



**Housing and Community Development Department
Affordable Housing Program
Housing Development Division**

Preliminary Report on Restrictive Covenant Compliance and on the
Monitoring and Lottery Selection Processes

March 15, 2006



INTERNAL AUDIT DIVISION

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Background, Purpose and Scope

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Background

The County of Santa Barbara Housing and Community Development Department (hereafter referred to as "HCD") administers several programs that provide affordable housing options to eligible residents of Santa Barbara County. These programs consist of the Inclusionary Housing Program, Density Bonus Program, Homebuyer Assistance Program (HAP), and the Housing Rehabilitation Loan Program. The Housing Development Division oversees the Inclusionary Housing and Density Bonus Programs while the Housing Finance Division manages the Homebuyer Assistance and Housing Rehabilitation Loan Programs.

The County of Santa Barbara...administers several programs that provide affordable housing options to eligible residents.

Purpose and Scope

The purpose of our examination is to address suspected weaknesses in the Affordable Housing Program. Our examination, thus far, has focused on the Housing Development Division. Our work has been limited to verifying affordable unit owner compliance, on a sample basis, with restrictive occupancy and rental covenant clauses. Additionally, we have conducted a preliminary assessment of HCD's lottery selection process for new affordable units. This report includes the conditions noted during our initial examination of the Division as of March 15, 2006.

In the coming months, we will continue our examination of the Affordable Housing Program and its component units. Based on the preliminary findings identified thus far, our test work will expand to include verification of owner occupancy and compliance with rental clause restrictions for *all* affordable units. We will evaluate the effectiveness of HCD's compliance monitoring procedures and violation enforcement practices. We will also continue our assessment of the accuracy and efficiency of the HCD lottery selection process.

The final phase of our work will include a thorough examination of the Housing Finance Division. We will determine the effectiveness of the internal controls designed by management to properly fund and track the loans made under its various programs.

This is a preliminary report and should not be construed as a comprehensive assessment of the Affordable Housing Program. The purpose of this report is to provide an interim summary on owner covenant compliance and HCD process weaknesses noted as of March 15, 2006. A preliminary report is not intended to express an opinion on the overall effectiveness of the internal controls designed by management nor on the covenant compliance by all program participants, and accordingly, we do not express such an opinion. However, our examination has included sufficient inquiries, observations, and tests of records to provide a basis for our preliminary findings and to enable us, where appropriate, to recommend changes to procedures to assist management in achieving its objectives. A comprehensive report will be issued upon completion of our examination.

Our examination, thus far, has focused on the Housing Development Division.

Preliminary Findings and Recommendations

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Restrictive Covenants: Occupancy and Rental

Summary of Process

A resale restrictive covenant (hereafter referred to as the “covenants”) is executed by each home buyer of an affordable unit. The restrictions principally limit the resale price of an affordable home, set income thresholds for future buyers, require owner occupancy, and prohibit rental of the units. The covenants vary by development, but the intent is consistent to ensure the units remain affordable for a determined amount of time.

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Procedures Performed

The Specialty and Advanced Accounting Division of the Auditor-Controller’s Office assisted HCD in compiling a preliminary inventory of 395 affordable housing units. From this inventory, 81 units (“Auditor Sample”) were tested for owner occupancy and rental covenant compliance. An additional 26 units (“HCD Identified Problem Units”), identified by HCD for suspected violations, were also tested for covenant compliance.

Our procedures for verifying owner compliance with occupancy and rental clauses in restrictive covenants are a work in progress. Accordingly, findings are presented only through the date of this report. Significant investigation remains for suspected violations.

Auditor Sample

Responses

81 home owners were mailed requests to submit evidence of occupancy. A signed statement certifying compliance with applicable covenants was also requested of the home owners. 60% of the recipients responded to the first request, 14% responded to the second request, 15% responded to the *hand-delivered* third request, 6% did not respond, and 5% submitted incomplete documentation.

Of the 81 units tested, we suspect that 20 home owners are in violation of the occupancy or rental clauses in their respective resale restrictive covenants

Preliminary Findings

Of the 81 units tested, we *suspect* that 20 home owners are in violation of the occupancy or rental clauses in their respective covenants for the following reasons:

- 2 provided conflicting evidence of occupancy
- 5 failed to respond to requests for information
- 5 have property tax billing addresses different from unit addresses

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- 4 own additional residences within the County
- 4 provided incomplete documentation

Of the 81 units, we have confirmed 3 participants are renting a portion of their residence. Restrictions against partial-rental vary by covenant.

HCD Identified Problem Units

Responses

26 home owners were identified to us by HCD for suspected violations of occupancy, rental, and/or other restrictive clauses. We mailed requests to all 26 owners to submit evidence of occupancy. An owner signed statement certifying compliance with applicable covenants was also requested. 46% of the participants responded to the first request, 12% responded to the second request, 23% responded to the third *hand-delivered* request, and 19% did not respond. In addition to the 11 hand-delivered requests for documentation, home visits were made to 16 units to verify owner occupancy. Home visits were reserved for suspected violators due to the questioned validity of the documentation provided by the home owner.

Of the 26 home owners tested, we have concluded that 7 are in violation of the occupancy or rental clauses in their resale restrictive covenants.

Preliminary Findings

Of the 26 home owners tested, we have concluded that 7 are in violation of the occupancy or rental clauses in the covenants, as follows:

1. Owner is in violation of the occupancy requirement. Unit is unoccupied with a lockbox on front door. Owner's current location is unknown and no response was received from auditor's request.
2. Owner is in violation of the occupancy requirement and rental clause. Individual has relocated to Arizona and has acknowledged renting the unit for four years.
3. Owner is in violation of the occupancy requirement and rental clause. Individual owns and resides part-time in a separate property in Boston, Massachusetts and has acknowledged renting the unit on numerous occasions during past years.
4. Owner is in violation of the occupancy requirement. Individual owns and resides in a separate property in the County while remaining on title at the affordable unit.
5. Owner is in violation of the occupancy requirement and rental clause. Individual resides in San Diego, California and has acknowledged renting the unit for several years.
6. Owner is in violation of the occupancy requirement and rental clause. Individual owns and resides in a separate property in the County and has acknowledged renting the unit for several years.

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7. Owner is in violation of occupancy requirement. Individual owns and resides in a separate property in the County while remaining on title at the affordable unit.

Of the 26 home owners tested, we suspect an additional 10 are in violation of the occupancy or rental clauses in their respective covenants.

Of the 26 home owners tested, we *suspect* an additional 10 are in violation of the occupancy or rental clauses in their respective covenants for the following reasons:

- 3 are identified by HCD as potential violators, for various causes
- 2 provided conflicting evidence of occupancy
- 1 failed to respond to requests for information
- 3 own additional residences within the County
- 1 disclosed non-occupancy, declaring a prolonged intent-to sell

We will continue our inquiries to substantiate our suspicions of non-compliance. Our final report will document the results of our examination.

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Compliance Monitoring Program

Preliminary Finding

HCD does not maintain a complete listing of all affordable units under its authority. We conducted our examination based upon an estimated list of units compiled by the Specialty and Advanced Accounting Division of the Auditor-Controller's Office from HCD records, physical files, and recorded legal documents. The lack of a complete inventory of units limits management's ability to properly account for and safeguard County shared assets.

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Recommendation

We recommend that HCD develop and implement formal policies and procedures to compile and maintain a complete and accurate inventory of affordable units. As new units are purchased, they should be immediately accounted for by HCD personnel. A frequent reconciliation of the inventory should be performed with exceptions resolved in a timely manner. Furthermore, supporting documentation should be maintained for each unit in a well organized manner. A clear audit trail of the creation, sale, and subsequent resale of each unit should be maintained.

Preliminary Finding

HCD has failed to create a comprehensive compliance monitoring and enforcement program. HCD does not maintain updated written policies and procedures for compliance monitoring. We noted only one effort (in 2004) by HCD to test compliance with occupancy and rental clauses in the resale restrictive covenants. We noted limited follow-up on the violations discovered during the 2004 survey or on other complaints filed by the public. The absence of a compliance monitoring and enforcement program increases the risk of owner violations of the restrictions placed on their property.

The absence of a compliance monitoring and enforcement program increases the risk of owner violations.

Recommendation

We recommend HCD develop a comprehensive, recurring monitoring and enforcement program. Such program would include annual surveys, random on-site visits, public record searches, and inquiry of interested parties (home owner associations, neighbors, etc.). Additionally, all identified violations must be pursued in a timely fashion and resolved in a manner consistent with the intent of the County's affordable housing objectives. An annual compliance report to the Board of Supervisors is recommended.

Preliminary Findings and Recommendations

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Lottery Selection Process

Summary of Process

HCD conducts a computerized random ranking lottery to select the purchasers of its new affordable units. The adequate screening of each home buyer is the key control in ensuring only qualified applicants are permitted into the program. HCD conducts each lottery from a list of eligible applicants. Eligible applicant(s) must:

- Reside or be employed in Santa Barbara County.
- Have a combined household income that is within the allowable range for the housing unit under consideration.
- Not have received a gift amount that exceeds a pre-determined threshold.
- Obtain a loan pre-qualification letter.
- Agree to reside in the unit and not rent in whole or in part.
- Not own assets that exceed ½ the purchase price of the unit.
- Not have owned any residential property within the last three years, with limited exceptions.
- Possess sufficient funds to pay the required 5% down payment.
- Maintain a household size that is within the allowable range for the housing unit under consideration.
- Be United States citizens or permanent residents.

Procedures Performed

We reviewed HCD's processes and procedures for developing the lottery eligibility lists for two new affordable housing developments. We observed the computerized random ranking process of the lottery and the resulting list of top applicants. As of the date of this report, we have reviewed, for accuracy and completeness, 7 HCD certified applications made by participants selected for home purchases.

Preliminary Finding

We noted several deficiencies and inefficiencies in HCD's lottery and eligibility policies and procedures. We also noted inconsistent and insufficient application of the existing policies and procedures. Our examination requires further inquiry of HCD personnel and additional examination of documentation to adequately assess the lottery and eligibility determination process. Although we have not reviewed an adequate number of applications to base an opinion on the process as a whole, we noted several weaknesses during our review. The weaknesses we have noted thus far are as follows:

- A lengthy and onerous initial application for the lottery process.
- Insufficient written policies and procedures for the lottery process.
- Inconsistent application of HCD policies and procedures to include: refunds of non-refundable application fees, waivers of minimum

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income requirements, waivers of other stated eligibility criteria, and acceptance of incomplete applications.

- Insufficient documentation of policy waivers granted.
- Acceptance and certification of incomplete applications.
- Acceptance of photocopies in place of original documents to substantiate proof of citizenship or permanent US residency.
- Inadequate document requirements to substantiate proof of US citizenship or permanent residency.
- Inaccurate understanding of permanent residency status classification by HCD personnel.
- Incomplete understanding of basic personal financial data analysis by HCD personnel.
- Lack of secondary review and sign-off of certified applications by HCD management.
- Insufficient documentation of HCD performed verification of applicant's first time homeownership.
- Inadequate document filing procedures and a general disorganization of applications and supporting documentation.

Recommendation

We recommend HCD assess the adequacy of its existing policies and procedures for the lottery and application certification processes. A complete understanding of eligibility requirements should be developed prior to establishment of an updated policy manual. We recommend that HCD provide training to all personnel and reassess its policies and procedures on an annual basis to ensure proper internal controls are maintained for the processes at all times. Updated policies and procedures should include required documentation of all policy waivers and a secondary review process for certified applications. Adequate policies and procedures and employee training are vital to ensuring only eligible applicants participate in the Affordable Housing Program.

The current lottery process is significantly time-consuming and burdensome. We recommend a redesign of the process to include the implementation of an abbreviated initial application with a comprehensive application reserved only for applicants selected to participate in the program through the lottery. A simplified initial application will encourage more community members to participate in the lottery and will reduce the total number of hours required for the application review process by HCD personnel. A streamlined process will result in fewer processing errors and inconsistencies in the application of policies and practices.

We further recommend the implementation of a structured document retention practice. All documents should be filed in an orderly and consistent manner utilizing multi-part files, where appropriate. A well organized file will facilitate an efficient review process as well as insure long term retention of confidential documentation.

Adequate policies and procedures and employee training are vital to ensuring only eligible applicants participate in the Affordable Housing Program.

Conclusion

The Housing and Community Development Department, through its Affordable Housing Program, is responsible for oversight of the County sponsored effort to increase the number of affordable units within its boundaries. The Department utilizes various programs to meet its goals.

In February 2006, we commenced with an examination of the component units of the Affordable Housing Program. The examination is designed to identify weaknesses in the administration of the individual programs; as well as, determine compliance by participants with applicable program rules and covenants. The scope of our examination includes:

- Identifying incidences of non-compliance with restrictive resale covenants by owners of affordable units
- Assessing the effectiveness of the current HCD lottery and participant eligibility process to select home-buyers for new affordable units
- Determining the effectiveness of the HCD compliance monitoring and restrictive resale covenant enforcement program
- Determining the effectiveness of the internal controls designed by management to properly fund and track loans made by the Housing Finance Division

This is a partial report on the preliminary findings of our examination as of March 15, 2006. This report is not intended to be a comprehensive assessment of the HCD Affordable Housing Program and its component units. It is, however, an indicator of the weaknesses in internal controls currently designed by management to administer and protect the shared housing assets of the County.

Our preliminary conclusions are:

- We discovered a significant number of violations or *suspected* violations by affordable unit home owners with the covenant clauses of the occupancy and rental restrictions. Of the 26 HCD Identified Problem Units examined, 17, or 65%, are either in clear violation of one or more covenant restrictions or are suspected of violations. Of the 81 Auditor Sample units, 20, or 25%, are suspected of violations of the restrictive covenants. A simple extrapolation of the results of our examination to the total population suggests as many as 108 affordable units could be in violation of their covenants.
- We encountered varying amounts of resistance by home owners during our examination. We believe it stems from a general lack of understanding by the owners of the authority by which the County of Santa Barbara may conduct compliance examinations. The lack of a comprehensive, on-going compliance monitoring program has created an environment ripe for exploitation and misunderstanding.
- An inadequate lottery and eligibility determination process creates an opportunity for unqualified participants to purchase affordable units. We noted

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many inconsistencies in the application of stated policies and practices in the process.

- The examination has proven to be a time intensive process. We encountered significant delays in receiving responses from participants. As of the date of this report, we have performed 22 on-site visits and have executed alternative procedures to substantiate suspected violations. Additionally, reviews of lottery eligibility documentation are a labor intensive process. An ineffective and inefficient application and review process has led to significant delays in our procedures.

We anticipate our examination to continue through the latter part of 2006; requiring an estimated 1000 hours to complete. The extent of our outstanding work is summarized below:

- Test owner compliance with occupancy and rental restrictive covenants for all affordable housing units. Continued investigation of suspected violations discussed in this report.
- Assess completeness of existing covenants for all affordable units.
- Document and assess the lottery and eligibility process.
- Review eligibility documentation for remaining affordable units in the Providence Landing and Jensen's Crossing developments (36 units).
- Review enforcement efforts by HCD to resolve known violations.
- Examine Finance Housing Division processes and procedures. Assess and test internal control framework. Verify accuracy and completeness of current loan portfolio.
- Any additional procedures deemed necessary.

We sincerely appreciate the efforts by HCD staff and management in assisting in our examination. We look forward to their continued participation in the coming months as we complete our examination.

Respectfully submitted,

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Auditor-Controller