

California Housing Finance Agency

2015 SLAA REPORT

December 7, 2015

Alexis Podesta, Acting Secretary
California Business, Consumer Services and Housing Agency
915 Capitol Mall, Suite 350-A
Sacramento, CA 95814

Dear Ms. Podesta,

In accordance with the State Leadership Accountability Act (SLAA), the California Housing Finance Agency submits this report on the review of our systems of internal control and monitoring processes for the biennial period ended December 31, 2015.

Should you have any questions please contact Cherissa Lee, Financing Officer, at (916) 326-8655, clee@calhfa.ca.gov.

BACKGROUND

CalHFA was established per Health and Safety Code (HSC) Sections 50900 – 52533. The California Housing Finance Agency's mission is to finance loans to create safe, decent and affordable rental housing and to assist first-time homebuyers in achieving the dream of homeownership. CalHFA was statutorily chartered in 1975 to be the State's affordable housing bank. Per HSC 50956, "It shall be the policy of the agency to conduct its operations so as to be fiscally self-sufficient and so as not to require appropriations from the General Fund for payment of its administrative costs or to service bonds of the agency." CalHFA is a professional organization charged with providing mortgages to middle to low income home buyers and with lending to developers of affordable rental units. The agency sets loan interest rates slightly above its cost of funds and charges fees for specific services to cover its lending costs and risks.

It is important to recognize that mortgage banking is an inherently risky business. During the past several years, California has faced historic challenges: disruption in our state's real estate market, high unemployment, a tightening of the United States credit and bond markets, and an extremely difficult overall economic climate. These issues have had a deep impact on the California families that CalHFA serves. This led to a fundamental change in our mission: we focused much of our attention on assisting borrowers and increasing our role in helping California families remain in their homes.

Historically, CalHFA has offered three main financial programs: 1) make loans to first-time homebuyers; 2) make loans to owners and developers of multifamily affordable rental units; 3) make loans to local governments to finance local housing initiatives. The objective of these programs is to finance housing at affordable interest rates using the proceeds of tax-exempt mortgage revenue bonds, State of California general obligation (GO) bonds, special federal program funds, and a limited amount of internal equity. Additionally, CalHFA previously provided primary mortgage insurance (almost exclusively to CalHFA borrowers) at favorable rates by working with participating lenders, government agencies, government-sponsored enterprises, and the secondary mortgage market to develop and offer innovative homebuyer lending and mortgage insurance programs. Unfortunately, high delinquencies and a dramatic drop in home prices have had a devastating impact on the financial condition of the California Home Loan Insurance Fund (CalHLIF) which provides funding for the MI Division operations. At the present time, CalHFA has discontinued its mortgage insurance activity, the MI Division is no longer writing new insurance policies and all funds in CalHLIF have been committed to paying loan losses.

CalHFA also administers the Keep Your Home California Program, a federally funded program to help California homeowners struggling to pay their mortgages, through a non-profit corporation, CalHFA Mortgage Assistance Corporation (CalMAC), formed for that purpose. California has received nearly \$2 billion in funding from the U.S. Treasury's Troubled Asset Relief Program (TARP) and CalMAC is working with housing counselors and servicers to provide assistance to eligible homeowners and prevent avoidable foreclosures. The program is to support new and innovative foreclosure prevention efforts in the areas hardest hit by housing price declines and high unemployment rates. It runs through 2017.

CalHFA is administered by a Board of Directors consisting of 13 voting members and three non-voting members, including a chairperson selected by the Governor from among his or her appointees. Of the 13 voting members, seven are appointed by the Governor, four are ex-officio and two are appointed by the Legislature. The term of the appointed members of the board is six years. The California Housing Finance Fund is continuously appropriated and expenditures of the fund are not subject to the supervision or approval of any other officer or division of State government. The Executive Director prepares a preliminary budget on or before December 1 of each year for the ensuing fiscal year to be transmitted to the Secretary of the Business, Consumer Services and Housing Agency, the Director of Finance, and the Joint Legislative Budget Committee. This preliminary budget is included in the Governor's January Budget Proposal for informational purposes. The Agency's final budget is reviewed and approved by the CalHFA Board on its May meeting each year. According to Health and Safety Code 51005, the Agency shall, by November 1 of each year, submit an annual report of its activities under this division for the preceding year to the Governor, the Secretary of the Business, Consumer Services and Housing Agency, the Director of Housing and Community Development, the Treasurer, the Joint Legislative Budget Committee, the Legislative Analyst, and the Legislature. The report shall include specific information evaluating the extent to which the programs administered by the Agency have attained the statutory objectives of the Agency.

RISK ASSESSMENT PROCESS

An enterprise risk management team was established in 2013 to collect, mitigate, and monitor CalHFA's risks, as well as complete the requirements of FISMA. For 2015, our process involved reviewing the prior FISMA reports, analyzing budget and spending reports, and conducting interviews with the directors and managers of each division. The division directors and managers were asked to discuss the operations and existing procedures in their unit with a focus on any risks that may exist in their division and the impact it would have to the Agency. Once the risks were collected, each risk was analyzed for its potential impact, probability of occurrence, timeframe of the risk, and the risk management controls needed to mitigate each risk. Each year audits of both the Housing Finance Fund and the Home Loan Insurance Fund are conducted by an independent outside auditing firm, CliftonLarsonAllen LLP. The most recent audit was completed on October 12, 2015 and focused on fiscal and management internal controls for the fiscal year ended June 30, 2015. The analysis did not reveal any significant gaps in processes that might weaken internal controls. The analysis did identify a small number needing improvements, but none that represented a material weakness of internal controls. If a recommended improvement was determined to be warranted, an action plan would be initiated to follow up and correct the item.

EVALUATION OF RISKS AND CONTROLS

Operations- External- Business Interruption, Safety Concerns

Having only one Single Family Master Servicer

CalHFA provides low interest rate home financing to low and moderate income homebuyers. This is done by developing CalHFA's single family home loan programs, developing and maintaining a network of lenders, underwriting and originating single family first-mortgages and overseeing and administering the securitization of the first mortgages. CalHFA partners with many different business entities to accomplish its goals and mission, and one such partner is a master servicer.

The role of a master servicer is crucial to CalHFA's operations. The master servicer purchases first mortgage loans closed by CalHFA-approved lenders, and warehouses the loans until they are assembled into appropriate mortgage backed securities as directed by CalHFA or CalHFA's hedging institution. The master servicer then sells the securities to CalHFA who in turn will sell the securities to the hedging institution. During this time, the master servicer must perform all the normal duties associated with the pooling and servicing of the mortgages. The master servicer is responsible for all reporting, administering the collections/custodial account where all payments received on the loans are held until the funds are remitted to the investors, advancing any shortages in the event of delinquencies, and taking the property through foreclosure in the event of default. The master servicer is required to

maintain records reflecting the status of taxes, assessments, and insurance premiums. They are also required to ensure that mortgage properties are adequately insured. If CalHFA's master servicer decides to get out of the servicing business or quits, CalHFA may be forced to shut down its single family loan program until a new master servicer can be identified. If the master servicer changes its policies, CalHFA would be forced to comply and such changes may adversely impact CalHFA's business model and impede its goals and mission.

CalHFA is actively searching for another master servicer to diversify the outlets for delivering and servicing loans on the secondary market. CalHFA is in active negotiations with several possible options for master servicing.

Operations- Internal- Program/Activity—Changes, Complexity

Need to update guidelines and procedures for Multifamily programs.

Multifamily Programs provides financing for the acquisition, rehabilitation, and preservation or new construction of rental housing that includes affordable rents for low and moderate income families and individuals. However, with the recent financial crisis, CalHFA endured a period of reduced capital resources needed for new lending activity, as well as substantial portfolio instability. During that time, CalHFA made the decision to nearly eliminate new lending activities, instead focusing on stabilizing the existing loan portfolio. Now, with improved financial health, CalHFA has a renewed commitment to the preservation of multifamily properties throughout the state. However, the lending landscape has changed, and the previous methods of operation may be dated. To be competitive, CalHFA recognized that the operations of the Multifamily division must be updated or changed. CalHFA needs to update the loan program based upon current affordable housing development practices and prevailing industry lending standards. The terms and guidelines must be fairly consistent with other available loan products, and must have a loan approval and closing process that is fast and consistent.

CalHFA has retained the services of a firm that is expert in the area of affordable housing developments to conduct a review of the Multifamily Division's operations and programs. The work will include conducting a goals and policy assessment, identifying operational resource challenges, compare CalHFA's current practices to other affordable multifamily development lenders, and recommending document and procedural changes to improve marketability and operations. Updating the guidelines would provide an efficient tool to aid in the organizing and presenting of pertinent information to CalHFA's loan committee and its Board of Directors to consider in their potential approval of new loans. It would also make it easier for CalHFA to both market its loan products to the affordable housing industry and to have an easier time approving and closing transactions.

Establish formal cross-divisional loan review teams; assign people from the different units that are involved in each multifamily project to assemble a team for each project.

Provide more formal communication with borrowers:

- Letter of Interest--provides deal terms
- Final Commitment Letter
- Yield Maintenance Letter

Provide better internal documentation of loan details and exceptions; redesign Board write-ups and Senior Loan Committee write-ups to provide information clearly and communicate project details for approval. Provide an Exceptions Protocol--to highlight exceptions to underwriting guidelines or term sheets, and bring attention to exceptions for approval.

Compliance- External- Service Provider—Inadequate Internal Control System

Update Lender Manual for Homeownership – Single Family Lending

The 63 page Lender Manual was updated and published in May 2003 and subsequently updated and amended through the issuance electronic Program Bulletins, dozens of which are issued each year. The risk is that both lenders and CalHFA staff find it difficult to comply with the plethora of instructions that sometimes conflict with normal business practices and mandates from GSEs, and HUD-related lending requirements, and which do not provide adequate processes for servicers or CalHFA staff. Not having an updated version of the Lender Manual causes monthly remittance, reconciliation and reporting problems for the Agency. Servicers must print a copy of the guide to keep current on e-mail notifications. Servicers need a single resource document that clearly identifies their role and responsibilities in order to better service our loans. The Lender Manual includes administration and policy requirements regarding lending programs.

The lack of an updated Lender Manual causes lenders to submit incomplete loan files which cause processing delays during CalHFA compliance reviews. Unless instructions are clear and comprehensive they may not be legally enforceable if contested, and increase legal, compliance and financial risk to CalHFA.

The CalHFA Single Family Lending division is currently reviewing needed changes for the Lender Manual. The Division is working with CalHFA's Office of General Counsel to update the Lender Manual. When the updated Manual is released, lenders will be able to refer to one source document for instructions to be in compliance with CalHFA's lending standards. Once the updated Lender Manual is released, all existing and future Program Bulletins will be immediately incorporated into the Lender Manual. In the meantime, the Single Family Lending division continues to provide lender training and program outreach to all lenders to ensure that CalHFA's expectations are understood by our business partners.

Operations- Internal- Staff—Key Person Dependence, Succession Planning

CalHFA has no formal plan or policy in place for succession planning. Currently, backfilling for key employees or senior management when they retire or leave are done on a case-by-case basis.

CalHFA needs to actively develop a succession plan that address both short term and long term staffing needs. The impending retirement of an aging workforce is on the rise and will have a major impact on senior management expertise and experience. CalHFA relies on management and staff to carry out the missions, provide services, and meet the agency's goals. As such, CalHFA needs to develop a plan to support business continuity and a process to identify a supply of qualified, motivated people who are prepared to take over when senior staff and other key employees leave.

CalHFA will develop a plan to manage the gaps that will arise when individuals in key positions leave or are promoted. This will include identifying key positions that are crucial for the operation of the agency, and because of skill, seniority and/or experience will be hard to replace. The plan would include a combination of training and developing for existing staff as well as processes and procedures for external recruitment, promotions and employee retention to help maintain a pool of experienced and capable people who can step into positions as they become available.

ONGOING MONITORING

Through our ongoing monitoring processes, the California Housing Finance Agency reviews, evaluates, and improves our systems of internal controls and monitoring processes. As such, we have determined we comply with California Government Code sections 13400-13407.

Roles and Responsibilities

As the head of California Housing Finance Agency, Tia Boatman Patterson, Executive Director, is responsible for the overall establishment and maintenance of the internal control system. We have identified Don Cavier, Chief Deputy Director, as our designated agency monitor(s).

Frequency of Monitoring Activities

Senior management meets biweekly to discuss current issues, identify potential issues and provide a plan to mitigate the issues. Reconciliation of key agency accounts is done on a daily, monthly and quarterly basis. Collections and foreclosures are audited monthly by an external firm. Various loan servicing functions are audited quarterly by an external firm. Operating payments are regularly verified for accuracy and compliance with contract terms or agreements. CalHFA performs a monthly review of reports from outside servicers and compare it to internal reports. CalHFA conducts an annual on-site lender inspection of operations and quality control. CalHFA's information technology unit continuously monitors security measures in the areas of technical support, application support and information security. CalHFA engages one of the nation's largest accountancy firm to conduct an annual review of its internal controls.

Reporting and Documenting Monitoring Activities

Weekly, biweekly, and monthly reports are provided to management regarding the status of each unit. Audit findings from external auditors are formally documented and reported to the Agency's Board of Directors. Management review audit reports and respond to audit findings.

CalHFA has established standards for professional and ethical behavior for all staff. This is communicated and practiced by the executive management throughout the organization. This information is communicated to staff verbally, through "Message from the Director" broadcast emails, an online Employee Suggestion Box, and via the Executive Director (State of the Agency all-staff meeting).

In addition, each year employees receive training and are re-certified with regard to federal and state laws requiring safeguarding sensitive borrower information. Finally, CalHFA regularly updates its Employee Handbook and has made it available online to employees.

Procedure for Addressing Identified Internal Control Deficiencies

Management reviews reports from each unit. All internal control deficiencies identified are resolved as quickly as possible. Follow-up discussions are held at the meetings and documentation (and retention of those documents) of any issues are required until the issue is resolved. Deficiencies identified by external auditors require formal documentation and communication of our progress on mitigating the deficiencies with the auditor is required until the issue is adequately addressed.

CONCLUSION

The California Housing Finance Agency strives to reduce the risks inherent in our work through ongoing monitoring. The California Housing Finance Agency accepts the responsibility to continuously improve by addressing newly recognized risks and revising risk mitigation strategies. I certify our systems of internal control and monitoring processes are adequate to identify and address material inadequacies or material weaknesses facing the organization.

Tia Boatman Patterson, Executive Director

cc: Department of Finance
Legislature
State Auditor
State Library
State Controller
Secretary of Government Operations