's Response

Our procedures require that staff meet minimum qualifications of an approved position description prior to placement into that position. These procedures have several review steps, which include the review of the duties of the position, the qualifications of the employee for that position, and related activities prior to placement.

Discussion

The specific reference in the audit report was that "...several staff working in clerical type positions were reclassified as evaluation assistants although they did not meet educational (college degree) or work experience requirement for the new position."

This statement is in error for two reasons:

1. These positions were not reclassified to evaluation assistant, and

2. The educational requirement for evaluation assistants is a high school diploma and not a college degree. The draft position descriptions for evaluation assistants I and II confirm this requirement. This requirement may have been confused with the evaluation specialists I and II descriptions, as they indicate an educational requirement of a college degree.

In addition, at the end of Fiscal Year 1999, staff was developing plans to transition from their former assignments and to receive training on their newly assigned functions. As one of the desired outcomes of the reorganization was to increase staff knowledge and abilities, a staff development program was developed to assure that training needs and opportunities could be realized.

Further, our retitling process not only reviews the duties of the position, but also assures that the employee is qualified to perform the new functions of the position. This process was installed on December 23, 1999 via the Personnel Manager's memorandum on Human Resources Management Capabilities. Item B, 6, a, (4) makes reference to the request for a current resume to verify whether the employee meets the requirements of the new position.

Lastly, as noted previously, the staff attached resumes to the "Employment Opportunity Form" that indicated their first and second choices for the positions they were interested in. When staff noted their interest for new positions that were different from their current ones, they were asked to prepare a resume for review by the supervisor of the new unit. It was this form that the employees' resume for the new positions was attached. This form and the resumes were not filed in the employee's personnel folder, but were filed separately with the employee's Transition Plan.

Our procedures require that employee qualifications be evaluated after the administrator has approved the position description. The administrator will not act favorably on "Draft" descriptions, which have not been reviewed by the supervisor, program manager, and the Personnel Manager.

Exodus of Staff

Page 26

OHA's Response

In a review of staff vacancies for the period from November 1, 1998 to December 31, 1999, 12 employees who separated from their positions were identified. Of this total, there were nine resignations, two terminations, and a death.

Discussion

A review of the reasons noted for the nine resignations were that six were responding to other employment opportunities, one reported relocating to the mainland with her family, and two did not identify a specific reason for their separation. There was one officer, ten professional specialists, and two clerical employees. Of the ten specialists, only four had more than two years of services with OHA.

It should be noted that the reorganization was not designed to eliminate division officer positions but sought to:

Improve teamwork
Improve the planning process
Provide more meaningful information to Trustees
Improve staff knowledge and capabilities
Improve community relations

Grievance Process

Page 27

OHA's Response

We intend to document a formal grievance process. While we may not have a grievance process, as reflected in the collective bargaining process, we employ a complaint process to receive and respond to employee grievances and concerns. This process has been in existence since July 14, 1998.

Discussion

Section 10-12, Assistant; staff of the Hawaii Revised Statutes states that "...Such officers and employees may be hired without regard to chapters 76 and 77, and shall serve at the pleasure of the administrator..." Instead of a grievance procedure, OHA employs the complaint process in the OHA Policy Against Sexual and Other Forms of Harassment.[24] This process advises the employee to bring the matter to OHA's personnel specialist (or staff) or in the case of a Trustee to the Chair of the Board of Trustees. The process also provides the employee an opportunity to contact the Chair of the Board of Trustees, the appropriate deputy administrator or the administrator. The Board of Trustees approved this policy on July 14, 1998.

CLOSING REMARKS

Our endnotes provide you with the list of source documents to support our statements. We would be pleased to discuss them with your staff.
To ensure our continuous high priority in responding to your recommendations, OHA will apprise you of progress on our action plans through regular status reports.

We appreciate your efforts to strengthen OHA in its mission of improving the conditions of all persons of Hawaiian ancestry. The Board of Trustees and OHA staff have recommitted ourselves to that mission for 2001 and beyond. Mahalo.

Sincerely,

Haunani Apoliona
Chairperson
Board of Trustees

Endnotes

[1] BOT Minutes of 11/3/00

[2] BOT Minutes of 10/31/00

[3] Cambridge Associates LLC, OHA Spending Policy Report, August 2000, p. 6

[4] Posted BOT Agenda for 2/5/01

[5] OHA Investment Policy approved by the BOT on 8/1/00

[6] OHA Spending Policy approved by the BOT on 10/31/00

[7] EAFE Risk return graph from 12/31/94 to 12/31/00

[8] GSPD Program Guidelines for Funding

[9] Assurance of Service to Native Hawaiians (OHA Form)

[10] OHA NHRLF Operations Manual, Chapter 6 (Loan Processing Procedures)

[11] Federal Register 45 CFR Part 1336, Discussion of the Regulation in Section 1336.68

[12] OHA NHRLF Operations Manual, Chapter 7 (Loan Collections Procedures), Section 7.C.2-3

[13] Department of Health and Human Services Financial Assistance Award (9/30/00-9/29/01)

[14] Federal Register §1336.77

[15] OHA, State of Hawai`i Single Audit Report for Fiscal Year Ending June, 2000

[16] Special Reporting Requirements for NHRLF, dated September 15, 2000

[17] State of Hawai`i Administrative Directive, No. 90-01, January 26, 1990, p. 24; Section – Proposal Narrative, Subsection F,2,a-e

[18] Memo from Administrator to Chairperson, January 4, 1999, "Proposed Organization," with attachments

[19] BOT Minutes of 03/19/99 and Action Item from Budget and Finance Committee to Board of Trustees Chairperson, March 19, 1999, including attachments

[20] OHA Employment Opportunity Form (yellow), undated, unnumbered

[21] Memorandum from Director of Program Systems to OHA Administrative Officers, May 28, 1999, forms and attachments A,B,C and D

[22] Staff Reorganization Presentation, June 22, 1999

[23] OHA Organizational Charts as of July 7, 2000

[24] OHA Policy Against Sexual and Other Harassment, approved by the Board of Trustees on July 14, 1998

February 12, 2001

EXPLANATORY NOTE

TO: Marion M. Higa, State Auditor
FROM Trustee Haunani Apoliona, Chairperson

The **preceding 30 page document signed by Chairperson Haunani Apoliona is the OHA response to the State Auditor's Report** as approved by the Board of Trustees on February 9, 2001 as follows:

Trustee Oswald Stender moved and Trustee Donald Cataluna seconded, **to forward OHA's response to the State Auditor's Report, under signature of the Chairperson, and affirm that OHA's response is the document prepared by the staff work teams, incorporating input from Trustees and the Administrator**. Voting yes were Trustees Donald Cataluna, Linda Dela Cruz, Colette Machado, Oswald Stender, John Waihe'e IV and Haunani Apoliona; voting no were Trustees Rowena Akana, Clayton Hee and Charles Ota.

The documents attached to this explanatory note are any individualized responses from Trustees, including a report provided by the OHA Administrator, pursuant to paragraph 3 of my memorandum to Trustees dated February 6, 2001 (Attached), and voted on February 9, 2001 by the Board of Trustees to be added to the Transmittal packet as follows,

Trustee Linda Dela Cruz moved and Trustee Rowena Akana seconded, **to include all other Trustees' and Administrator's report to add to the transmittal packet by 9:00 a.m., Monday, February 12, 2001**. Voting yes were Trustees Rowena Akana, Linda Dela Cruz, Oswald Stender, John Waihe'e IV and Haunani Apoliona; Voting no were Trustees Donald Cataluna and Colette Machado; Absent for the vote were Trustees Clayton Hee and Charles Ota.

Mahalo.

PHONE (808) 594-1888

FAX (808) 594-1865

STATE OF HAWAI'I
OFFICE OF HAWAIIAN AFFAIRS
711 KAPI'OLANI BOULEVARD, SUITE 500
HONOLULU, HAWAI'I 96813

February 6, 2001

To: Trustee Cataluna, Vice-Chairperson
Trustee Akana
Trustee Dela Cruz
Trustee Hee
Trustee Machado
Trustee Ota
Trustee Stender
Trustee Waihee IV

From Trustee Apoliona

Re: Extension of Deadline – State Auditor Marion M. Higa

Yesterday, in the presence of Trustee Dela Cruz, Trustee Akana advised me that she is contemplating preparation of her own individual response to certain aspects of the Auditor's report and the one day between February 7, 2001 and the deadline of February 8, 2001 would not provide her or her staff adequate time to complete that individual response.

Consequently, talked with Ms. Higa and I have attached her response.

I would welcome any and all Trustees who wish to develop their own individualized responses to get them to me no later than 9 a.m Monday, February 12, 2001 so I may attach them as part of the OHA transmittal package.

Haunani Apoliona, Trustee
Chairperson Board of Trustees

cc: Sherry Broder, BOT Attorney
Randall Ogata, Administrator

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

MARION M. HIGA
State Auditor

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

February 5, 2001

MEMORANDUM

TO: The Honorable Haunani Apoliona
Chairperson, Board of Trustees
Office of Hawaiian Affairs

FROM: Marion M. Higa Marion M. Higa

SUBJECT: Extension of Deadline

This is to confirm my agreement with your telephone request this morning (in the presence of Trustee Linda Dela Cruz), for an extension of the deadline for the Office of Hawaiian Affairs to respond to our draft report of the audit of the Office of Hawaiian Affairs. As we agreed, that new deadline will be 4:30 p.m. Monday, February 12, 2001. My deputy and I took into consideration Trustee Dela Cruz's request for a substitute extension of Thursday, February 15, 2001, but have decided to adhere to the original extension date agreed upon.

We look forward to OHA's response on February 12.

OFFICE OF

Office of Trustee Rowena Akana

FEB 12 9 10 AM '01

Memo

To: Madame Chairman Apoliona

From: Trustee Rowena M. N. Akana

Date: 02/09/01

Re: Auditor's Report Response

OFFICE OF HAWAIIAN AFF STATE OF HAW RECEIVED-B FEB 12 9 10 AM '01

Madame Chairman:

As voted on by the Board of Trustees on February 9, 2001, the attached document prepared by the Administration is to be included in the transmittal documents to be sent to the state Auditor Marion Higa's office.

Mahalo nui.

February 8, 2001

Ms. Marion M. Higa
State Auditor
Office of the Auditor
State of Hawaii
465 South King Street, Room 500
Honolulu, HI 96913-2917

Dear Ms. Higa:

We are pleased to respond to your audit of the Office of Hawaiian Affairs after previous audits by your office performed in 1990, 1993, and 1997. For your information our agency has never been stronger.

- The Native Hawaiian Trust Fund has increased from $152,409,637 (market value) in June 1993 to $330,710,564 in June 2000, a 117% increase;
- The home loan program has disbursed $11.5 million to Hawaiian homesteaders in calendar year 2000;
- OHA and the DOE have a partnership for a Hawaiian language program, Kula Kaiaupuni, to spend up to $7.5 million in five years. To educate DOE students in the Hawaiian language and continue the nationally premier program; and
- The President of the United States of America and the executive branch through the office solicitor general acknowledged a trust responsibility to Hawaiians in their brief in support of Rice v. Cayetano. This position was consistent with the position of the Office of Hawaiian Affairs.

We do agree that despite our many successes we can be better. We have reviewed your audit and offer the following comments for your consideration.

FINDING #1

THE BOARD OF TRUSTEES HAS NOT ADEQUATELY PLANNED FOR THE IMPROVEMENT OF BENEFICIARY CONDITIONS

The trustees have failed to provide OHA with the leadership and direction needed to improve the conditions of native Hawaiians and Hawaiians.

The Board of Trustees has failed to establish priorities

RESPONSE: OHA disagrees that the "Trustees have failed to provide OHA with the leadership and direction needed to improve the conditions of native Hawaiians and Hawaiians." Planning is an ongoing process of setting goals and objectives, implementing applicable activities and measuring results. The Board has undertaken efforts to improve its planning efforts.

OHA's master and functional plans are outdated

RESPONSE: OHA agrees that our master and functional plans must be updated and corrective action is underway.

DISCUSSION: The reorganization created the ability to collect and analyze data, to increase collaboration and teamwork, and to allow for staff to envision programs broader than their individual experience. In light of this organization, the Board is now positioned to more effectively plan for the future. The OHA Board has renewed its commitment and declared strategic planning as a priority for the year. They convened their first planning session on February 5, 2001. The Trustees are continuing this effort through a series of scheduled meetings.

OHA is unlikely to fulfill the legislative mandate for the development of a comprehensive master plan

RESPONSE: OHA agrees that OHA must work hard to fulfill the legislative mandate to develop a comprehensive master plan.

DISCUSSION: The Legislature through Act 147 (1999 SLH) mandated OHA to complete a Comprehensive Hawaiian Master Plan within 18 months. From the outset that timeline was unreasonable given that other agencies:

- had different levels of commitment to the planning process;
- did not send policy makers to meetings with authority to bind their agencies; and
- had yet to formulate a common vision for the future.

Despite these obstacles, OHA is committed to achieving consensus on behalf of its beneficiaries.

The Board of Trustees has not adequately planned for expenditures

RESPONSE: We agree that expenditures must be planned and have taken bold steps to accomplish this.

- On October 31, 2000 the Office of Hawaiian Affairs adopted a Spending Policy for all of its ceded land revenues (the Native Hawaiian Trust Fund),[1] which protects OHA's funds in perpetuity for future generations of native Hawaiian beneficiaries.
- On November 3, 2000 the Office of Hawaiian Affairs adopted the practice of a Total Budget Approach,[2] which requires all funds received by OHA be accounted and budgeted for.

DISCUSSION: Currently, all of OHA's expenditures are subject to OHA Spending Policy and are reflected in the fiscal year operating budget. This practice requires that all expenditures be enumerated during the initial development of the budget. The net effect of this action will be to

[1] BOT Minutes of 10/31/00.
[2] BOT Minutes of 11/3/00.

minimize the number of "unbudgeted" appropriation requests and ensure the protection of OHA's corpus for future generations.

The development of a spending policy lack coordination with other key plans and policies

RESPONSE: The Spending Policy was created to adjust to changed circumstances and was coordinated with OHA's key plans and policies.

DISCUSSION: OHA did not have the luxury of completing a master planning process prior to the development of a Spending Policy given that the State withheld approximately 40% of OHA's ceded land revenues in FY:00. Instead, OHA created a Spending Policy to protect the corpus for future generations and scale down expenses to meet our reduced levels of ceded land payments.

The auditor's criticism that OHA's Spending Policy is flawed because it was not completed concurrently with the Investment Policy is not well founded. The Investment Policy was fully activated prior to the development of the Spending Policy, was reviewed by our consultant, Cambridge & Associates, and was considered in adopting the Spending Policy.

Although OHA's contract with Cambridge Associates recognizes the close relationship between asset allocation and spending policies, it does not include the analysis of alternative portfolio asset allocation under the scope of services.

RESPONSE: Although the contract did not specifically identify the "analysis of alternative portfolio asset allocation," Cambridge & Associates did analyze this criterion and did provide the Board with that information in their report[3].

RECOMMENDATION #1

The auditor recommends that OHA improve the conditions of Hawaiians by accomplishing the following:

- Identify and prioritize its goals and objectives within the context of the Comprehensive Hawaiian Master Plan;
- Update OHA's master and functional plans so as to balance present needs for services with the long-term protection of the trust corpus. These updates in the plans should be consistent with OHA's spending and investment plans; and
- Prepare a budget reflecting the Board's priorities.

RECOMMENDATION #1 RESPONSE: On October 31, 2000 the Office of Hawaiian Affairs adopted a Spending Policy for all of its ceded land revenues (the Native Hawaiian Trust Fund),[4] which protects OHA's funds in perpetuity for future generations of native Hawaiian beneficiaries.

[3] Cambridge Associates LLC, OHA Spending Policy Report, August 2000, p. 6.
[4] BOT Minutes of 10/31/00.

- On November 3, 2000 the Office of Hawaiian Affairs adopted the practice of a Total Budget Approach,[5] which will reflect OHA's spending priorities.
- The OHA Board has determined that strategic planning is a priority. The Board convened their first planning session on February 5, 2001. They are continuing this effort through a series of scheduled meetings.

FINDING #2

THE BOARD OF TRUSTEES FAILED TO UPHOLD ITS FIDUCIARY DUTIES AND POORLY MANAGED THE PUBLIC LAND TRUST

Certain trustees misused funds

Trustee expense account funds are used for personal gain

RESPONSE: OHA agrees. Trustees are wholly accountable for their actions.

DISCUSSION: The Trustee responsible for the beauty salon services has reimbursed the OHA trust.

Inaccurate income reporting could violate Internal Revenue Code

RESPONSE: OHA agrees.

Protocol funds are inappropriately used

RESPONSE: OHA agrees and intends to take corrective action.

Petty cash funds are inappropriately parceled

RESPONSE: The auditor is incorrect.

DISCUSSION: The two refreshment check requests identified by the auditor were prepared, paid on two separate days, and for meetings held on Oahu and Maui on August 6^{th}, 11^{th}, and 25^{th}.

The Board of Trustees did not ensure compliance with OHA's investment policy

[5] BOT Minutes of 11/3/00.

Failure to hire international investment managers resulted in the loss of over $2 million

RESPONSE: OHA disagrees. The auditor is incorrect. There never was a loss of $2 million.

DISCUSSION: International investments (as measured by Morgan Stanley Dean Witter's own Europe Australia Far East (EAFE) international index) performed exceptionally poorly from 1995 through 2000. Not only did international investments have more risk than our other investments, they returned less than even bonds during this six-year period.[6]

In point of fact, had OHA hired international managers in May 2000, the following would have occurred:

- Lazard International, one of OHA's managers from May to December 2000, returned an interest rate of 9.3% for a profit of $1.5 million on $17 million invested.
- Simms Capital Management, OHA's second manager from May to December 2000, experienced a loss of 19.3% or $3.3 million on $17 million invested.

Therefore, had OHA invested in international equities from May to December 2000, OHA would have lost $1.8 million on an investment of $34 million.

What the auditor evidently fails to understand is that OHA would have been much better off if OHA had not invested in any international equity at all in 2000.

In the last four months of 2000, Lazard was down –1.1% and Simms was down –16.8%. Therefore, OHA lost approximately $3 million during these four months. This does not include what we would have made on our cash investments that were used to fund the respective managers.

Furthermore, the auditor unreasonably assumes that OHA could have executed their advisory agreements immediately without any diligent or thorough legal reviews.

Under-performing managers are not terminated in a timely fashion

RESPONSE: The Merrill Lynch report on Dennis Wong & Associates (DWA) was flawed. The report did not evaluate DWA on the basis of this style of management. Merrill Lynch has since been terminated. Subsequent OHA consultants Morgan Stanley Dean Witter and Salomon Smith Barney have both analyzed DWA. Both agree that DWA has consistently outperformed its benchmark for the trailing periods of 3 months, one year, three years and five years.

[6] EAFE Risk return graph from 12/31/94 to 12/31/00.

Large Cap Value Oriented	4th Q 99	1999	3 Years (Annualized)	5 Years
DWA	22.16%	27.25%	20.01%	21.52%
DWA Rank (Percentile)	2	4	26	49

OHA respectfully submits that DWA's management portfolio has gained 21.52% since its inception. DWA remains one of the best performing managers in the OHA portfolio.

"Morgan Stanley Dean Witter (MSDW) estimated that the Bidwell portfolio decreased by approximately $1.3 million between the time the board voted to terminate Bidwell and the time Bidwell was notified of termination."

RESPONSE: OHA disagrees with the auditor's findings. The Board decided to terminate Bidwell on July 5, 2000. Bidwell was terminated on August 8, 2000. In point of fact, during that period of time, Bidwell's portfolio gained .86% in value or $159,765.

DISCUSSION: Institutional investment managers are hired to implement a portion of an institution's overall investment strategy. Several criteria are normally implemented to determine which one of the several thousand investment managers available should be hired. Some of the criteria include:

- Past performance over an extended period of time, such as 3, 5, and 10 year performance records;
- Performance in both up and down markets;
- Overall risk characteristics of the manager's style;
- Performance relative to similar investment managers;
- The manager's ability to retain key investment professionals over time; and
- The manager's adherence to their investment style.

These criteria are not only used to hire an investment manager, but also to evaluate a manager's performance. The over-riding consideration is to remember the mandated disclaimer, "past performance is no guarantee of future performance." This disclaimer is required by the federal government (Securities and Exchange Commission) specifically to remind institutions that OHA cannot rely ***solely*** on past performance to estimate a manager's future expected performance. As fiduciaries, Trustees are expected to do more than just simplistically invest our beneficiary's funds in yesterday's hot asset classes or investment managers.

It should come as no surprise that money managers make money and lose money in the stock market. What is most important, is despite losses experienced in the stock market, the OHA portfolio has continued to experience exponential growth. Since 1993, the OHA portfolio has tripled in value. Unfortunately, both managers were not evaluated according to these principals on institutional investing.

The auditor correctly stated that much of the data needed to perform a full evaluation of Bidwell was not presented by Morgan Stanley Dean Witter. Bidwell was evaluated by MSDW on its performance for only 6 months contrary to institutional policy and procedures.

6

"Quarterly benchmarks are needed. The Board has not adopted short term or quarterly benchmarks for each of OHA's money managers. Consequently, the quarterly performance of each manager may only be compared to the long-term benchmarks established in OHA's investment policy."

RESPONSE: OHA acknowledges that quarterly benchmarks are helpful and intends to discuss this recommendation with OHA's investment consultant.

"Investment consultant and bank custodian provided services without executed contracts."

RESPONSE: OHA agrees and has taken corrective action.

RECOMMENDATION #2

The Board should fulfill its fiduciary duties and improve management of its investments by accomplishing the following:

- Assure adherence to internal policies by both staff and trustees;
- Disburse trustee expense funds on a cash-reimbursable basis;
- Comply with OHA's investment policies;
- Consider and review the investment's consultant's reports and document the reasons these recommendations are not being followed;
- Adopt quarterly benchmarks for each money manager and require OHA's investment consultants to compare money manager performance against these benchmarks on both a quarterly and annual basis;
- Timely terminate under-performing money managers; and
- Immediately secure a valid contract for OHA's bank custodian services

RECOMMENDATION #2 RESPONSE: OHA agrees and has already taken steps to implement these recommendations.

FINDING #3

THE GRANT AND NATIVE HAWAIIAN REVOLVING LOAN FUND PROGRAMS ARE POORLY MANAGED

RESPONSE: OHA disagrees.

DISCUSSION: Over the last eighteen months, there have been significant improvements in OHA's management of the Native Hawaiian Revolving Loan Fund program. The audit report relating to the Grants program does not take into account the unique nature of the Office of Hawaiian Affairs, the profile of the population we are intending to serve, and the applicability of Federal Law. However, OHA acknowledges that some of the auditor's comments have merit and in some cases we have already implemented appropriate changes.

Grant oversight needs improvement

RESPONSE: OHA agrees.

Grant Program is inappropriately used to fund purchase of services and subsidies

RESPONSE: OHA acknowledges that some grants could be considered a purchase of services and subsidies. OHA intends to comply with the State Procurement Law.

Native Hawaiian Revolving Loan Funds are disbursed without adequate review

Loan officers do not always complete credit checks and financial analysis

Funds are disbursed prior to receiving required loan closing documents

Native Hawaiian Revolving Loan Fund losses are not minimized

Loan officers' efforts to secure loans are inadequate

Collection efforts for delinquent accounts are inadequate

The Administration for Native Americans could demand that federal funds be refunded.

RESPONSE: OHA acknowledges the recommendations, but OHA submits that it is in compliance with Federal Law and Regulations governing a program that meets the needs of businesses operated by economically and socially disadvantaged native Hawaiians.

Since 1989, OHA has received annual funding from ANA, most recently approved for fiscal year 2001 on September 15, 2000[7]. Although ANA has the option to recover costs for losses incurred by the Loan Fund[8], it must carefully review required annual audit reports along with program progress

[7] Department of Health and Human Services Financial Assistance Award (9/30/00-9/29/01).
[8] Federal Register § 1336.77

reports in order to receive annual funding. NHRLF is a federally funded program and is required to have an outside single audit performed each year. Since inception, OHA has passed all single audits and complied with federal requirements. The most recent audit was completed on December 21, 2000[9] and states, "The results of our test disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards." OHA is confident that ANA will continue to support this program and plan to apply for continued funding via reauthorization this year.

The NHRLF's Operating Manual is consistent with the Federal Rules and Regulation contained in the Federal register, Volume 53, No. 122, dated Friday, June 24, 1988.

If there is any conflict between the policies and procedures of the NHRLF and the rules and regulations of the Federal Rules and Regulations, the latter shall prevail.

As part of OHA's reorganization effort, the credit and collection efforts have been moved from the Native Hawaiian Revolving Loan Fund department to our Fiscal Office. This separation of responsibility and authority is intended to improve our credit and collection process by clearly defining the role and expectation of this effort and remove potential conflict between lending and collecting.

RECOMMENDATION #3

The Board should clarify its Bylaws to require the Board Chairperson to place all items on the Board agenda within a reasonable number of days once a committee recommendation is received.

RECOMMENDATION #3 RESPONSE: By March 2001, the Board of Trustees will request the Committee on Policy and Planning to promulgate polices to adopt time limits that the Board Chairperson must place a committee's recommendation on the full Board's meeting agenda.

RECOMMENDATION #4

OHA should improve management of its grants program by accomplishing the following:

- Develop policies and procedures for awarding subsidies and purchases of services;
- Identify necessary health care services and procure them in compliance with state law; and
- Assure that contracted for services are performed and a tax clearance is received by OHA before grant funds are disbursed.

RECOMMENDATION #4 RESPONSE: OHA acknowledges that it is not possible to fund all grant requests and must establish processes to prioritize the requests, to determine the amount and timing of expenditures, and to monitor the progress of the programs funded. In addition, a process that includes a mechanism to measure whether the goals of OHA have been met as a result of making such grants or expenditures.

OHA acknowledges that some grants could be considered a purchase of services and subsidies. We plan to implement the proper procedures necessary to comply with State Procurement Law.

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[9] Office of Hawaiian Affairs, State of Hawaii Single Audit Report for Fiscal Year End June 30, 2000.

RECOMMENDATION #5

Reduce NHRLF's losses by accomplishing the following:

- Review an applicants credit history, market and financial plans as part of the loan approval process;
- Disburse loan funds only after all closing documents are received;
- Develop guidelines for determining when collateral is necessary and under what conditions it should be seized;
- Notify borrowers that they are in arrears and assess late fees as necessary;
- Notify the ANA of all loans that are at least 90 days overdue; and
- Develop accurate monthly reports of delinquent accounts.

RECOMMENDATION #5 RESPONSE: OHA is in compliance with all of the auditor's recommendations.

FINDING #4

THE ON-GOING REORGANIZATION WITHIN THE ADMINISTRATOR'S OFFICE HAS LED TO A STATE OF CRISIS

RESPONSE: OHA disagrees. The Office of Hawaiian Affairs is not in a state of crisis. At the present time, OHA's staff is at a higher level of expertise and more responsive to the needs of the beneficiaries, other Hawaiian organizations, and the Trustees, than ever before.

The reorganization was inadequately planned

RESPONSE: The reorganization was necessary, properly planned, and continues.

DISCUSSION: On March 19, 1999, by a vote of 6 to 3, the OHA Trustees authorized the Administrator to "*to delineate the structure, functions, duties and responsibilities performed by each program area and define the lines of authority between program areas.*"

The reorganization of OHA was necessary to meet the needs of the beneficiaries and the goals set forth in H.R.S. Chapter 10. An analysis of the scope of responsibility of each of the original ten divisions clearly indicated that they were severely understaffed. For example, one should not expect a division of three employees to address the Health and Human Service needs of the Hawaiian people. In addition, OHA needed to place more efforts in gathering data and information to improve planning and funding decisions.

Planning for the reorganization included an analysis of the strengths and weaknesses of each employee, goals and resources of the organization, goals and objectives of the reorganization, management controls and reporting, and involvement and support from all employees and the Board of Trustees and an implementation process.

To place the reorganization in its proper perspective, it should be noted that less than seventy employees were involved in the reorganization. Due to this relatively small number of affected employees, the Administrator was able to interview every employee that did not receive a requested assignment. During this interview, an attempt was made to balance the employees needs with OHA's needs. This type of meeting took place before implementation and continues till today.

OHA agrees with the auditor's report no. 97-7 dated February 1997, where in the auditor stated "OHA's Administrator as its principal executive is responsible for managing its operations, conducting OHA's business according to Board policies, and providing general supervision and direction of all employees."

Further, on March 10, 1999, OHA's Board Attorney, in a legal opinion requested by the Trustees recognized the role of the Administrator as the principal executive of OHA and has general managerial responsibilities over employees. The Board Attorney stated that "the Board cannot micromanage this area of the Administrator's duties…"

Lastly, OHA agrees with the legislative auditor in its report no. 90-11, dated February 1990, wherein the auditor stated *"As can be expected in any reorganization effort, the changes created concerns among some trustees and staff. Not everyone agreed with the new structure, nor were all changes popular. Nevertheless, time is needed before their success can be measured. It would benefit the office for the trustees and staff to give these actions sufficient support in the interim."*

Policies and procedures for effecting organizational change are needed

RESPONSE: OHA agrees

Not all staff may be qualified for newly assigned positions

RESPONSE: OHA disagrees.

DISCUSSION: OHA's procedures require that staff meet minimum qualifications of an approved position description prior to placement into that position. These procedures have several review steps, which include the review of the duties of the position, the qualifications of the employee for that position, and related activities prior to placement.

An exodus of key staff plagues OHA

RESPONSE: OHA disagrees. There has not been an "exodus" of "key staff" caused by the reorganization.

DISCUSSION: The auditor's statement is not accurate in implying that, "*approximately half of the former division officers had resigned,*" because of the reorganization (page 26). In point of fact, 11 employees separated from their positions between January 1, 1999 to December 31, 1999. None were division officers, ten were specialists, and one was a clerical position. Of the ten specialists, only four had more than two years of service with OHA. Reorganization began in July 1999. Currently all key staff positions are filled by highly qualified individuals.

To avoid the picture that the auditor is painting and to improve OHA's capabilities, OHA has implemented a number of improvements to its Human Resource management practices such as:

- A system for the review of employee's job description and salary range;
- An employee development report program with a focus on improving work performance, teamwork, and communication;
- A merit review or pay for performance system to recognize an employee's work accomplishments, conduct and related activities;
- A means to provide across-the-board salary adjustments;
- Provisions for unprecedented levels of training for managers and employees;
- A system to address declining work performance at an early stage; and
- A strengthened process relating to the filling of vacancies and position action requests.

Lack of grievance process places OHA at risk of litigation

RESPONSE: OHA disagrees.

DISCUSSION: OHA employs a complaint process to receive and respond to employee grievances and concerns. This process has been in existence since July 14, 1998.

RECOMMENDATION #6

The Board should adopt policies for accomplishing organizational change. These procedures should require:

- An assessment of the organizations strengths and weaknesses and the purpose intended to be accomplished by the reorganization;
- A timeline for implementation;
- A revised organizational chart identifying all positions and titles; and
- Accurate position descriptions and minimum qualifications required for each position.

RECOMMENDATION #6 RESPONSE: OHA intends to research the administrative directives, audit recommendations, and reorganization guidelines during 2001.

RECOMMENDATION #7

The immediate development and approval by the Board of an employee grievance policy.

RECOMMENDATION #7 RESPONSE: OHA intends to consider the creation of an employee grievance policy.

CLOSING REMARKS

Thank your for allowing us to add to, comment on, and clarify the Findings of the audit report. We consider the issues that you have brought to our attention to be serious and plan to take appropriate action to address those issues within our scope of authority. You concluded in your 1993 audit that "OHA has initiated several significant programs and has demonstrated its ability to implement programs that are progressive and beneficial to the native Hawaiians and Hawaiians." We have demonstrated that we continue to build upon this effort today. The Office of Hawaiian Affairs remains committed to fulfilling its fiduciary duties in managing its portion of ceded land trust and more importantly the betterment of conditions of Hawaiians and native Hawaiians.

OFFICE OF HAWAIIAN AFFAIRS

February 8, 2001

Memorandum

TO: Madame Chair Haunani Apoliona

FR: Trustee Rowena Akana

CC: ADM Ogata; CFO Bolte

RE: Recommendations Relating to the Discussions on the State Auditor's Draft Report at the February 7, 2001 Board of Trustees Meeting.

Dear Madame Chair Apoliona:

To reiterate my concerns relating to the State Auditor's draft report brought up in yesterday's executive session I am summarizing my comments below:

Past Audits/Deloitte & Touche (Reference Page 2 of OHA's Response)

- It is important to look at past audits by the state auditor's office along with the 1999 audit of OHA by Deloitte and Touche.
- Management of Grants Program.
- Four provisos to create grants were inserted into the budget: (1) Alu Like, (2) Na Pua Noeau, (3) Waianae Diet, (4) Native Hawaiian Legal Corporation.
- These four provisos will now be subjected to future audits.

Money Managers

- Inaccuracies must be corrected. The reference to the Chairman firing Merill Lynch is inaccurate. Language must be inserted to reflect that the contract for Merill Lynch was not renewed.
- In terms of hiring the international money mangers, it is inaccurate to say that because of the delay in procuring the contracts that OHA suffered a loss of $2.1 million, therefore, I believe that this language should be deleted.

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Native Hawaiian Revolving Loan Fund (Reference Page 3 of 23 of OHA's Response)

- No federal guidelines given to the state auditor's office. Instead they only asked for the applications of the loan applicants.
- Feds do not require collateral.
- Feds already audit this program on an annual basis.
- The Administration for Native Americans (ANA) has, on numerous occasions, referred to OHA in testimony to the United States Congress.
- The auditors wrongly compared this lending program (NHRLF) to the standards of a commercial lending institution, which it is not.
- The ANA forgave twenty-nine (29) default loans in the amount of $1,094,703.00 in October 1999. Moreover, in October 1995, the ANA also forgave 52 loans in the amount of $1,737,106.00.
- It has not been said that these loans that are being offered are considered to be "high risk." It is the position of NHRLF that applicants must show proof of being denied a loan from no less than two commercial lending institutions.
- Further, the Board of Trustees of the Office of Hawaiian Affairs does not administer this program. Independent people, including those with commercial banking experience oversee this program.
- The purpose of this program is to loan monies to those considered "high risk."

Frequency of Audits

- To audit the Office of Hawaiian Affairs again in 2000 is unusual, as we were last audited in 1997.

Reorganization of the Board of Trustees (Page 4)

- On March 19, 1999, the Board of Trustees voted, in a 6 to 3 vote, to authorize the Administrator to reorganize. The "clarified" statement regarding this board action was then added to the policy manual.

Grants

- The line items that were included in the budget should not be considered grants at all because of the amount of money that OHA is giving to these various organizations. In the spirit of accuracy, more correct terms for these organizations should be "service providers" as OHA contracts out services so that these organizations can conduct its mission and purpose.

Grants, Services, Purchases, Donations (GSPD)

• The Master plan is obsolete. It is better for OHA to give out as much money as needed to 501 (c) 3 non-profit organizations that service areas that are referred to in the Master plan such as Health and Human Services, culture, language, etc.

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OFFICE OF HAWAIIAN AFFAIRS
STATE OF HAWAII
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MEMORANDUM

DATE: February 12, 2001

TO: Marion Higa
Board of Trustees
OHA Administrator
OHA Attorney

FROM Clayton Hee
Member, Board of Trustees

RE Audit Report

On Friday, February 10, 2001, Trustee Dela Cruz made a motion that the OHA Board of Trustees transmit the response from the Chair, the Administrator's response (pink papers) and "any other responses from trustees." The motion was carried by a majority of the Board members present.

Attached, please find a response to the Ms. Marion Higa, State Auditor from me. Please include my four pages of concerns to Ms. Higa and include my response with any distribution to the press and/or others in the general public (should such a distribution take place).

Lastly, please be advised that the original document has been hand delivered to Ms. Marion Higa, State Auditor.

Thank you

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February 12, 2001

Ms. Marion M. Higa
Office of the Auditor
State of Hawaii
465 South King Street, Room 500
Honolulu, HI 96913-2917

Dear Ms. Higa

I respectfully request you give serious consideration to making the following changes to the audit draft for the Office of Hawaiian Affairs. The changes recommended are because the audit statements below are incorrect or misleading. I have attached data that supports my statements for your information.

1. **Failure to hire international investment managers resulted in the loss of over $2 million (page 17)**

Your report states that OHA's investment policy **required** trustees to invest in international equities as early as 1995 (para 3). It was always the **intent** to invest in international equities but only after such time that the international investment universe was profitable.

The audit states the untimely implementation of this policy has resulted in the **significant loss of potential earnings** (para 3). This statement is misleading and false. It implies that if OHA had invested in international monies earlier, OHA would have earned a profit of 2 million dollars.

The truth of the matter is that International investments (as measured by Morgan Stanley Dean Witter's own Europe Australia Far East (EAFE) international index) performed exceptionally poor from 1995 through 2000. Not only did international investments have more risk than our other types of equity investments international investments returned less than even fixed income bonds during this six-year period.[1]

[1] EAFE Risk return graph from 12/31/94 to 12/31/00

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2. **The report states that the chief procurement officer (also the board's chair) failed to execute a contract with these firms in a timely manner (para 5).**

The fact is the contracts were immediately signed after a thorough review by the OHA Board Attorney, not unlike state government contacts that are signed only after a thorough review by the Office of the Attorney General. In addition, the amount of funds called for by the two contracts was 34 million dollars, a significant quantity of trust funds.

Issues such as "best execution and best price" as well as "jurisdiction of venue" were time consuming for the respective attorneys involved. Moreover, after the Budget and Finance Committee made their recommendation to the Board, the Board of Trustees requested that representatives for the two firms (Simms and Lazzard) avail themselves at a Board meeting. Obviously, logistical arrangements added to a time delay. After a check with the Attorney General's Office OHA concludes that the time involved was not unreasonable given the amount of trust funds at risk.

In point of fact, if OHA had hired international managers in May 2000 (as the report suggests it should have), the following would have occurred:

Lazard International, (one of OHA's two international managers) returned an interest rate of 9.3% for a **profit of $1.5 million** on $17 million invested from May to December 2000.

Simms Capital Management (OHA's second international manager) experienced a **loss of 19.3% or $3.3 million** on $17 million invested from May to December. Consequently, **OHA would have lost $1.8 million** on its total investment of $34 million.

To illustrate the point further, OHA did invest 34 million dollars by September 2000. Since that time (and for the period September through December 2000), Lazard International lost 1.1% and Simms Capitol Management lost 16.8%. **Therefore, OHA lost approximately $3.3 million during those four months.**

In hindsight, OHA would have been much better off if OHA had not invested in any international equity at all in 2000.

3. Under-performing managers are not terminated in a timely fashion

The Budget & Finance Committee terminated Denis Wong & Associates (DWA) in August 1997. When I was informed (as Board Chair) I requested the Chair of the Budget & Finance Committee (Abraham Aiona) to reconvene a Budget & Finance committee meeting and decide what to do with the funds managed by DWA upon termination. I requested the Chair to consider making one or more of the following recommendations: hire another manager, divide the funds amongst existing OHA managers, place the funds in certificates of deposits or keep the funds in cash. As it turned out the Budget & Finance committee did not have the time to make any recommendations to the Board Chair as by October 1997 the Board of Trustees was reorganized and Trustees DeSoto and Beamer replaced the Board Chair as well as the Budget and Finance Chair respectively. Interestingly enough, the new leadership did not follow up with the previous action.

4. Our analysis is that Denis Wong & Associates as compared to OHA's investment policy has indicated that it continued has to under-perform (para 3).

The Merrill Lynch consultant report on DWA was flawed. The report did not evaluate DWA on the basis of their style of management. Merrill Lynch has since been terminated. Subsequent OHA consultants Morgan Stanley Dean Witter and Salomon Smith Barney have both analyzed DWA. Both consultant firms agree that DWA has **consistently outperformed its benchmark** for the trailing periods of 3 months, one year, three years and five years.

Large Cap Value Oriented

	4th Q 99	1999	3 Years (Annualized)	5 Years
DWA	22.16%	27.25%	20.01%	21.52%
DWA Rank (Percentile)	2	4	26	49

OHA respectfully submits that DWA's management portfolio has gained 21.52% since its inception. DWA remains one of the best performing managers in the OHA portfolio.

5. **"Morgan Stanley Dean Witter (MSDW) estimated that the Bidwell** portfolio decreased by approximately $1.3 million between the time the **board voted to terminate Bidwell and the time Bidwell was notified of termination" (page 19).**

RESPONSE: OHA disagrees with the auditor's findings. The Board voted to terminate Bidwell on 7/5/00. The OHA Administrator on 8/8/00 terminated Bidwell. During that period of 34 days, Bidwell's portfolio **gained** .86% in value or **$159,765**.

DISCUSSION: Institutional investment managers are hired to implement a portion of an institution's overall investment strategy. Several criteria are normally implemented to determine which one of the several thousand investment managers available should be hired. Some of the criteria include:

Past performance over an extended period of time, such as 3, 5, and 10 year performance records;
Performance in both up and down markets;
Overall risk characteristics of the manager's style;
Performance relative to similar investment managers;
The manager's ability to retain key investment professionals over time; and
The manager's adherence to their investment style.

Since these are the criteria used to hire an investment manager they are also typically used for the purpose of evaluating a manager's performance. The over-riding consideration is to remember the mandated disclaimer, **"past performance is no guarantee of future performance." This disclaimer is required by the federal government (Securities and Exchange Commission) specifically to remind institutions that OHA cannot rely *solely* on past performance to estimate a manager's future expected performance.** As fiduciaries we are expected to do more than just simplistically invest our beneficiary's funds in yesterday's hot asset classes or investment managers.

It should come as no surprise that money managers make money and lose money in the stock market. What is most important is despite losses experienced in the stock market the OHA portfolio as a whole has continued to experience exponential growth. Since 1993, the **OHA portfolio has tripled in value**. Unfortunately, both managers were not evaluated according to these principals on institutional investing.

As the auditor correctly stated much of the data needed to perform a full evaluation of Bidwell was not presented by Morgan Stanley Dean Witter. In point of fact, Bidwell and Riddle was evaluated by MSDW on its performance for **only 6 months** contrary to institutional policy and procedures.

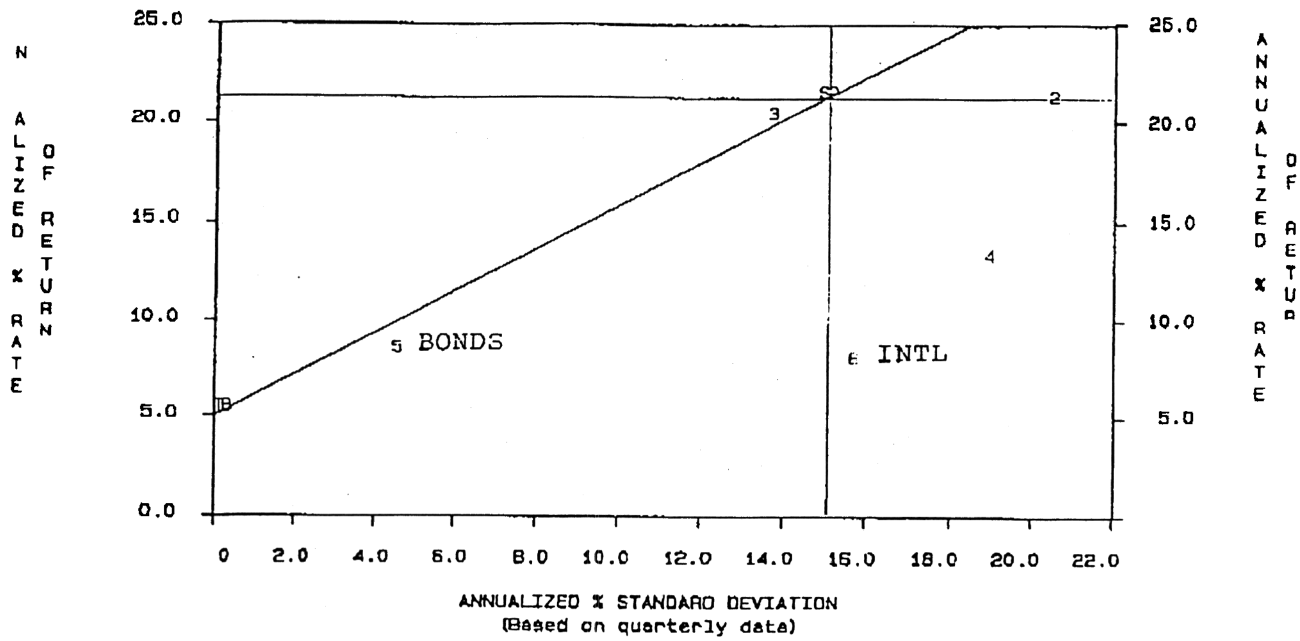
Thank you for your consideration of these changes.

Yours truly,

Clayton Hee

CLAYTON HEE
OHA Trustee

12/31/1994 - 12/31/2000



The Risk/Return Graph depicts the amount of volatility associated with the quarterly rates of return generated by the investment advisor. Annualized rates of return are depicted on the vertical axis and volatility on the horizontal axis.

From 12/31/1994 to 12/31/2000

LABEL	MANAGER	SECTION	ANNUALIZED STD. DEVIATION	ANNUALIZED RETURN
SP	S&P 500		15.06	21.34
2	RUSSELL 1000 GROWTH INDEX		20.50	21.12
3	RUSSELL 1000 VALUE INDEX		13.76	20.24
4	RUSSELL 2000 SMALL STOCK INDEX		18.96	13.15
	LEHMAN BROS. GOVT/CORP BOND INDEX		4.58	8.30
6	MORGAN STANLEY EAFE INDEX - NET		15.72	7.81
TB	90-DAY TREASURY BILLS		0.22	5.27

[redacted]

ATTACHMENT 4

OFFICE OF HAWAIIAN AFFAIRS

REC VED
FEB 12 12 PM '01
OFC. OF THE AUDITOR
STATE OF HAWAII

February 12, 2001

Ms. Marion Higa
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813

RE: Office of Hawaiian Affairs Audit Response

Dear Ms. Higa:

This letter is a follow up on our meeting this morning and the matter of Trustee Hee's memo to you that he personally delivered on Friday, February 9, 2001. In his memo to you and conversation with you, he indicated that the "pink" document represented the response of the Board to your audit of the Office of Hawaiian Affairs. As we discussed, I also wish to clear up the matter of my signature appearing on the "pink" document attached to Trustee Apoliona's transmittal packet, which is the response of the majority, to your audit.

The document delivered by Trustee Hee does not represent the response of the majority and was to be delivered to you as an <u>attachment</u> to the transmittal packet from Chairwoman Haunani Apoliona. I signed the "pink" document only to indicate that I was aware of the document and that it was to be <u>attached</u> to Trustee Apliona's response to you. I <u>do not endorse</u> the "pink" document response.

The letter signed by Trustee Apoliona, along with its transmittal packet, is the response adopted by the majority of OHA's trustees. A majority vote of 6-3 was taken at the Board of Trustees Meeting held on February 9, 2001.

711 Kapi'olani Boulevard, Suite 500, Honolulu, Hawai'i 96813-5249
Phone 808 594-1888 • Fax 808 594-1865

Ms. Marion Higa
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February 12, 2001

It is unacceptable that Trustee Hee would deliver this document to you and state that it was the official response of the majority when he knew, in fact, that it was not. Trustee Hee was at the meeting of the Board when the majority vote was taken in favor of Trustee Haunani Apoliona's signed response. I think it is appalling that Trustee Hee would attempt to mislead you in this most serious matter.

Sincerely,

Oswald K. Stender
Trustee, Office of Hawaiian Affairs

oks:lad

cc Trustee Haunani Apoliona, Chairwoman
Trustee Rowena Akana
Trustee Donald Cataluna
Trustee Linda Dela Cruz
Trustee Clayton Hee
Trustee Colette Machado
Trustee Charles Ota
Trustee John Waihe'e IV
Randall Ogata, Administrator
Sherry Broder, OHA Board Attorney