

City of Detroit

OFFICE OF THE AUDITOR GENERAL



Audit of the Casino Development Fund Project: Real Property Rehabilitation GAP Fund

October, 2019



Office of the Auditor General


Mark W. Lockridge, Auditor General

Coleman A. Young Municipal Center
2 Woodward Avenue, Suite 216
Detroit, Michigan 48226
Phone: (313) 224-3101
Fax: (313) 224-4091
www.detroitmi.gov

MEMORANDUM

DATE: October 24, 2019

TO: Honorable City Council
Honorable Mayor Mike Duggan

FROM: Mark W. Lockridge, CPA 
Auditor General

RE: **THE CASINO DEVELOPMENT FUND AUDIT**
Real Property Rehabilitation Gap Fund Project

CC: Glen Long, COO, EDC
Stephanie Washington, Esq., City Council Liaison
David Whitaker, Director, Legislative Policy Division
Casino Representatives

Attached for your review is our report on the Audit of the Casino Development Fund Real Property Rehabilitation Gap Fund project. This report contains our audit purpose, scope, objectives, methodology and conclusions; background; our audit findings and recommendations; and the response from the Economic Development Corporation.

Responsibility for the installation and maintenance of a system of internal control that minimizes errors and provides reasonable safeguards rests entirely with the Economic Development Corporation.

Copies of all of the Office of the Auditor General reports can be found on our website at [www.detroitmi.gov/Government/Office of the Auditor General](http://www.detroitmi.gov/Government/Office%20of%20the%20Auditor%20General).

**Audit of the Casino Development Fund
Real Property Rehabilitation GAP Fund**

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AUDIT PURPOSE, SCOPE, OBJECTIVES, METHODOLOGY AND CONCLUSIONS

AUDIT PURPOSE

The audit of the Casino Development Fund – Real Property Rehabilitation Gap Fund project was performed in accordance with the Office of the Auditor General's (OAG) charter mandate as noted in Section 7.5-105(1) which states:

Make audits of the financial transactions, performance and operations of City agencies based on an annual risk-based audit plan prepared by the Auditor General, or as otherwise directed by City Council and report findings and recommendations to City Council and the Mayor.

City Council requested that the Office of the Auditor General (OAG) perform an audit of the Casino Development Fund in relation to a Legislative Policy Division report dated October 11, 2016.

AUDIT SCOPE

The scope of this audit was an independent review and assessment of the Real Property Rehabilitation GAP Fund project. Our audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States, except for the completion of an external peer review of the OAG within the last three years.

AUDIT OBJECTIVES

The overall audit objectives were:

- Review financial reports and audited financial statements from each sub-grantee to ensure the Casino Development Funds are properly accounted for and spent in accordance with program objectives and guidelines as stated in the casino agreements, Economic Development Corporation (EDC)/City of Detroit and EDC/sub-grantee funding agreements.
- Conduct a performance audit of each sub-grantee to ensure the Casino Development Funds are effectively and efficiently received and spent in accordance with best practices and in support of project objectives and guidelines.

AUDIT METHODOLOGY

To accomplish our audit objectives, our audit work included:

- Reviewing the Casino Development Agreements, project funding agreements, City Charter, the project budget reports, and organization charts.
- Gathering policies and procedures of core operations and similar data.
- Conducting an audit-planning meeting to determine the scope and audit objectives, and to determine the financial transactions and/or areas to audit.

- Identifying risks relative to financial transactions and mitigating controls with appropriate personnel.
- Developing questions regarding the Casino Development Fund project's transactions, controls, functions, records, and personnel.
- Interviewing appropriate personnel, reviewing documentation, and making observations to aid in developing audit programs.

CONCLUSIONS

As a result of our audit we have concluded that:

- The EDC did not effectively administer the application and approval process for the Real Property Rehabilitation Gap Fund project.
- The EDC did not properly service its loan portfolio resulting in a total of \$89,031.70 in uncharged late fees as of April 30, 2018.
- EDC reprogrammed and used \$407,559.05 of the Real Property Rehabilitation Gap Fund project funds for administrative cost. Under the funding agreement between the Economic Development Corporation and the City of Detroit, EDC is allowed to draw funds from programs to cover administrative services if they do not earn enough interest to cover their administrative cost.

Project Objectives

- EDC has distributed a total of \$1,080,950.25 in loans towards the project.
- Three loan projects were funded and completed.
- One project did not meet the project guidelines of Detroit resident ownership.
- One project did not receive approval from the EDC Board to receive funds from the Real Property Rehabilitation Gap Fund project.
- There is a total of \$2,238,375.70 available for additional project loans.

NOTE: The Economic Development Corporation of the City of Detroit Credit Policy Manual, Credit Authority, reads *"Authority to extend credit resides solely with the EDC Board of Directors."* While we understand this policy, use of this authority may deprive Detroit resident's the opportunity to obtain funding for their business ventures.

BACKGROUND

Origination of Casino Development Fund

The Casino Development Fund is a commitment made by the three Detroit casinos (MGM Grand Detroit, MotorCity, and Greektown) and the City of Detroit, to contribute money for the purpose of assisting minority business development in a specified area within the City. The assistance to business development focuses on: financing façade improvements, GAP financing, loan guaranties, rehabilitation, equipment and working capital for existing and new businesses.

The City received \$2.5 million from MotorCity Casino during the period of the initial Casino Development agreements (1998-1999). The City received \$30 million from the three casinos (\$10 million from each casino) in accordance with the revised Casino Development agreements.

Economic Development Corporation

EDC is a public body corporation created by the City Council of the City of Detroit by enactment of Ordinance 120-H effective June 9, 1979. All services to be performed are set forth in the "Scope of Services" section of the EDC/City of Detroit personal service contract and is coordinated and performed by the DEGC. The DEGC is a private non-profit 501(c)(4) organization and is an agent of the EDC that acts as a liaison between the EDC and the City.

Real Property Rehabilitation Gap Fund Project

In an effort to further the City's ability to assist the small Detroit-based, women-owned, and minority-owned businesses throughout the City, EDC received Casino Development Funds to administer various programs per their funding agreement including the Real Property Rehabilitation Gap Fund Project (RPGF).

The project was originally established by the DEGC to foster greater investment in real property rehabilitation projects by City of Detroit residents. The projects selected for this program were to be located along the Woodward Corridor (from Jefferson Avenue to Warren Avenue) and within the Central Business District area. All loans disbursed for the project were to be limited to real property rehabilitation projects owned, operated, and financed by City of Detroit residents with at least 60% ownership of the project.

Project Budget and Expenditures

According to the EDC Casino Development Funds Budget and Expenditure report dated March 31, 2019, RPGF had a budget of \$6,000,000. The EDC revised the budget to \$3,726,885. EDC stated that the total amount of loans approved for the RPGF program was \$1,130,000. EDC disbursed \$1,080,950.25 and \$407,559.05 was used for administrative cost. Total disbursements for the project were \$1,488,509.30 leaving \$2,238,375.70 available for additional loans.

AUDIT FINDINGS AND RECOMMENDATIONS

1. Economic Development Corporation (EDC) Did Not Have an Application Process for the Real Property Rehabilitation (RPGF) Project

We reviewed the application process for the RPGF project. Our review included the EDC process for applying for a loan, required document submission, loan document review, loan approval, loan closing and finally funding of the loan. Based on our review, we determined that:

Applying for a Loan

- There was no loan application on the EDC website for the RPGF project.
- EDC did not have a written process for perspective applicants on how to apply for a RPGF loan.
- Applicants were able to email or call EDC to initiate a loan application.
- The loan files for three recipients of RPGF project did not have a loan application.

Loan Approval

- One of the loan recipients did not meet the RPGF project Detroit residency-ownership requirement.
- One loan recipient did not receive approval from the EDC Board to receive funds from the RPGF project.
 - Loan Recipient A was approved to receive funds from the National Retail Loan project. There was no record of any documentation submitted to change the funding allocation.
- The documentation deficiencies in borrowers' files provided no assurance that agency staff insured that all required information had been submitted to perform an adequate application analysis or verification before submission to the EDC Board.

Best business practices for loans management include a standard applications process and required documentation, a loan review and approval process. The Small Business Administration program, an industry leader in assisting businesses requires the following steps in the life of a loan:

- A loan application.
- Loan application review.
- The lender makes a decision on whether to approve the loan.
- Upon satisfaction of all items and conditions of the loan authorization, the loan is closed.

In addition, the Federal Deposit Insurance Corporation recommends, at a minimum for installment lending policies, and a process that addresses the loan application.

The EDC Loan Credit Policy states that staff shall ensure that all loans are properly documented in accordance with the loan approval and the requirements of the particular loan program. The loan approval authority resides solely with the EDC Board of Directors.

Due to a lack of standard required application and loan documents, we cannot determine if proper documentation was submitted and reviewed for the loans approved. Failure to require and maintain proper documentation can result in fraud and other losses of funds by approving ineligible applicants.

We determined that EDC's lack of a comprehensive RPGF project standard operating procedures allowed for inconsistencies in the management of the project.

Recommendations

We recommend that the EDC Board:

- Review and revise the EDC credit policy manual, ensuring that it is consistent with the relevant provisions of the Funding Agreement.
- Implement a transparent application process.
- Ensure that the EDC provides oversight consistent with the sections of the Funding Agreement and approved guidelines governing loan program management.
- Require that EDC retain documents to ensure that eligibility requirements are met and included on all required documents for EDC Board review.

2. EDC Failed to Enforce Loan Agreements

We reviewed the entire RPGF portfolio of three loans. Based on our review of the loans, we determined that:

- EDC failed to charge and collect late fees for delinquent payments for the three loans totaling \$89,031.70.
- Late payments for the borrowers ranged from 12 to 46 occurrences with the average late payments for the borrowers totaling 87%. **NOTE:** We reviewed payments through 2019 and found the late payment percentage to be the same.
- EDC sent collection notices to the borrowers but there was no indication that late fees were charged at any time during the period of the delinquencies.
- EDC did not report the payment histories of borrowers to any credit reporting agency.

According to the Payments section in two of the recipients' loan agreements, if any payment is not received by the 10th day of the month, it shall be deemed late, and a late charge equal to five cents (\$.05) for each dollar of any monthly installment not paid timely shall be due and payable.

The Payments section in the third loan agreement stated that late payments may be deemed late and late charges may be due and payable.

EDC failed to collect \$89,031.70 in penalties and interest on loans creating lost revenue to the loan portfolio. In addition, EDC did not receive consistent payments to be used for additional loans to other borrows.

We determined that EDC did not:

- Enforce the loan repayment agreements.
- Charge late fees which contributed to the borrower's late payment patterns.
- Report the payment histories of borrowers to credit reporting agencies; a practice that could have encouraged prompt monthly payments.

Recommendations

We recommend that the EDC:

- Follow, adhere to and enforce the loan agreements approved by the EDC Board.
- Assess and collect required late charges per the loan agreements.
- Report loan recipients' payment history to credit reporting agencies.

3. EDC Did Not Follow the Guidelines Established for the RPGF Project D-3

We reviewed three loans to determine if the loan recipients met the criteria for the RPGF project. EDC approved a loan for a recipient who did not qualify for the loan program. The loan recipient did not meet the RPGF 60% Detroit residency-ownership requirement.

Two Companies are involved in the redevelopment of properties into mixed use space. Company X is a 35% owner and Company Y is a 65% owner in the project. Both Company X and Y are located in Detroit. However, the majority owner in Company Y is a Southfield resident which is not consistent with the rules of the program. The ownership of Company Y is as follows:

COMPANY Y		
Owner	Ownership Percentage	Residency
A	43%	Detroit, Michigan
B	4%	Detroit, Michigan
C	53%	Southfield, Michigan

The information contained in the loan file did not document that the recipients met the RPGF criteria prior to the loan application being submitted and approved by the EDC Board.

The EDC/City of Detroit Funding Agreement requires that loans will be limited to real property rehabilitation projects to be owned, operated, and financed by City of Detroit residents who have a minimum of 60% ownership over the project. City of Detroit resident ownership is defined as a minimum of 60% of the ownership entity being comprised of City of Detroit residents (minimum two year residency requirement).

The EDC Loan Credit Policy states that staff shall ensure that all loans are properly documented in accordance with the loan approval and the requirements of the particular loan project.

The failure of EDC to follow the policy resulted in \$250,000 being distributed to an ineligible applicant.

We determined that EDC:

- Did not ensure that loans were in compliance with the rules established in the EDC/City of Detroit Funding Agreement for the RPGF project.
- Failed to require proper documentation to verify compliance to the Detroit residency requirement.
- Did not have and maintain proper documentation in borrowers' files to substantiate the borrower's eligibility for the project.

Recommendations

We recommend that the EDC Board requires EDC to:

- Follow, enforce and adhere to the eligibility requirements.
- Obtain and retain proper documentation in the borrower's file to confirm and verify eligibility for the loan program.



TO: Mark W. Lockridge, Auditor General

FROM: Glen W. Long, Jr, Authorized Agent

DATE: October 21, 2019

RE: THE CASINO DEVELOPMENT FUND AUDIT
Real Property Rehabilitation GAP Fund

We are in receipt of your Final report concerning the Real Property Rehabilitation GAP Fund (RPGF) projects. We recognize all of the hard work that your staff has done in their auditing of the fund. We acknowledge their findings, and appreciate their suggested improvements; but feel that their conclusions require further clarification. Our response is as follows:

CONCLUSIONS:

Your staff concluded that EDC did not have all of the proper documentation in its files and did not charge late fees on delinquent payments. These first two conclusions became findings and our responses are detailed in the next section.

The third conclusion of the report notes that the EDC reprogrammed project funds for administrative costs; however, the report also notes that this reprogramming is expressly permitted under the terms of the funding agreement where interest income is insufficient to cover the administrative cost. We note that this reprogramming became necessary because the City's contribution to the program was \$10,250,000 less than contemplated when the program was approved and payments from the City were not made on the agreed upon schedule.

FINDINGS AND RECOMMENDATIONS:

- I. **EDC Did Not Have an Application Process for the RPGF Project**
 1. **Applying for a Loan**

The auditors are correct when they say that there was no loan application on the website and that the loan files did not have a loan application. Staff

has initiated corrective measures. An application process has been put in place for other EDC loan programs and will be applied to this program as well. These applications appear on the website. This will ensure a transparent application process.

EDC does have a written checklist for its Loan Officer to follow when working with a borrower. It has always been followed, but in an attempt to correct this perceived weakness, EDC will make the checklist available to prospective borrowers going forward.

Applicants have always been able to email or call EDC to initiate a loan application. The loan programs have been marketed by the Business Development staff of the DEGC as well as by Program Partners such as Invest Detroit and Detroit Development Fund. These loan programs have specific geographical and usage restrictions, and as such it has been our experience that a narrowly tailored and targeted marketing strategy has led to the most successful applications.

Some of the loan files may not have had an application on file. That said, it is not as if the information necessary to review and underwrite a loan request was not all gathered and meticulously vetted. This is clear from the Board memos and resolutions. It is important to remember that this audit has gone back to 2007 when there were different staff members in place over the program. Current staff has agreed to utilize an application on every loan, and we will incorporate that into our next Credit Policy Manual revision.

2. Loan Approval

The auditors contend that one of the loan recipients did not meet the Residency ownership requirement. This is inaccurate. In the loan in question, the borrowing entity was jointly owned by two separate LLCs that were Detroit Headquartered. The first company with 35% ownership was 100% owned by Detroit Residents, while the second company with 65% ownership was 47% owned by Detroit residents resulting in 66% Detroit ownership, above the necessary threshold. We clarify this more in response to Finding III(1) further below.

The auditors contend that one loan recipient did not receive approval from the EDC Board to receive funds from the RPGF portion of the program, but rather the National Retail portion. The Loan Officer on staff at the time was using a template to prepare his write-up for the Board. He mistakenly identified the wrong portion of the Casino Development Loan Funds in his write-up. He subsequently corrected it with the disbursement request and

later notified the Board of the correction. Further, when that loan was repaid, the proceeds were returned to the RPGF program funds for additional use. That said, we acknowledge that we were not able to find his correction in the Board Minutes we reviewed and that our minute keeping several years ago was not as complete as it is now.

The auditors cite that deficiencies in borrowers' files provided no assurance that agency staff ensured that all required information had been submitted. Again, these deficiencies are found in the older files that were maintained by staff no longer with us. Furthermore, it is worth noting that the underwriting, vetting, and Board document preparation could not have been completed had staff not gathered all pertinent information. We can testify that current staff ensures that all files are complete. Unfortunately, completeness of the files can be a problem with an audit spanning a 12 year period, where staff turnover has happened and retention deadlines have been passed.

3. Recommendations

The auditors recommend a review and revision of the EDC's Credit Policy Manual. The EDC Staff and Board currently review the Credit Policy Manual every few years and a review was already scheduled for 2020.

The auditors recommend implementation of a transparent application process. We recognize the weaknesses of the previous process and have already implemented changes including the posting of the applications, guidelines, and checklists on to our website.

The auditors recommend that the EDC provides oversight consistent with the Funding Agreement. While the EDC feels that it already does this, we will be making improvements to our application process as well as updating the Credit Policy Manual. Again, some of these weaknesses have already been improved, but an audit over a 12 year period can uncover some old weaknesses that have already been addressed.

Lastly in this section, the auditors recommend that EDC ensure eligibility requirements are met and included on all required documents for EDC Board review. This is already being done, however the EDC Board does have the right to approve exceptions to the eligibility requirements. Again, existing improvements in current staff record keeping must be considered.

II. EDC Failed to Enforce Loan Agreements

1. Late Fees

The auditors noted several loan payments that were late and cite delinquency rates and the lack of late charges and credit reports being made. We acknowledge that \$89,031.70 (an average of about \$7,500/year) could have been collected from the Casino Development Loan Program Funds in late fees over the last 12 years, but it has been the experience of staff that adding on late fees, that are often uncollectable, ultimately creates more problems than it solves.

This finding highlights a fundamental difference between a bank and an economic development agency. These Loan Programs were meant to provide “but for” financing and many of the loans are high risk. At the beginning of the program EDC Staff and Finance Committee made a conscious decision to be extremely judicious when levying any late fees on borrowers. While the auditors feel that late fees would encourage the borrowers to pay on time, it has been staff’s finding that additional charges only serve to put the borrowers further behind. Staff has a dedicated employee who works with the borrowers and who is responsible for collections. She has a remarkable record for collecting the principal and interest on the loans, but adding late fees only serves to poison that relationship. Staff and previous Committees did not feel that was worth \$7,500 a year.

Further, staff insists that the reporting of payment histories on these borrowers to credit reporting agencies would damage these small local businesses, which would be in clear contradiction to purpose of the program and the very mission statement of the EDC and DEGC. Staff feels that damaging the credit rating of the local businesses and damaging the relationship of the Loan Officer with the borrower by charging late fees that are difficult to collect is not good practice.

Having said all of that, we will be reviewing this audit and our responses with the current version of the EDC Finance Committee at an upcoming meeting and if the current committee feels differently than the previous versions then staff will adjust accordingly.

2. Recommendations

The auditors recommend that the EDC enforce the loan agreements approved by the Board, assess and collect late fees, and report borrower payment history to credit reporting agencies.

As stated previously, staff feels that this would disadvantage our high risk borrowers and would cause damage to the very local businesses we are trying to assist, however we will revisit this topic with the EDC Finance Committee and Board and will enforce whatever directive they give us.

III. EDC Did not follow the Guidelines established for the RPGF project

1. Ownership Percentage

The auditors contend that one of the loan recipients did not meet the Residency ownership requirement. This is confusing because of the multiple owners of multiple LLC's involved in the ownership structure, but inaccurate. The Woodward Theater loan was special in many ways. It was a priority of the Administration at the time, as well as the State to get this project up and running. The EDC Finance Committee and Board both reviewed all aspects of the deal and felt that it was important to use these specific high risk funds in order to make the development of this key block on Woodward work. The Loan Officer and Committee did feel that the loan met the requirements of the program since the borrowing entity was jointly owned by two separate LLCs that were Detroit Headquartered. The first company with 35% ownership was 100% owned by Detroit Residents, while the second company with 65% ownership was 47% owned by Detroit residents ($47\% \times 65\% = 31\%$) resulting in 66% Detroit ownership ($35\% + 31\% = 66\%$), which is above the necessary threshold of 60%.

2. Recommendations

The auditors recommend that the EDC adhere to the eligibility requirements and obtain and retain proper documentation to verify eligibility.

EDC Staff feels that the eligibility requirements have been adhered to, but acknowledges that on some of its older loans the files are not as complete as they should be. Unfortunately, an audit going back 12 years will identify some shortcomings like this between staff changes and document retention expirations. Current staff has kept complete files and will continue to do so.