Follow-Up on Recommendations Made in Report No. 13-02, *Audit of the Department of Hawaiian Home Lands' Homestead Services Division*

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

Report No. 16-04
April 2016

THE AUDITOR
STATE OF HAWAI‘I

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaiʻi 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 other investigations and prepare additional reports as directed by the Legislature.

Under its assigned missions, the office conducts the following:

1. **Management audits** (also called **performance audits**), which examine the efficiency and/or effectiveness of state-funded programs. These are also called *program audits* when they focus on whether programs are attaining their expected objectives and results, and *operations audits* when they examine how well agencies are organized and managed, and how efficiently they acquire and use resources.

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

3. **Procurement audits**, which focus on agencies' procurement of goods and services, and assist the Legislature in overseeing government procurement practices.

4. **Analyses of proposed special and revolving funds**, which determine whether proposals to establish new special funds meet statutory criteria.

5. **Reviews of existing special, revolving, and trust funds**, which determine whether these existing funds continue to meet statutory criteria.

6. **Sunrise analyses**, which evaluate new regulatory measures that, if enacted, would subject unregulated professions and vocations to licensing or other regulatory controls. Before a new professional or occupational licensing program can be enacted, statute requires that the measure be analyzed by the Office of the Auditor as to its probable effects.

7. **Sunset evaluations**, which evaluate recently enacted professional and occupational licensing programs to determine whether they should be terminated, continued, or modified. The evaluations are conducted in accordance with criteria established by statute.

8. **Health insurance analyses**, which examine bills proposing to mandate certain health insurance benefits. Prior to enactment, such bills cannot be referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

9. **Audit recommendations follow-ups**, which review the status of recommendations made in prior audit reports. Statute requires the Auditor to report to the Legislature annually on each audit recommendation more than one year old that has not been implemented by an audited agency.

10. **Special studies**, which respond to requests from both houses of the Legislature. Studies typcially address specific problems for which the Legislature is seeking solutions.

Hawaiʻi's laws provides the Auditor with broad powers to examine all books, records, files, papers, and documents as well as all financial affairs of every agency that receives state funding. 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
STATE OF HAWAIʻI
Kekuanaoʻa Building
465 S. King Street, Room 500
Honolulu, Hawaiʻi 96813

Follow-Up on Recommendations Made in Report No. 13-02, *Audit of the Department of Hawaiian Home Lands' Homestead Services Division*

Report No. 16-04, April 2016

Office of the Auditor
465 S. King Street
Rm. 500
Honolulu, HI 96813
Ph. (808) 587-0800

Jan K. Yamane
Acting State Auditor
State of Hawai'i

As of November 2015, the department had 4,996 loans valued at nearly $612 million in its portfolio.

The 2008 Legislature amended the Auditor's governing statute to require follow-up reporting on recommendations made in various audit reports to ensure agency accountability over audit recommendations. The purpose of this change was to apprise the Legislature annually of recommendations not implemented by audited agencies, and to require such agencies to submit a written report not later than 30 days after issuance of our report explaining why the recommendation was not implemented and the estimated date of its implementation.

DHHL's Loan Administration Has Improved, but Lack of a Risk Ceiling Remains a Concern

Our review focused on the Department of Hawaiian Home Lands' (DHHL) implementation of 20 audit recommendations made in our 2013 Report No. 13-02, *Audit of the Department of Hawaiian Home Lands' Homestead Services Division*. This report details each recommendation, its status, and actions taken related to the recommendation. We deemed five recommendations closed (25 percent), four open (20 percent), ten open but in progress (50 percent), and one open and not likely to be pursued (5 percent).

Commission did not meet fiduciary duty to provide loan program risk guidance

Our 2013 audit found the Hawaiian Homes Commission, as a whole, may not have understood its role as fiduciary and did not assert its authority to set loan program risk policies for the department. Managing loan risk is a key function of the Hawaiian Homes Commission, but we found the commission lacked strategic perspective on loan risk. As a result, the commission had not exercised appropriate leadership and oversight of the department's loan programs. Instead, it assumed loan liabilities without understanding the risk associated with the department's direct loans. We also found the extent of delinquent loan risk was not reflective in department reports to the commission. Departmental policies governing direct loans were vague and internal controls governing loan collections and monitoring compliance with commission orders were weak.

The department has provided clearer guidance but the commission has not followed suit

Our follow-up review found the commission has taken steps to implement 15 of the 20 recommendations but has not actually implemented any of them. The commission has not established a risk management plan and does not have any direct involvement in adopting policies or procedures re-lated to the issuance of direct loans, delinquent loan collections, or monitoring contested case hearing orders. The department has, however, more clearly identified staff responsibilities for collecting and monitoring delinquent loan-related contested cases through amendments to the department's loan policies and procedures manual. It has also established financial requirements for direct loan applicants and reassessed and adjusted departmental direct loan interest rates to help identify qualified loan candidates and to provide financial relief for borrowers. However, the department continues to provide monthly reports to the commission that do not fully reflect the severity of loan delinquencies. The department argues its current reporting method is based on industry practices. However, the department is drafting an additional quarterly report.

For the full text of this and other reports, visit our website: http://auditor.hawaii.gov/

Follow-Up on Recommendations Made in Report No. 13-02, *Audit of the Department of Hawaiian Home Lands' Homestead Services Division*

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

Submitted by

THE AUDITOR
STATE OF HAWAI'I

Report No. 16-04
April 2016

Foreword

This is a report on our follow-up review of the recommendations we made to the Department of Hawaiian Home Lands in Report No. 13-02, *Audit of the Department of Hawaiian Home Lands' Homestead Services Division,* released in April 2013. We conducted our work pursuant to Section 23-7.5, Hawai'i Revised Statutes, which requires the Auditor to report to the Legislature on each recommendation the Auditor has made that is more than one year old and has not been implemented by the audited agency. We wish to express our appreciation for the cooperation and assistance extended to us by the Hawaiian Homes Commission chair and the Department of Hawaiian Home Lands' management, staff, and others whom we contacted during the course of our review.

Jan K. Yamane
Acting State Auditor

Table of Contents

List of Exhibits

Chapter 1
Introduction

To ensure agency accountability over audit recommendations, the 2008 Legislature amended the Auditor's governing statute to require follow-up reporting on recommendations made in various audit reports. The purpose of this change was to apprise the Legislature of recommendations not implemented by audited agencies. Section 23-7.5, Hawai'i Revised Statutes (HRS), now requires the Auditor to report to the Legislature annually on each audit recommendation more than one year old that has not been implemented by an audited agency.

Legislative Request

The 2008 Legislature intended to provide itself greater oversight over the implementation of audit recommendations. Act 36, Session Laws of Hawai'i (SLH) 2008, was modeled after a 2006 California law that enabled legislators to use agencies' claims of progress against audit recommendations in their budget discussions.

The Hawai'i Legislature asked the Auditor to report annually, for each unimplemented recommendation: (1) the agency that was audited; (2) the title and number of the audit report containing the recommendation; (3) a brief description of the recommendation; (4) the date the audit report was issued; and (5) the most recent explanation provided by the agency regarding the status of the recommendation.

In addition, agencies notified by the Auditor that a recommendation is considered not implemented must submit a written report to the Auditor, the Senate president, and the speaker of the House of Representatives within 30 days of being notified by the Auditor. The report must also include an explanation of why the recommendation was not implemented and an estimated date of when it will be implemented.

Objectives of the Review

1. Validate the claims made by the Department of Hawaiian Home Lands regarding implemented audit recommendations.

2. Report to the Legislature on audit recommendations not yet implemented.

Criteria

We relied on Chapter 23, *Auditor*, HRS; *GAO-07-731G Government Auditing Standards*, U.S. Government Accountability Office (GAO), December 2011 Revision; and *How to Get Action on Audit Recommendations*, U.S. General Accounting Office, July 1991, in the conduct of our review.

The GAO's criteria are especially useful for our purposes, since GAO also reports on the status of recommendations not fully implemented. GAO's reports are intended to "help congressional and agency leaders determine the actions necessary to implement the open recommendations so that desired improvements to government operations can be achieved." In particular, GAO reports on whether:

- Monitoring and follow-up are done by staff members responsible for, and knowledgeable about, the recommendation;
- Each recommendation is followed up on an ongoing basis, with at least semi-annual updates, and an individual recommendation follow-up plan is developed for each assignment; and
- Results intended by each recommendation and benefits expected from its implementation are defined as a basis for determining the adequacy of implementation.

Scope and Methodology

We based our scope and methodology on GAO's guidelines in *How to Get Action on Audit Recommendations* (1991). According to GAO, saving tax dollars, improving programs and operations, and providing better service to the public represent audit work's "bottom line." Recommendations are the vehicles by which these objectives are sought. However, it is action on recommendations—not the recommendations themselves—that helps government work better at less cost. Effective follow-up is essential to realizing the full benefits of audit work.

Our review, conducted between November 2015 and March 2016, focused on the Department of Hawaiian Home Lands' implementation of our recommendations in Report No. 13-02, *Audit of the Department of Hawaiian Home Lands' Homestead Services Division*, which we issued in April 2013. We followed standard office procedures for conducting reviews pursuant to the Office of the Auditor's *Manual of Guides* and generally accepted government auditing standards. Those standards require that we plan and perform our work to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions, based on our objectives. We believe the evidence we obtained provides a reasonable basis for our conclusions based on our review objectives.

Determining progress

The rate of progress of a recommendation's implementation depends on the type of recommendation. While some fall fully within the purview of an audited agency and can be addressed relatively quickly, others may deal with complex problems and involve multiple agencies, resulting in a long implementation period. Therefore, ample time should be afforded to agencies implementing recommendations in order for a follow-up system to be useful and relevant.

With those observations in mind, we have determined an active follow-up effort is most effective and relevant if conducted three years after publication of an initial audit report. Too short an interval between audit report and follow-up might not give agencies enough time to implement a complex recommendation; too long might allow agencies to lose valuable personnel and institutional knowledge needed to conduct an adequate follow-up.

This review included interviews with selected administrators, managers, and staff from the department. We examined the department's policies, procedures, records, and relevant documents to assess and evaluate whether its actions adequately fulfilled our recommendations. Our efforts were limited to the inquiry, testing, and reporting on implementation of recommendations made in Report No. 13-02. We did not explore new issues or revisit old ones that did not relate to our original recommendations. Site visits and observations were conducted as needed to achieve our objectives.

Identifying key recommendations

Our practice is to make an effort to follow up on all audit recommendations. However, the extent of work done to verify implementation depends on the significance of individual recommendations. For instance, GAO notes that while all audit recommendations should be aggressively pursued, some are so significant that added steps are needed to implement them. The significance of a recommendation depends on its subject matter and the specific situation to which it applies. Significance can be addressed in terms of dollars; however, dollars are only one measure, and not necessarily the most important one. For instance, recommendations to ensure safe operations often take precedence, since their implementation could prevent the loss of life, substantial bodily injury, or environmental contamination.

Closing recommendations

In accordance with GAO guidelines, we consider recommendations "closed" for the following reasons:

- The recommendation was effectively implemented;
- An alternative action was taken that achieved the intended results;
- Circumstances have so changed that the recommendation is no longer valid; or
- The recommendation was not implemented despite the use of all feasible strategies.

While these and other guidelines provide the basic ground rules for our review efforts, we recognize that effective follow-up needs to be tailored to particular recommendations and the results they seek.

Definition of terms

1. ***Closed***: Recommendation has been addressed and implemented.
2. ***Open***: Work on the recommendation has not started or cannot start because a precursor event has not occurred.
3. ***Open but in progress***: Agency has taken action, but implementation of the recommendation is not complete.
4. ***Open and likely not to be pursued***: Agency has no intention of pursuing implementation of the recommendation.
5. ***Not applicable***: Recommendation is no longer applicable.
6. ***Did not assess***: Did not assess recommendation implementation.

Summary of recommendations

Of the 20 recommendations in Report No. 13-02, five were deemed closed (25 percent), four were open (20 percent), ten were open but in progress (50 percent), and one was open but not likely to be pursued (5 percent). Exhibit 1.1 shows the status of the 20 recommendations.

Exhibit 1.1
Status of Recommendations in Report No. 13-02, *Audit of the Department of Hawaiian Home Lands' Homestead Services Division*

Status of Recommendation	No. of Recommendations	Percent of Total
Closed	5	25%
Open	4	20%
Open but in progress	10	50%
Open and not likely to be pursued	1	5%
Not applicable	0	0%
Did not assess	0	0%
Total	**20**	**100%**

Source: Office of the Auditor

This page is intentionally left blank.

Chapter 2

DHHL's Loan Administration Has Improved, but Lack of a Risk Ceiling Remains a Concern

Our follow-up review found that the commission has yet to engage in any meaningful action to develop risk policies for the Department of Hawaiian Home Lands' (DHHL) direct loan program. However, the department has made progress in implementing recommendations to provide greater loan administration guidance. This includes addressing problems with loan application criteria, loan case file access, and unclear responsibilities relating to monitoring contested cases. We also found improved departmental accountability for ensuring the terms of decision and orders are fulfilled. However, the department still does not provide adequate loan delinquency information to the commission for members to make informed decisions affecting loan risk exposure.

Background on Report No. 13-02

Our 2013 audit of the department's Homestead Services Division (HSD) was requested by the Legislature under a proviso in Act 106, Session Laws of Hawai'i 2012. The audit was to include or address: (1) the total amount of the direct, insured, and guaranteed loans, related delinquencies, issues relating to the processes and procedures of the direct and indirect loans, and their impact on the department's mission and goals; (2) responsibilities of the division that are not adequately achieved due to inadequate resources; (3) issues relating to the division's strategic and financial plan, its budgeting process, and its process of forecasting financial needs to address its loan program; and (4) the method for determining priorities for expenditures for the division.

Commission did not meet fiduciary duty to provide risk guidance to loan program

In Report No. 13-02, *Audit of the Department of Hawaiian Home Lands' Homestead Services Division*, we found the commission, as a whole, may not have fully understood its role as fiduciary and as a consequence, did not assert its authority to set loan program risk policies for the department. Lacking guidance, the commission was unable to ensure the Hawaiian Homes Commission Act (HHCA) was administered on behalf of all beneficiaries of the trust, instead favoring those who held leases. As of June 2011, there were roughly 9,200 beneficiary leases and nearly 26,200 on the lease wait list. As of June 2014, the wait list had grown 4.4 percent to more than 27,300 applicants, while the number of homestead leases rose nearly 7 percent to more than 9,800.

Further, the commission had assumed loan liabilities without recognizing and mitigating loan risks. We found the commission lacked a strategic perspective on loan risk, even though the management of such risk was a key function of the commission. As a result, the commission did not articulate how much potential liability for defaulted mortgages the commission would allow the department to assume. Ultimately, the commission fell short of fulfilling its fiduciary duty to exercise "such care and skill as a person of ordinary prudence would exercise in dealing with one's own property in the management of Hawaiian home lands," as required by the HHCA and the department's administrative rules.

Our 2013 report also found that the department had vague policies and few standards governing its direct loans; and neither the department's loan issuance nor its collection efforts took into account the high-risk nature of those loans. The department lacked strong internal controls governing loan collections and monitoring of compliance with commission orders, and did not coordinate the oversight of either, which resulted in a lack of accountability for chronically delinquent lessees.

Finally, we found the department had not brought the severity of the delinquency issues to the attention of the commission. In turn, the commission inappropriately exercised its discretion by not cancelling leases of chronically or seriously delinquent homesteaders. By doing so, the commission provided long-term tenancy to beneficiaries, but undermined other goals of the HHC Act, such as enhancing economic self-sufficiency and placing Native Hawaiians on the land in a prompt and efficient manner.

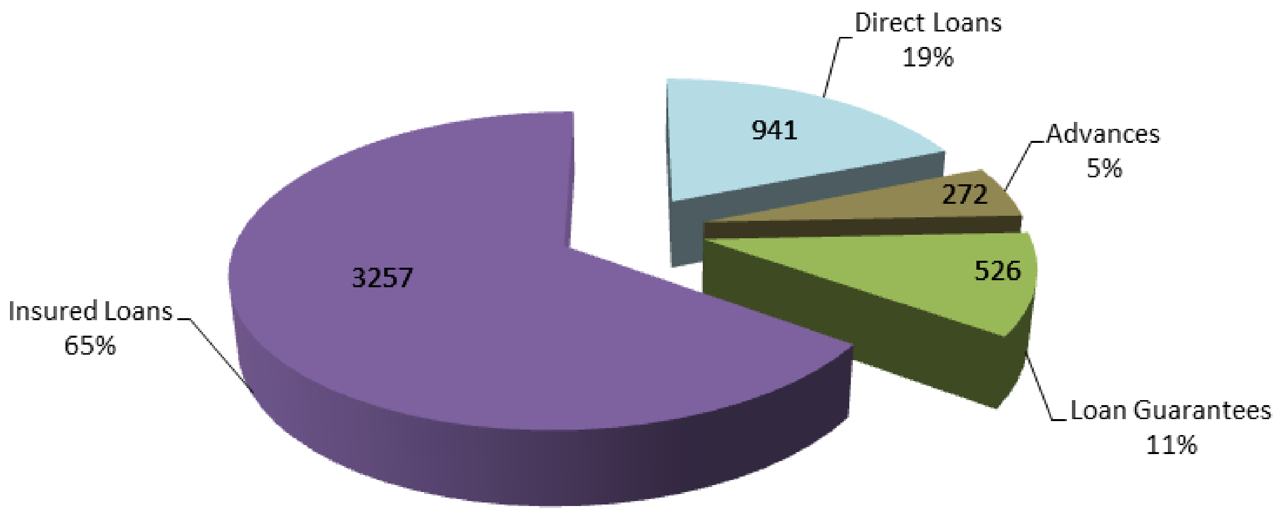
Status of Recommendations

Report No. 13-02 included 20 recommendations to the Hawaiian Homes Commission, the department, the Homestead Services Division's Loan Services Branch, and the Office of the Chairman's Compliance and Community Relations Sections Enforcement Team (E-Team). Our follow-up review found steps have been taken to implement 15 of the 20 recommendations (75 percent).

Commission has yet to establish a risk management plan

A key focus of our 2013 audit was direct loans because they pose the highest and most immediate financial risk to the department. As of November 2015, the department had 4,996 loans valued at nearly $612 million in its portfolio. Exhibit 2.1 illustrates that the department's 941 direct loans constituted roughly 19 percent of all its loans as of November 2015.

Exhibit 2.1
DHHL Loans by Type as of November 2015



Source: DHHL and Office of the Auditor

We made three recommendations to the commission to fulfill its fiduciary role by acknowledging and mitigating loan risk. First, we recommended adoption of a risk management plan with an appropriate risk appetite to support a sustainable direct loan program. Best practices define risk appetite as the amount of risk, on a broad level, an organization is willing to accept in the pursuit of its objectives.[1]

Our 2016 follow up work found that the commission chair, who also serves as the department director, said the department had not developed a risk management plan for its loan portfolio. Department administrators and the commission have not collaborated to develop a risk appetite for the issuance or administration of direct loans, according to the deputy director and the acting HSD administrator. No action has been taken in part because of a significant turnover in commissioners since the release of the audit report, according to the commission chair; three of the nine commissioners on the panel in 2013 remained as of February 2016. The commission chair added, however, that there are ongoing efforts to educate commission members about the department's loan portfolio.

The commission chair told us a new quarterly delinquency report is being developed that identifies delinquent direct loans that pose a potential financial risk to the department. She said the department also is looking to procure the services of an actuary to help identify financial risks in the department's loan portfolio. We found the new delinquency

[1] *Enterprise Risk Management, Understanding and Communicating Risk Appetite*, Committee of Sponsoring Organizations of the Treadway Commission, January 2012.

report identifies direct loan cases in which the total unpaid loan balance exceeds the assessed property value of a lessee's home. In the event of a cancelled loan, the department would have to write off the difference as a loss. The commission chair said she would like to present the report to the commission in April 2016 and that the data would help members understand the financial risks in the department's loan portfolio. However, because the report had not been finalized, and there was no timeframe for procuring actuarial services, we deem Recommendation No. 1 **Open**.

Second, our 2013 audit recommended the commission adopt and disseminate risk guidance through policies, procedures, and performance goals relating to issuing direct loans, collecting delinquent payments, and monitoring contested case hearing decisions and orders. The department has since amended its 2012 loan policies and procedures manual to include additional direct loan underwriting guidance. Upon review, we found the manual includes loan qualification standards that align with the department's administrative rules, procedures for addressing each category of delinquency, and the assignment of responsibilities to the HSD's Loans and Services Branch and the E-Team to monitor the contested case hearing process.

However, the manual's contested case monitoring guidance does not fully identify who is responsible for overseeing specific stages in the contested case process once the commission issues a decision and order. Further, the manual does not contain clear risk policies and it is unclear whether the updated manual has been reviewed and approved by the commission. The acting HSD administrator said the department intends to present the manual to the commission by June 2016 and that discussions are ongoing to determine whether the manual and its policies must be approved by the commission; the commission chair concurred. Because we found no clear evidence of the commission's involvement in updating the manual, or that it has established clear risk policies, we deem Recommendation No. 2 **Open.**

Third, we recommended the commission comply with administrative rules by managing Hawaiian home lands with the same amount of care and skill as a prudent person would exercise when dealing with their own property. This includes cancelling leases when lessees do not comply with commission orders. In response, the department cited a resolution adopted by the commission in 2013 stating that the commission accepts an inherently high-risk direct loan program in order to fulfill the mission of the land trust. The resolution also states that lease cancellation has been vigorously pursued in unresolved defaulted loans cases. However, the resolution does not establish a risk appetite or set an acceptable level of risk to guide the department's operations. Risk tolerances communicate a degree of flexibility while risk appetite sets a limit beyond which additional risk should not be taken.

Our follow-up review also found that the department and the commission differ as to whether lessees should be allowed to stay on the land when they do not comply with the terms of the commission's decision and orders. The E-Team administrator told us the commission rejects recommendations to cancel leases of lessees who violate the commission's decision and orders "90 percent of the time." However, the E-Team administrator said his office does not keep statistics on such occurrences. The commission chair would not comment on whether the commission typically rejects the E-Team's lease cancellation recommendations. Such decisions are made on a case-by-case basis, she said. Therefore, since the department was unable to provide data to show the commission cancelled non-compliant leases in the prudent manner required by state law and departmental rules, we deem Recommendation No. 3 **Open**.

DHHL is providing improved loan administration guidance to loan officers

In 2013, we recommended the department and HSD's Loan Services Branch develop procedures outlining the contested case process and staff responsibilities for collecting and monitoring delinquent loan-related contested cases. Our follow-up review found the department has amended its loan policies and procedures manual and included a contested case hearing flow chart that provides improved clarity to the process. However, we found the manual still does not clearly identify who is responsible for monitoring and enforcing the commission's decisions and orders. The department also has a separate and more comprehensive contested case process chart that includes post-decision and order activities and specifies monitoring and enforcement duties of the HSD and the E-Team. However, the tracking flow chart and accompanying procedures were not included in the manual. Therefore, we deem Recommendation Nos. 6, 9, and 19 **Open but in progress**.

We also recommended the department prevent inconsistent practices among collection staff by adopting a manual with criteria for reviewing and approving loan applications that includes risk rating and credit counseling for loan applicants, procedures for enforcing actions against chronically delinquent lessees, and clearly written collection procedures for each phase of delinquency. Further, we recommended HSD ensure loan officers adequately analyze applications and only recommend loans for financially capable applicants. As previously noted, the department has added a direct loan underwriting section to its loan policies and procedures manual with financial requirements for loan applicants that include income and credit history. Loan personnel review and analyze the financial information and forward applicants deemed satisfactory to the Loan Services Branch (LSB) manager and HSD administrator for review. Final approval is made by the commission chair. Therefore, we deem Recommendation No. 11 **Closed**.

However, there is still no risk rating in the manual. And while financial counseling services are offered to lessees who become delinquent, the services are not automatically provided because of the high cost of these services. Therefore, we deem Recommendation No. 7 **Open but in progress**.

Our 2013 audit found the department and the commission had not reassessed departmental loan interest rates since 1995 and used an outdated method to calculate household expenses when determining loan eligibility. This raised concerns the department may have issued loans to borrowers who could not afford them. Our follow-up review found that in November 2012 the commission approved a policy change to reduce the interest rate for new direct loans from 6 percent to 4.5 percent and to annually evaluate and adjust the rate as warranted. Therefore, we deem Recommendation No. 14 **Closed**.

We also recommended DHHL provide clearly written collection procedures to employees after we found that a collection specialist in the HSD's East Hawaiʻi District Office performed unsupervised and undocumented collection activities that did not comply with department procedures. We recommended the department establish policies and procedures for chronically delinquent lessees, and re-institute clear written collection procedures for each phase of the delinquency process to ensure all staff follow the same procedures. Our follow-up review found the East Hawaiʻi District Office employee continued to perform collection activities until retirement in October 2015. Subsequently, all statewide collection accounts are serviced by Oʻahu staff. The department also amended its Loan Policies and Procedures manual to include separate collection procedures for delinquent lessees that fall within 30-, 60-, and 90-days past due categories. However, the manual still requires district office personnel to perform collection duties for neighbor island accounts not monitored by the LSB and there are no plans to eliminate the now-vacant East Hawaiʻi District Office collection specialist position. Therefore, we deem Recommendation Nos. 8 and 10 **Open but in progress**.

Our 2013 audit found a number of loan files were missing key documents and in some cases, files were found outside the secured filing area. In keeping with best practices, we recommended HSD's Loan Services Branch adopt a system of controls and documentation standards, require documentation of all collection activity, properly maintain loan files, and periodically review income analysis and interest rates policies. Our follow-up review found the department's loan policies and procedures manual requires fiscal office staff to produce a monthly delinquency report, which serves as the primary method for tracking direct loan delinquencies. These monthly reports identify loan delinquencies by 30-, 60-, 90-, 120-, and 180-days past due categories. The manual also requires all collection activities be recorded in an electronic "collection card." Our follow-up review also found that loan case files are now stored electronically, enabling staff access to documents through their computers instead of retrieving hard copy files. Hard copies of loan case files are stored in a secured room and can only be accessed by designated staff members with electronic key cards. Therefore, we deem Recommendation No. 13 **Closed**.

The department also said delinquency goals are included in the annual performance appraisals for mortgage loan and collection specialists, which we verified. However, as previously noted, the commission has not established a risk management plan and our follow-up review found no risk appetite statement in the manual. Best practices define risk appetite as the amount of risk on a broad level, an organization is willing to accept in the pursuit of its objectives.[2] Once risk appetite is established, an organization should develop risk tolerances to guide operational actions. We could not assess whether the performance appraisal delinquency rate goals are within the department's acceptable risk limits because DHHL has not identified a level of acceptable risk. Therefore, we deem Recommendation No. 12 **Open but in progress**.

Our 2013 audit also found the department did not maintain a complete docket of contested case files and the only way to determine the status of a contested case was to review individual case files. We recommended the E-Team ensure the status of each contested case was available and readily obtainable. Our follow-up review found that E-Team staff can now electronically monitor the status of a contested case through the department's print statement code system and the use of a contested case tracking system flow chart. Based on these developments, we deem Recommendation No. 20 **Closed**.

Commission is still not receiving reports needed to make informed loan risk decisions

Our 2013 audit report recommended the department change its reporting methods in order to provide the commission with better loan delinquency information needed to make informed decisions on loan risk exposure. The recommendations urged the department to create a more effective report to assist the commission in quickly understanding the true position of the department's direct loans and the status of delinquent loans in the contested case process. In response, the department is developing a new quarterly report that identifies delinquent direct loans that may become "write off" losses in the event of cancellation. The commission chair

[2] *Enterprise Risk Management, Understanding and Communicating Risk Appetite*, Committee of Sponsoring Organizations of the Treadway Commission, January 2012.

said the report will be a starting point to help commissioners identify the financial risks of DHHL's loan portfolio. However, we found the report had not been finalized or presented to the commission as of February 2016. We also found the department no longer provides contested case reports to the commission. Therefore, we deem Recommendation Nos. 4 and 5 **Open but in progress**.

We also recommended the department automate its delinquency reports to ensure management and the commission received critical information necessary for identifying deficiencies and weaknesses in delinquent loan collections. To address our recommendation, the department provided a Request for Proposals (RFP) it issued in 2010, before we commenced our audit in 2012. The RFP sought a contractor to provide the department with loan servicing, including generating and mailing monthly billing statements for loan accounts and transmitting real-time loan account transaction and status reports to department staff. The RFP responses contained annual cost estimates of between $106,000 and $235,000, which the acting HSD administrator said were too costly for the department. He said the proposal may be revisited if the department can afford such costs at a future date. Therefore, we deem Recommendation No. 16 **Open**.

Our 2013 audit also found the method the department used to categorize delinquent loans in monthly delinquency reports to the commission did not provide a clear picture of the duration or the severity of loan delinquencies. The department said this practice followed industry practice by categorizing delinquencies by the number of missed monthly payment installments, rather than by the duration of the delinquency. Under this system:

- One missed monthly payment falls within a 30-days past due category;
- Two missed monthly payments falls within a 60-days past due category;
- Three missed monthly payments falls within a 90-days past due category; and
- Four or more missed monthly payments falls within a 120-days past due category.

DHHL has not altered this reporting practice, according to the acting HSD administrator. Further, we found that the current delinquency report clouds the severity of delinquencies. Delinquent loans that should be categorized as 120-day and 150-day delinquencies are now included in the report's 90-day category, according to a DHHL Fiscal Office accountant. As a result, borrowers with four to five missed payments have been placed in a category labeled for lessees with only three missed payments. The change was needed to accommodate the addition of a 180-day past due category, which the department considers as severely delinquent.

Working with the department's fiscal office, we compiled delinquent direct loan data to determine the actual number of missed payments for each loan. As of June 30, 2015, there were a total of 237 delinquent direct loans. We recorded the total number of missed payments by each of these borrowers as of June 30, 2015, then contrasted the results with the department's method of reporting direct loan delinquencies. We found the department's 120-days or more past due category includes lessees who missed anywhere from four to as many as 300 payments. Still, the department made clear it will not change its current delinquency reporting method. Therefore, we deem Recommendation No. 15 **Open and not likely to be pursued**.

Department allows financial options for delinquent lessees, but has not explored wage assignment as a collection measure

Our 2013 audit recommended the department formalize all unwritten payment plans in keeping with best practices. Direct loan repayments are expected to be timely so that funds can be used to provide new loans. Therefore, improved loan collections help ensure that the maximum number of beneficiaries can be assisted. We recommended the department use salary assignments and garnishments as a means to improve collections and that DHHL consider providing lessees with debt restructuring options such as reduced interest rates and loan maturity date extensions. Our follow-up review found the commission approved a new financial tool in August 2013 that provides options for lessees to reduce their loan interest rate and refinance their loans. The loan refinancing option is only offered to borrowers who make monthly mortgage payments for 12 consecutive months. We also found that a lessee who qualifies for loan refinancing will receive a new loan that consolidates outstanding delinquent payments and erases the lessee's delinquency record. Because the department offers debt restructuring options through its streamlined refinance loan options, we deem Recommendation No. 18 **Closed**.

Our follow-up review also found that whenever a department mortgage loan specialist adjusts a borrower's monthly mortgage as part of a repayment plan, a letter with the new terms is provided to the borrower. The acting HSD administrator said this replaces the previous practice in which mortgage loan specialists documented changes to payment terms within loan files without providing a hard copy to the lessee. The acting HSD administrator said garnishments are not pursued by the department because delinquencies are addressed through contested case hearings. Once the administrative process is exhausted, court proceedings may take place in the event a lease is cancelled. Wage garnishments are typically the result of a legal action or order. As of February 2016, 20 loan accounts were forwarded to the Department of the Attorney General; however, the acting HSD administrator said he did not know whether garnishments were pursued.

Regarding our recommendation to pursue collections through wage assignments, the department said it inquired with the Department of Accounting and General Services (DAGS); however, the department stated that DAGS was unable to receive electronic payments. Therefore, the recommendation could not be implemented. However, our follow-up review found that the Department of Budget and Finance (B&F) was the appropriate agency to assess whether DHHL could utilize wage assignments to pursue payments from delinquent lessees. B&F said such wage assignments could be done in consultation with the Department of the Attorney General. The funds custody manager of the B&F Treasury Section said electronic fund transfer instructions and guidance are provided to all state departments that expect to receive such payments, which are called Automated Clearing House payments. Because wage assignments remain a viable option that the department has not fully explored, we deem Recommendation No. 17 **Open but in progress**.

RECOMMENDATION	PURPOSE	STATUS	COMMENTS
Recommendations to the Hawaiian Home Lands Commission			
(1) Adopt and communicate a risk management plan, including developing an appropriate risk appetite that can support a sustainable direct loan program; risk appetite should be considered when approving all loan requests.	A key function of the Hawaiian Homes Commission is managing loan risk and identifying how much potential liability for defaulted mortgages the commission allows the department to assume. The commission had not considered risk appetite when formulating loan risk policies for the department.	**Open**	The commission chair said there is no risk management plan for DHHL's loan portfolio. According to the deputy director and the acting HSD administrator, DHHL administrators and the commission had not collaboratively developed a risk appetite for the administration of direct loans.
(2) Adopt and disseminate policies, procedures, and performance goals relating to direct loan issuance, delinquent loan collections, and monitoring contested case hearing orders.	The commission lacked strategic perspective on loan risk by having neither articulated a risk appetite nor adopted loan underwriting or policies for analyzing direct, guaranteed, and insured loan obligations, or monitoring loans.	**Open**	DHHL amended its loan policies and procedures manual on direct loan issuance, delinquency, and monitoring; however, there was no indication the commission participated in making these changes.

RECOMMENDATION	PURPOSE	STATUS	COMMENTS
Recommendations to the Hawaiian Home Lands Commission			
(3) Comply with administrative rules requiring "the exercise of such care and skill as a person of ordinary prudence would exercise in dealing with one's own property in the management of Hawaiian home lands," including cancelling leases where loans are not in compliance with commission order.	When exercising trust powers, each commissioner is required to apply the prudent person rule. Statute defines prudent person as one who is reasonable and equitable in the view of the interests of the beneficiaries. Failing to collect delinquencies or cancelling accompanying leases was contrary to the trustee duty of impartiality.	**Open**	The E-Team administrator said the commission typically rejects E-Team recommendations to cancel leases for lessees who violate commission orders. The commission chair said the commission makes such decisions on a case-by-case basis.
Recommendations to the Department of Hawaiian Home Lands			
(4) Coordinate resources of the Loan Services Branch and Fiscal Office to provide the commission with adequate information to make informed decisions on loan risk exposure.	The extent of delinquent loan risk was not reflected in department reports to the commission. The branch did not provide sufficient monthly delinquent loan totals or perform meaningful analysis of direct loan profitability. As a result, the commission was unaware of the potential impact of its decision-making and was unable to meet its fiduciary duty to mitigate loan risk exposure.	**Open but in progress**	DHHL is developing a new quarterly report that identifies loans that are potential "write-offs" in DHHL's direct loan program. The report is in draft form.
(5) Require Fiscal Office and Homestead Services Division to create a more effective report that allows commissioners to quickly understand the true position of DHHL's direct loans; and provide more financial information so commissioners have a more complete picture of the status of delinquencies in the contested case process, including the status of each contested case.	The duration of time that loans were delinquent was not reported to the commission. Lacking effective and timely reporting, the commission could not understand the true position of the department's direct loan exposure or provide leadership via informed decision-making.	**Open but in progress**	DHHL is developing a new quarterly report that identifies loans that are potential "write-offs" in DHHL's direct loan program. The report is in draft form . The commission chair plans to procure the services of an actuary to identify risk areas in DHHL's loan portfolio, but no timetable was provided.

RECOMMENDATION	PURPOSE	STATUS	COMMENTS
Recommendations to the Department of Hawaiian Home Lands			
(6) Develop policies and procedures outlining the contested case hearing process, including procedures on how the department carries out the commission's orders to ensure lessees comply with their terms and conditions.	DHHL lacked a tracking system to monitor contested cases and was not monitoring delinquent lessees' compliance with the commission's decision and orders. DHHL lacked policies and procedures for monitoring compliance with the commission's decision and order. As a result, DHHL could not assure compliance with commission orders.	**Open but in progress**	DHHL amended its loan manual to specify which staff are responsible for monitoring compliance with the commission's orders and enforcement. However, the manual does not specify whether LSB or E-Team staff are responsible for follow-up actions in the contested case process.
(7) Require the Homestead Services Division's Loan Services Branch to adopt a manual with criteria for reviewing and approving loan applications, including policies and procedures requiring a risk rating and credit counseling for each loan applicant.	The LSB's loan policies and procedures were vague. Consequently, loan specialists were given broad discretion when conducting their analysis and may have been recommending loan approval for financially incapable lessees.	**Open but in progress**	DHHL added a direct loan underwriting section to its loan manual that includes financial requirements for loan applicants. However, the manual lacks any risk rating of loan applicants and financial counseling is only offered but not required for delinquent lessees.
(8) Require HSD's Loan Services Branch to establish policies, procedures, and enforcement action for chronically delinquent lessees.	HSD lacked a system for coordinated oversight of chronic and serious loan delinquencies. Loan collection policies and procedures were vague and responsibilities were unclear.	**Open but in progress**	DHHL included a section on direct loan underwriting in its loan manual with added loan applications, collections, and contested case hearings guidance. However, the manual lacks formal procedures on risk rating or credit counseling for new home buyers. Financial services for delinquent lessees are not required.

RECOMMENDATION	PURPOSE	STATUS	COMMENTS
Recommendations to the Department of Hawaiian Home Lands			
(9) Require HSD's Loan Services Branch to clearly outline the responsibilities of branch staff in collecting on delinquent loan-related contested cases.	By not tracking compliance with commission orders, the HSD, E-Team, and the commission chair were unaware of the compliance status of each loan case; therefore, such issues were not brought to the attention of the commission.	**Open but in progress**	DHHL amended its loan manual to include separate delinquent loan collection procedures for the LSB. However, the manual does not provide clear guidance on contested cases as to who is responsible to follow-up on actions once the commission has issued its decision and order.
(10) Require the HSD's Loan Services Branch to reinstitute clear written collection procedures for each phase of delinquency to avoid inconsistent practices among collection staff.	Contrary to best practices, DHHL's loans manual had vague instructions on dealing with delinquencies. A loan collection specialist at the department's East Hawai'i District Office was engaged in unsupervised collection activities that did not follow department procedures.	**Open but in progress**	DHHL amended its loan manual to include procedures to provide guidance for more delinquent loan categories. The loan collection specialist at the East Hawai'i District Office retired in October 2015. However, that position has not been eliminated even though all statewide collection accounts are now serviced by O'ahu staff.
(11) Require HSD's Loan Services Branch to ensure loan officers adequately analyze applications and only recommend loans for financially capable applicants.	Loan specialists had few criteria for determining whether the DHHL should issue a direct loan. Consequently, loan specialists had broad discretion to evaluate and recommend loan approval.	**Closed**	DHHL's added financial requirements allow staff to evaluate the financial viability of direct loan applicants within DHHL's loan standards.

RECOMMENDATION	PURPOSE	STATUS	COMMENTS
Recommendations to the Department of Hawaiian Home Lands			
(12) Require HSD's Loan Services Branch to document standards and objectives regarding delinquent loan collections.	Loan collection policies and procedures were vague and unclear.	**Open but in progress**	DHHL's amended loan manual requires borrowers to agree to and follow a repayment action plan at each stage of a delinquency. However, the manual does not include a risk appetite or risk tolerances.
(13) Require HSD's Loan Services Branch to require complete and accurate documentation of collection activity, and ensure loan officers properly file and maintain loan files in accordance with best practices.	More than half of the loan files we reviewed were missing collection status information regarding delinquent borrowers. A failure to record all collection activity risks a lack of documented evidence for contested case hearings and other legal proceedings.	**Closed**	All collection activities by mortgage loan specialists and E-Team staff are documented in the department's electronic "collection card" system. Loan case files can be accessed electronically and there are 11 employees authorized to access a secured room with hard copy files.
(14) Require HSD's Loan Services Branch to periodically review policies governing income analysis and interest rates to determine whether they meet program goals.	DHHL and commission had not reassessed loan interest rates since 1995. We also found an estimate used to calculate household expenses for determining loan eligibility was not updated for a decade.	**Closed**	The commission approved in 2012 to change the DHHL's interest rate policy to 4.5 percent for direct loans. The annual rate will be reviewed for possible adjustment each calendar year.
(15) Require HSD's Loan Services Branch to redefine how delinquent loans are characterized as 30, 60, 90, and 120 days delinquent.	DHHL's Fiscal Office reports classified delinquencies by the number of missed payment installments rather than the number of days a loan was past due. Follow-up actions depended upon the category of delinquency.	**Open and not likely to be pursued**	According to the acting HSD administrator, the department's delinquency reporting method is a standard housing lending industry practice, and the department will continue to use this method.

RECOMMENDATION	PURPOSE	STATUS	COMMENTS
Recommendations to the Department of Hawaiian Home Lands			
(16) Require HSD's Loan Services Branch to customize automated delinquency reports to ensure management and the commission receive critical information needed to identify deficiencies and weaknesses in delinquent loan collections and take prompt action to remedy them.	The commission chair told us the DHHL's way of reporting delinquencies did not give the commission an accurate picture of the duration and severity of delinquencies. A Fiscal Office accountant said DHHL's computer system was not designed to handle a loan collection function.	**Open**	DHHL solicited bids in 2010 to procure a contractor to provide loan servicing, but determined such cost to be prohibitive.
(17) Require HSD's Loan Services Branch to formalize unwritten payment plans and use salary assignments and garnishments.	A majority of the loan sample we reviewed did not include information on the status of the loans or whether lessees were making efforts to pay past due amounts. The ability to effectively collect loan installments is vital to ensure funds are used to issue more loans.	**Open but in progress**	Mortgage loan specialists are now required to provide a letter to borrowers whenever loan repayment terms are changed. DHHL refers certain delinquent loans to the Department of the Attorney General, which may garnish wages as an option. However, DHHL did not contact the appropriate agency to assess whether wage assignments were a viable option.
(18) Require HSD's Loan Services Branch to consider debt restructuring when repayment under current terms and conditions is doubtful; such actions may include reducing the interest rate of the original loan, extending the loan's maturity date and re-amortization, and/or reducing accrued interest.	DHHL and commission had not reassessed loan interest rates since 1995 and an estimate used to calculate household expenses for determining loan eligibility has not been updated in a decade. This raised concerns the branch may have underestimated the cost of living and miscalculating lessees' ability to pay off loans.	**Closed**	The commission in 2013 approved new financing options that provide an opportunity for lessees to lower their monthly mortgage through a refinance of their loan as well through a reduction in the interest rate.

RECOMMENDATION	PURPOSE	STATUS	COMMENTS
Recommendations to the Department of Hawaiian Home Lands			
(19) Require the Office of the Chairman's Compliance and Community Relations Section's Enforcement Team to outline its responsibilities in monitoring delinquent loan-related contested cases.	HSD's acting administrator said the E-Team was responsible for monitoring compliance with the commission's orders. However, the E-Team contended that the Loan Services Branch had that responsibility. The commission chairman stated that both were responsible.	**Open but in progress**	DHHL amended its loan manual to identify department staff responsible for monitoring compliance of the commission's orders and which staff is responsible for enforcement.
(20) Require the Office of the Chairman's Compliance and Community Relations Section's Enforcement Team to ensure that information needed to obtain the status of each contested case is available and readily obtainable.	DHHL did not maintain a complete docket of contested cases. E-Team members did not track orders related to loan delinquencies and efforts to develop a database to track delinquent loan contested cases had stagnated.	**Closed**	DHHL's electronic print statement code system and a tracking chart allow E-Team and Loan Services Branch staff to obtain the status of each loan in the contested case process.