EXECUTIVE SUMMARY

Commonwealth Development Authority - Audit of Loans Receivable as of September 30, 2001

Report No. AR-02-03

Summary

This report presents the results of the Office of the Public Auditor's audit[1] of the Commonwealth Development Authority's Development Corporation Division (DCD) loan receivables as of September 30, 2001. The objectives of our audit were to determine whether: (1) DCD loans receivable were delinquent, (2) borrower collateral was sufficient to cover outstanding balances, and (3) DCD rules and regulations were complied with. This audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States.

Since its inception in 1986, CDA, through DCD has provided agricultural, fishing, commercial and real estate loans to qualified borrowers. This has helped create new businesses, expand existing ones, create jobs and broaden the CNMI's tax base. DCD has also encouraged the development of technical expertise in business and financial management by working with government and private groups, and providing training services. As of September 30, 2001, DCD had 231 outstanding loans receivable of over $34.7 million from private sector borrowers. Of this, $11.4 million, or 33 percent, represents doubtful accounts that may not be collectible.

As of September 30, 2001, borrowers for 131 of DCD's 231 loan accounts were delinquent in making scheduled payments. Of the 131 delinquent accounts, 94 loan accounts or 72 percent were delinquent in excess of 90 days. Our review of 51 selected accounts indicates that the high delinquency rate was due to inter-related factors such as: (1) CDA's practice of granting high risk loans to borrowers with questionable capacity to repay; (2) CDA's practice of granting loans to borrowers without fully determining project feasibility; (3) CDA's practice of granting questionable loan remedies such as repeated loan revisions, unrealistic loan work out agreements, and non-foreclosure of delinquent loans; and lastly (4) the presence of unfavorable economic conditions that affected borrower repayment ability. As a result, over $11 million in past due loan repayments is considered delinquent.

DCD loans receivable should be covered by collateral adequate to secure CDA's interest. OPA found that three of 51 selected loans with 33 borrowers were inadequately secured because collateral had either not been verified or was insufficient in amount. This condition occurred because CDA had not strictly implemented loan security measures in accordance with DCD rules and regulations. As a result, as of September 30, 2001, CDA was exposed to possible loan losses of about $800,000 in loan principal. The total appraised value of the collateral securing the four loans was about $420,000. However, due to the prevailing economic condition, the actual market value of the properties may decrease even further.

Conclusions and Recommendations

DCD loans receivable are at risk because of the high percentage of delinquent borrowers, insufficient and unverified collateral, violations of DCD rules and regulations, and the recent overall economic decline in the CNMI. Accordingly, we recommend that:

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[1] In accordance with statutory restrictions in the Auditing and Ethics Acts, names of individuals and corporations are not disclosed in this report.

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1. The CDA Board develop and follow procedures and guidelines that would provide managers and board members sufficient basis to:

   - prohibit the approval of loans to borrowers having no capacity to repay. CDA should seriously consider prospective borrowers' past collection problems and defects in credit ratings when evaluating loan applications;
   - prohibit the granting of supplemental loans to highly delinquent borrowers as this circumvents the loan payment process, with the borrower using the additional loan proceeds to update his or her loan;
   - prohibit granting loan remedies to highly delinquent borrowers. CDA should approve loan revisions sparingly, and discourage repeated and routine approval of loan revisions as this practice masks delinquent borrowers by making their loans appear current;
   - help enforce the foreclosure of collateral of delinquent borrowers.
   - prohibit borrowers from substituting or selling mortgaged collateral unless they use the proceeds to repay outstanding loans; and
   - require that updated appraisal reports of collateral be obtained before initial and supplemental loans are granted. Also, appraisals of collateral property should be updated whenever the outstanding loan amounts have increased substantially.

2. The CDA issue a policy memorandum reminding management and Board members to strictly enforce DCD rules and regulations concerning the: (a) 20 percent equity requirement, (b) 20-year maximum loan term, (c) conflicts of interest, and (d) insurance requirements and any civil and criminal penalties for failure to do so.

3. The CDA and the Attorney General's Office continue to take necessary legal action to foreclose collateral of borrowers' highly delinquent loans.

Based on CDA's responses dated August 28, 2002 and September 20, 2002 to our draft report, we consider Recommendations 1 through 3 as resolved. The additional information or actions required to consider the recommendations closed are presented in **Appendix B**.

A copy of this report is available at the Office of the Public Auditor

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September 20, 2002

Mr. Juan S. Tenorio
Chairman
Commonwealth Development Authority
Saipan, MP 96950

Ms. Marylou S. Ada
Executive Director
Commonwealth Development Authority
Saipan, MP 96950

Dear Mr. Tenorio and Ms. Ada:

Subject: Final Report - Commonwealth Development Authority - Audit of Development Corporation Division's Loans Receivable as of September 30, 2001(Report No. AR-02-03)

This report presents the results of the Office of the Public Auditor's (OPA) audit of the Commonwealth Development Authority's Development Corporation Division (DCD) loans receivable[1] as of September 30, 2001. OPA initiated this audit as part of its annual audit plan for Fiscal Year 2000.

Our audit showed that as of September 30, 2001, borrowers for 131 of DCD's 231 loan accounts were delinquent in making scheduled payments. Of the 131 delinquent loans, 94 loan accounts or about 72 percent, were delinquent in excess of 90 days. Our review of 51 selected accounts indicated that the high delinquency rate was due to inter-related factors such as: (1) CDA's practice of granting high risk loans to borrowers with questionable capacity to repay; (2) CDA's practice of granting loans to borrowers without fully determining project feasibility; (3) CDA's practice of granting questionable loan remedies such as repeated loan revisions, unrealistic loan work out agreements, and non-foreclosure of delinquent loans; and lastly (4) the presence of unfavorable economic conditions that affected borrower repayment ability. As a result, over $11 million in past due loan repayments are considered delinquent.

DCD loans receivable should be covered by collateral adequate to secure CDA's interest. OPA found that three of 51 selected loans with 33 borrowers were inadequately secured because

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collateral had either not been verified or was insufficient in amount. This condition occurred because CDA had not strictly implemented loan security measures in accordance with DCD rules and regulations. As a result, as of September 30, 2001, CDA was exposed to possible loan losses of about $800,000 in loan principal. The total appraised value of the collateral securing the three loans was about $420,000**.** However, due to the prevailing economic condition, the actual market value of the properties may decrease even further.

We recommend that:

1. the CDA Board develop and follow procedures and guidelines that would provide managers and board members sufficient basis to:

   - prohibit the approval of loans to borrowers having no capacity to repay loans. CDA should seriously consider prospective borrowers' past collection problems and defects in credit ratings when evaluating loan applications;

   - prohibit the granting of supplemental loans to highly delinquent borrowers as this circumvents the loan payment process, with the borrower using the additional loan proceeds to update his or her loan;

   - prohibit granting loan remedies to highly delinquent borrowers. CDA should approve loan revisions sparingly, and discourage repeated and routine approval of loan revisions as this practice masks delinquent borrowers by making their loans appear current;

   - help enforce the foreclosure of collateral of delinquent borrowers;

   - prohibit borrowers from substituting or selling mortgaged collateral unless they use the proceeds to repay outstanding loans; and

   - require that updated appraisal reports of collateral be obtained before initial and supplemental loans are granted. Also, appraisals of collateral property should be updated whenever the outstanding loan amounts have increased substantially.

2. CDA issue a policy memorandum reminding management andboard members to strictly enforce DCD rules and regulations concerning the: (a) 20 percent equity requirement, (b) 20-year maximum loan term, (c) conflicts of interest, and (d) insurance requirements and any civil and criminal penalties for failure to do so.

3. CDA and the Attorney General's Office consider necessary legal action to foreclose collateral of borrowers' highly delinquent loans.

In her response dated August 28, 2002 and subsequent revision dated September 20, 2002, (**Appendix A**) to our draft report, the CDA Executive Director agreed that CDA needs to develop improved procedures and guidelines to minimize delinquencies. Also, it will distribute a policy memorandum outlining OPA's concerns and a copy of this report to all board members and senior management. Finally, it agreed to take legal action to foreclose collateral on highly delinquent loans.

CDA has concurred with our recommendations and plans to take needed action, namely to develop procedures and guidance to provide managers and board members with sufficient basis for prohibiting loans and loan revisions to highly delinquent borrowers, and for ensuring that adequate collateral is present. CDA's recent actions show it is committed to correcting the problem.

Based on CDA's updated response, we consider Recommendations 1, 2, and 3 to be resolved. Actions or documents needed to consider these recommendations as closed are presented in Appendix B.

BACKGROUND

Commonwealth Development Authority

The Commonwealth Development Authority (CDA) is an autonomous public agency of the Commonwealth of the Northern Mariana Islands (CNMI)created pursuant to Public Law 4-49 (as amended) for the purpose of stimulating economic development in the CNMI. It is composed of three activities. The Development Banking Division carries out government and public sector loan activities; the Development Corporation Division (DCD) carries out private sector loan activities; and the Northern Marianas Housing Corporation serves to develop and administer a low-cost residential housing program. CDA is governed by a seven-member Board of Directors appointed by the Governor of the CNMI with the advice and consent of the Senate. An Executive Director appointed by the Board conducts CDA's day-to-day operations.

Development Corporation Division

The Commonwealth Code (4 CMC §10102) provides that DCD is to:

- identify, formulate, initiate, stimulate and facilitate business and commercial enterprises, with special emphasis on agricultural and marine resources, manufacturing and processing activities, import substitution, export development, and responsible use of indigenous raw materials;

- identify, formulate, initiate, stimulate, and facilitate business and commercial enterprises where a service necessary and vital to economic development is required, or where profit incentives are not sufficient to attract private sector investors; and

- serve as the economic development loan fund agency for qualified private sector enterprises.

CDA's enabling legislation (4 CMC §10402(l)) also prohibits it from competing with commercial banks. For any loan CDA processes and funds, it must be satisfied that under prevailing rate conditions, the borrower could not obtain commercial financing under reasonable terms; this means that such loans are by definition higher risk than a commercial loan.

CDA is prohibited from making consumer loans which generally have shorter terms but higher rates of interest and are consequently usually higher risk but more lucrative (4 CMC §10203(B(6)).

Since its inception in 1986, CDA, through DCD, has provided agricultural, fishing, commercial and real estate loans to borrowers. This has helped create new businesses, expand existing ones, create jobs and broaden the CNMI's tax base. DCD has also encouraged the development of technical expertise in business and financial management by working with government and private groups, and providing training services. CDA's annual reports indicate that CDA offers services to its clients such as workshops and training in accounting, management, and the development of other business skills.

As of September 30, 2001, DCD had 231 outstanding loans receivable of over $34.7 million from private sector borrowers. Of this, $11.4 million, or 33 percent,[2] represents doubtful accounts that may not be collectible. The details are as follows:

Type of Loan	Number of Loan Accounts	Revised[3] Loans	Original Amount	Outstanding Loan Principal as of 9/30/01	Total Past Due
Agricultural Loan	25	17	$3,348,643	$2,835,710	$774,624
Commercial Loan	107	86	18,566,779	18,798,019	6,353,635
Marine Loan	43	38	6,342,020	5,740,352	2,414,586
Real Estate Loan	22	19	5,755,060	6,648,200	1,524,362
Trust Territory Loan[4]	3	1	76,243	12,122	7,924
Microloans [5]	31	0	683,591	616,125	21,888
Total	231	161	$34,772,336.14	$34,650,527.96	$11,097,019.33

[2] This rate was based on the average allowance for doubtful accounts on DCD loans receivable provided in CDA audited financial statements for fiscal years 1997 to 2000.

[3] Revised loans pertain to restructured loans. The restructured amount consists of the principal, accrued interest, late/penalty charges and revision fees, depending on the negotiation between CDA and the borrower. Loan revisions can take the form of time extension, loan consolidation, additional loan infusions (under the same account) and reduction of monthly amortization.

[4] Trust territory loans were previously administered by the Northern Mariana Islands Economic Development Loan Fund and were transferred to DCD.

[5] The US Small Business Administration granted CDA an initial fund of $300,000 in October 1999 for the Microloan Program. This program offers assistance to women, economically disadvantaged and disabled entrepreneurs, and other business owners capable of running successful businesses.

OBJECTIVES, SCOPE AND METHODOLOGY

The objectives of our audit were to determine whether: (1) DCD loans receivable were delinquent, (2) borrower collateral was sufficient to cover outstanding balances, and (3) DCD rules and regulations were complied with.

Although our work was initially limited to DCD loans receivable for the period ending September 1999[6], we later updated our review to address transactions through September 2001. Of the 231 DCD loans outstanding at September 30, 2001, we selected 51 of the larger loans for detailed examination. For these 51 loans, we reviewed their loan status as well as accrual and delinquency reports; examined documents such as loan applications, loan history documents, default notices, appraisal reports, and insurance policies; interviewed knowledgeable CDA officials and employees; reviewed loan practices for conformity with applicable DCD rules and regulations; and reviewed management controls over DCD loans receivable. Weaknesses we identified are discussed in the Findings and Recommendations section of this report. Our recommendations, if implemented, should improve management controls. This audit was made, where applicable, in accordance with Government Auditing Standards issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures as we considered necessary under the circumstances.

PRIOR AUDIT COVERAGE

This is OPA's initial audit of CDA's DCD loans receivable. An independent auditing firm has issued several audit reports addressing annual financial reports covering fiscal years 1995 to 2000. The latest of those audit reports showed that about 50 percent of DCD loans receivable were over six months in arrears which may lead to possible loan losses. In addition, the report found that CDA violated DCD rules and regulations because six of 42 loans examined showed no evidence of insurance coverage to cover assets pledged under chattel mortgage agreements. Similar findings were noted during OPA's audit.

FINDINGS AND RECOMMENDATIONS

A. High Percentage of Delinquent Borrowers

As of September 30, 2001, borrowers for 131 of DCD's 231 loan accounts were delinquent in making scheduled payments. Of the 131 delinquent loans, 94 loan accounts or about 72 percent, were delinquent in excess of 90 days. Our review of 51 selected accounts indicated that the high delinquency rate was due to inter-related factors such as: (1) CDA's practice of granting high risk loans to borrowers with questionable capacity to repay; (2) CDA's practice of granting loans to borrowers without fully determining project feasibility; (3) CDA's practice of granting

[6] For our initial audit samples as of September 1999, we did not include accounts which were being reviewed by CDA's Legal Counsel for collection proceedings. We substituted these items with the next high-value DCD loans receivable accounts.

questionable loan remedies such as repeated loan revisions, unrealistic loan work out agreements, and non-foreclosure of delinquent loans; and lastly (4) the presence of unfavorable economic conditions that affected borrower repayment ability. As a result, over $11 million in past due loan repayments are considered delinquent.

Measures to Protect CDA from Delinquent Borrowers

DCD rules and regulations contain provisions to protect CDA from potential loan delinquencies. For example, loans are not to be granted to borrowers who: (1) have no ability to repay the loan, (2) have filed for bankruptcy or have been placed under receivership, (3) have a record of defaulting on previous loans, or (4) have properties that were previously foreclosed. CDA can consider collection problems and defective credit ratings when evaluating loan applications.

If a borrower becomes delinquent, CDA must perform follow up collection procedures to update the loan. If a borrower does not remit payment within:

- 30 days after payment is due, CDA will send a non-payment reminder notice to the borrower;

- 60 days, CDA will contact the borrower by phone and again by mail;

- 120 days, CDA will have an attorney send a default notice to the borrower, and initiate foreclosure proceedings if the delinquency still persists.

Even though borrowers default and become delinquent in making loan payments, CDA allows various types of remedies, namely: (1) loan revisions, (2) placing the case on hold, or (3) enacting loan work-out agreements after a default judgment is rendered.

DCD rules and regulations allowing loan revisions and loan work out agreements are very general and do not specify when these remedies may be used. CDA may use loan revisions to modify terms of existing loan agreements and to consolidate or grant additional loans to borrowers. As an alternative to foreclosure, CDA may grant a loan work out if evidence shows the loan to be recoverable even if foreclosure action has been ordered.

According to CDA, DCD's loan review committee has exerted considerable effort to evaluate loan portfolios. CDA has identified delinquent borrowers who have been uncooperative in settling their obligations, and its Legal Counsel has sent out demand letters to such borrowers. Also, CDA is not quick to take foreclosure because the market for foreclosed property is limited, and CDA will incur legal and publication fees if the property is sold.

Borrowers delinquent by $4.4 million in court judgments and $6.7 million in other loans receivable

CDA records show that the Court had rendered default judgments of about $4.4 million on 23 borrowers with previous outstanding loans of about $4.7 million. In addition, of other loans receivable from 191 borrowers with outstanding balances totaling $29.9 million, we found that

131[7], or about 69 percent, were delinquent. Thus, of the $29.9 million outstanding on loans receivable, $6.7 million is past due. Of the 131 delinquent loans, 94 loan accounts or about 72 percent, were delinquent in excess of 90 days.

The loan status of these remaining 191 borrowers as of September 30, 2001 is shown in the following table:

Particulars	No. of Borrowers	Percent of Borrowers	Past Due Loan Payments	Total Outstanding Amounts
Judgment Loans Receivable[8]	**23**		**$4,385,323**	**$4,712,134**
Other Loans Receivable:				
Current	60	31	-	$ 7,613,151
Past Due Accounts				
30 - 59 days	17	9	16,261	1,398,829
60 - 89 days	11	6	32,464	1,491,368
90 days and over	94	49	4,354,570	15,944,224
Buy-Back Guaranty Bankruptcy	7	4	2,240,559	3,423,112
Bankruptcy	2	1	67,842	67,710
Sub-total - All Past Due Accounts	131	69	$6,711,696	$22,325,243
Total Other Loans Receivable	**191**	**100**	**$6,711,696**	**$29,938,394**

To test compliance with regulations and determine reasons for the high delinquency rate, OPA reviewed 51 loan accounts pertaining to 33 borrowers, and found that various inter-related factors had contributed to the delinquencies:

CDA Loans Granted To Borrowers Who Had Questionable Repayment Ability

Out of the 51 loans examined, CDA granted two high-risk loans to borrowers with questionable capacity to repay:

- In June 1998, CDA approved a 90 percent bank guaranty loan to a borrower with an unsatisfactory payment record. The borrower specified in his loan application that 79 percent of the loan proceeds was to be used to consolidate his existing past due loans with other financial institutions, and the remainder was to be used as working capital. The borrower's credit report showed an unsatisfactory payment history including an involuntary repossession. CDA subsequently paid its guaranty to the bank when the borrower became delinquent in February 1999. As of September 30, 2001, the borrower owed principal of $550,285, and was 31 months delinquent in making loan payments. (Loan A).

[7] The 131 loan accounts include 122 with past due payments of 30 to 90 days, as well as buy-back guaranty and bankruptcy accounts which are also past due.

[8] These are defaulted loans where legal action has been taken, and judgment has been rendered by the Court on three of them. On the other 20, the Board has not taken the final step of foreclosure and eviction because it does not see any economic value flowing to CDA from such action.

- In March 1997, CDA approved a loan[9] of $665,000 to a borrower in spite of the former CDA Executive Director's advice that it not be approved because of inadequate cash flow. Based on documents then available, the borrower had a severe cash flow problem and was saddled with several past-due loans from other financial institutions. Recognizing the credit risk, the Board imposed a requirement to obtain and secure a first mortgage lien on real estate valued at $1,841,000, to protect its risk exposure. Despite the CDA loan, the company defaulted immediately without making a single loan payment. CDA then repeatedly extended and revised the loan repayment terms in August 1997, and in January and July 1999. On April 29, 2000, the company's Board of Directors unanimously voted to dissolve the company under Chapter 7 of the Bankruptcy Law but later opted not to complete this resolution. As of September 2001, the borrower owed unpaid principal of over $818,000, was 20 months delinquent, and owed another $310,000 on a bank guaranty loan paid by CDA that was 13 months delinquent. According to CDA, a catastrophic event occurred in April 1997 which adversely affected the business.(Loans B.1 & B.2)

According to CDA, a borrower's credit history is not the sole factor CDA considers when it evaluates loan applications. If a borrower has an unsatisfactory credit history but can produce collateral which CDA deems satisfactory and sufficient, the borrower can still qualify for a loan guaranty.

Additional Loans Granted To Defaulting Borrowers

CDA granted additional loans to borrowers already in default on earlier loans. Subsequently, both the later as well as earlier loans became delinquent.

- In August 1999, CDA granted a delinquent borrower a new $263,000 loan even though the borrower's two previous loans of $887,000 and $197,000, respectively, were over 84 months past due. In January 2001, CDA sent the borrower Notices of Default on the 3 loans. As of September 30, 2001, these three loans, totaling about $1.3 million, were delinquent by 23, 95 and 84 months, respectively. CDA explained that this 1999 loan increased CDA's security position by "acquiring" three pieces of collateral. According to a CDA official this had the effect of increasing CDA's loan to value ratio. (Loans C.1, C.2 & C.3)

- In July 1998, CDA granted a borrower with a history of untimely payments a new $100,000 loan even though the borrower had three loans of $7,900, $209,800, and $273,500 that had been revised as many as four times each, and all were highly delinquent. Later in October 1998, CDA supplemented this latest loan with another $100,000 loan. As of September 30, 2001, the four newly restructured accounts of over $650,000 were again delinquent. Three of the four loans were seven months delinquent while the other loan was more than two years delinquent. (Loans D.1, D.2, D.3 & D.4)

CDA advised us that DCD can create different loan accounts for related loans with different loan terms so as to make maximum use of the 20-year allowable term. If a borrower defaults on an

[9] The March 1997 approval originated from a previous guarantee for $242,000 with a loan date of October 1996.

earlier loan, CDA generally should not approve a new loan. However, if CDA deems that the business can potentially revive its operations if given increased funding, it will extend additional loans.

CDA Granted Loans Without Adequately Reviewing Project Feasibility

CDA granted several loans without adequately ascertaining whether a borrower's project was financially feasible. Although CDA should review the feasibility of a borrower's project and ensure that the prerequisites for operating a business are in place before granting a loan, it has not always done so.

- In June 1983, CDA granted an initial loan of $240,000 to a borrower to start a major agricultural business even though the CNMI did not have a product processing plant approved by the United States Department of Agriculture (USDA) to process the product. Eventually, the borrower had to scale down its operations, and in 1990, USDA closed down the business because the CNMI lacked an approved product processing plant. As a result, the loan became very delinquent. As of September 30, 2001, the borrower owed $251,000 and was over 7 years delinquent in making payments. CDA explained that it granted the 1983 loan on the assumption that the product processing plant would be established. However, after three years of operation the product processing plant was closed. (Loan E)

- In April 1993, CDA granted an initial marine loan of $400,000 and two supplemental loans totaling $600,000 to a borrower without receiving assurance that the borrower could capably operate his marine venture. The marine venture was unable to operate legally because crew members had not complied with citizenship requirements imposed by the U.S. Coast Guard. As of September 2001, the borrower owed over $950,000 on the loans which by then was considered a judgment account that was 30 months past due. CDA explained that the unavailability of information at loan implementation impeded the successful operation of the borrower's business. More specifically, only after the loan was obtained did the borrower determine that all crew members needed to be U.S. citizens, a requirement it could not satisfy because of the additional cost. The borrower has the responsibility to know all information critical to the success of his business, including all requirements for the business to operate legally. (Loan F)

The DCD Rules and Regulations allow CDA's Board the options of authorizing a feasibility study or providing technical assistance to interested CNMI residents on specific projects in areas of agriculture, aquaculture, fishing and other economic projects. The regulations do not, however, contain any criteria requiring the Board to ensure that proposed projects are feasible or workable, or that borrowers are technically equipped or staffed before release of loan proceeds. In one case, the Loan Manager told OPA that the loan officer considered project feasibility in her initial loan evaluations which were the basis for the loan officer's recommendation to the loan committee. The Loan Officer cited the lack of a USDA facility as one of the areas of concern for the borrower's agricultural project. This factor was not duly taken into consideration and the Board still approved the loan.

CDA Lacks Clear Loan Guidelines in Granting Loan Remedies To Delinquent Borrowers

CDA has no clear guidelines for granting loan remedies to delinquent borrowers. As a result, the Board may have exceeded its fiduciary responsibility in granting loan remedies. Guidelines for granting loan remedies might include provisions that: (a) set the maximum number of loan revisions granted to a delinquent borrower annually and during the entire loan period, (b) require the borrower to make a minimum payment prior to loan revision, (c) define what constitutes a revised or restructured loan, (d) provide for reevaluation of the borrower's capability to repay the new loan amount, (e) allow borrowers to refinance the unpaid portion of the original loan, and (f) allow the granting of loan work-out agreements to borrowers.

CDA has not set a limit on the number of loan revisions that a borrower can receive. Loan revisions can take the form of a time extension, a loan consolidation, additional loan infusions (under the same account), or a reduction of monthly amortization.

CDA advised OPA that the existing DCD Rules and Regulations were somewhat ambiguous concerning the terms of loan revision. Citing the current economic downtrend as a major reason for borrowers' difficulty in repaying loans, CDA said DCD had been lenient in enforcing such rules and regulations, especially for borrowers who had sought better terms so as to give them time to recover from their financial difficulty. According to CDA, DCD planned to clarify the language on loan revisions in the DCD Rules and Regulations by setting limitations, such as allowing only one revision annually and increasing the revision fee. DCD, however, had not considered setting a minimum payment prior to loan revision.

Loan Revisions

CDA noted that although some borrowers are willing to pay, they are unable to raise sufficient funds to cover their projected monthly amortization. In re-evaluating loans, CDA loan officers normally conduct site visits and talk with borrowers. Upon CDA's approval of a loan revision: (a) DCD updates the computation on the penalty, interest and late charges to be paid by the borrower, (b) DCD normally requires a cash payment for the loan revision fee but may just add the revision fee to the new principal, and (c) CDA computes the required monthly payment. If a borrower attempts to negotiate a lower monthly amortization that CDA considers reasonable, CDA will usually grant the borrower's request during the first year and then accelerate monthly payments as the borrower's financial condition improves, and in some cases, require a balloon payment at the end of the loan term.

CDA may have not been fiduciarily responsible when it approved questionable and repeated loan revisions to change loan status from delinquent to current. OPA found that 121 of 231 borrowers, or about 52 percent, had their loans revised at least twice. CDA revised 12 of its delinquent loans from 3 to 8 times each to make the loan status current. Examples of questionable loan revisions follow:

- In 1985 CDA granted a $200,000 loan to a borrower for constructing an apartment, and in 1986 granted an additional $54,000 loan to the borrower to complete the apartment.

Thereafter, CDA consolidated the 2 loans into a $261,000 loan, and then in 1987, 1988, and 1993, revised it to extend the loan term and lower the monthly amortization. However, despite such revisions, CDA granted the borrower an additional $500,000 loan in 1991 for another apartment, which it revised in 1993 to extend the loan payment term. In late 1993, CDA consolidated the 2 loans into a single loan which it later revised in 1997, 1999 and 2000. Exclusive of the two loan consolidations, this real estate loan has been revised 6 times. With each revision, the loan status has reverted from delinquent to current because of new payment terms. The final consolidated loan which had a balance of about $1.2 million as of September 30, 2001, now has very lenient terms, namely a low $5,000 monthly payment, and a final balloon payment of $1.9 million in 2011. With the latest revision, the borrower is considered 5 months delinquent in making loan payments. CDA acknowledged that the loan term had been extended 6 years over the maximum allowed because two loans were consolidated with the later 1991 loan becoming the basis for repayment. It added that, in June 2002 after reviewing this loan, it initiated legal action against the borrower in light of the borrower's poor performance. (Loan G.2)

- In July 1981, CDA granted a $60,000 loan to a borrower, and later in November of that year supplemented it with a $30,000 loan. In 1982, CDA restructured the 2 loans to extend the term and lower the amortization payments. Then in 1984, it "consolidated" the 2 loans and granted the borrower an additional $16,000. A similar pattern ensued in subsequent years to "update" the loan as CDA revised the loan seven times in 1987, 1993, 1994, 1995, 1996, 1998 and 2000. Because of the yearly loan restructuring, the borrower now owes $299,000, and payments are 8 months past due. The borrower also has another loan of over $98,000, 7 months past due, that has been revised twice. CDA explained that loan revisions were needed to assist the borrower's business which had a reduced revenue flow because of economic disparities in the early 1990s. (Loans H.1 & H.2)

- In 1986, CDA granted a $500,000 loan to a borrower for 20 years. It then later supplemented it with loans of $200,000 in 1990 and $15,405 in 1992, and in 1998 granted the borrower a "new" loan to refinance previous debt. This extended the maturity date to 2013, or 27 years beyond the initial loan origination date. As of September 30, 2001, the new loan had an outstanding balance of over $807,000 and scheduled monthly loan payments were 4 months overdue. It is CDA's position that it did not exceed the 20-year loan term as the 1998 loan could be considered a new loan to the business which became a corporation. (Loans J.1, J.2 & J.3)

Loan Work outs and Non-Foreclosure of Delinquent Loans

As an alternative to foreclosure, CDA can grant a loan-work out if the loan is recoverable. However, CDA frequently provided loan work-outs even though there was no evidence that the loan could be recovered:

- In May 1998, CDA granted a loan-work out to a highly delinquent borrower subject to foreclosure proceedings despite the borrower's inability to continue business operations. Although CDA had previously granted loan revisions to this borrower, the borrower failed to comply with the loan terms. As of September 30, 2001, the borrower owes $251,000 and is 85 months delinquent. (Loan E)

- In August 1994, CDA obtained a default judgment to initiate foreclosure proceedings on a delinquent borrower's mortgaged property. This borrower owed CDA more than $717,000. However, instead of pursuing the foreclosure, CDA entered into a loan work out agreement with the borrower in 1996, two years after the default judgment. Meanwhile, the borrower continued to be delinquent in making payments. As of September 30, 2001, the borrower owes over $745,000 and is over 87 months delinquent in making loan payments. CDA explained that while it had deferred notice of sale due to a work-out, it still maintained its right to pursue foreclosure in event of property appreciation. In May 2002 CDA decided that borrower should either provide a feasible payment plan or CDA would require a Notice of Sale. (Loan I)

CDA's practices have contributed to the high rate of delinquent loans. More than $11 million in past due loan repayments are now considered delinquent.

The CNMI Economy

According to the Bank of Hawaii's Economic Report, dated August 30, 2001, most business gross revenues in the CNMI, exclusive of those from the garment industry, declined during the three years ending in 2000[10]. During this period when business revenue from other than apparel manufacturing was in decline, CDA revised 34 of 51 loans we had selected. These 34 accounted for 48 percent of the loan value of the 231outstanding loans as of September 30, 2001. CDA officials said that, to help business owners cope with the economic situation, it approved applications for loan revisions, and made loan revisions that generally had longer payment periods and lower monthly payments together with supplementary or additional loans than it would have otherwise have made.

Our review of practices noted above with delinquent loans indicates that *many predate the downturn in the CNMI's economy*. To illustrate, prior to the downturn in the economy, CDA had granted:

- a loan to a high risk borrower with questionable ability to repay, (Loan B.1)
- loans to two borrowers without adequately reviewing project feasibility, (Loans E and F)
- four questionable loan revisions, (Loans G.2, H.1, H.2 & J.4) and
- a loan work-out where there was no evidence that the loan could be recovered. (Loan I)

[10] Restaurant and bar revenues dropped 25.6 percent; hotel revenues declined 49.3 percent; and retail sales were down 34.4 percent. Garment revenues, however, increased 45.8 percent. Gains in garment sales prevented a much larger loss in GBR than the actual 13.6 percent recorded for 1997-2000.

Despite CDA actions to work with delinquent borrowers, many continue to be very delinquent as shown by previous examples summarized here:

- In August 1999, CDA gave a borrower a new $263,000 loan even though the borrower's two previous loans were 84 months past due. As of September 30, 2001, these three loans were 23, 95, and 84 months delinquent. (Loans C.1, C.2 & C.3)

- In July 1998, CDA gave a borrower with a history of untimely payments another $100,00 loan even though three previous loans had been revised as many as four times each and all were highly delinquent. Later, CDA supplemented this latest loan with another $100,000 loan. At September 30, 2001, all were again delinquent– three were 7 months delinquent and another was more than two years delinquent. (Loans D.1, D.2 & D.3)

- A loan work-out granted in May 1998 to a highly delinquent borrower has not achieved desired results. As of September 30, 2001, the borrower was 85 months delinquent in his loan payments. (Loan E)

- Despite loan revisions on two apartment complexes made during the economic crisis, the borrower is still considered 5 months delinquent in making loan payments. (Loan G.2)

CDA advised that the decline in the CNMI's economy has been accompanied by a decline in property value, and "this has placed many delinquent borrowers in the position of either giving up their security (deed-in-lieu-of-foreclosure) or paying a non-amortizing amount on their debt and hope that a turnaround will occur soon". To date, 21 of 86 clients contacted are reportedly seriously considering the option of a deed-in-lieu-of-foreclosure.

B. Loans Not Adequately Secured

DCD loans receivable should be covered by collateral adequate to secure CDA's interest. OPA found that three of 51 selected loans to 33 borrowers were inadequately secured because collateral had either not been verified or was insufficient in amount. This condition occurred because CDA had not strictly implemented loan security measures in accordance with DCD rules and regulations. As a result, as of September 30, 2001, CDA was exposed to possible loan losses of about $800,000 in loan principal. The total appraised value of the collateral securing the three loans was about $420,000. However, due to the prevailing economic condition, the actual market value of the properties may decrease even further.

Loan Security

Under DCD rules and regulations, CDA may secure loans using one or a combination of the following securities: (1) mortgages on real estate, (2) mortgages of leasehold improvements, (3) chattel mortgages and inventories, and (4) other securities such as assignments of life insurance policies, receivables, or individual guaranties. In securing loans, CDA uses the current market value of security to determine the maximum loan, and CDA's Board determines whether the security is adequate. Loan applications in excess of $25,000 must be accompanied by a complete appraisal report. Loan amounts for first mortgages are generally limited to 80 percent of the property value.

Unverified or Insufficient Collateral

CDA had not adequately secured three of 51 selected loans (covering 33 borrowers) because it had not verified or insured that sufficient collateral was used to secure loans.

- In 1996, CDA gave a borrower, with an outstanding loan of over $200,000, another $75,000 loan. CDA secured both loans with real property which, in 1984, was appraised at $179,000, and was subject to several mortgages and tax liens. CDA did not require the borrower to update the appraisal when it granted the 1996 loan. Consequently, CDA had no assurance that the value of the property was sufficient to secure the loans. As of September 30, 2001, the borrower owed $397,551 on the two loans and was 7 to 8 months delinquent in making loan payments on each. CDA stated that because of financial difficulties caused by a 1996 fire, the borrower had been allowed to use a 1994 appraisal to value the property, and as a result, the loan to value ratio is now within the 80 percent allowable for real estate. (Loans H.1 & H.2)

- CDA allowed the outstanding loan of a delinquent borrower to exceed the appraised value of her mortgaged real property. The loan, which had a balance of more than $104,000 as of September 2001, was only partially secured by property with a net appraised value of $86,800 in 1987 after deducting another collateralized loan from another institution. As of September 30, 2001, the borrower was three months delinquent in making payments. To ensure that the loan is adequately secured, CDA needs to request an updated appraisal and obtain additional security from the borrower, if necessary. CDA explained that when it reviewed this loan in June 2002, it recognized this deficiency and requested the borrower to provide additional collateral needed to secure the deficiency. (Loan K)

- In March 1994, CDA provided $243,000 of the $293,000 in loan proceeds to a borrower before it had received either a title opinion or an evaluation of property to be used as collateral. CDA subsequently found the collateral of $154,000 to be defective and the borrower failed to rectify the defects. Consequently, CDA did not allow the borrower to draw down the balance of the approved loan. As a result, the loan was not adequately secured. As of September 30, 2001, the outstanding loan amount had increased to $304,800 and the borrower was 45 months delinquent in making loan payments. CDA explained that it had conditionally approved a partial disbursement of loan proceeds because the proceeds were urgently needed to begin the business venture. However, after CDA recognized the inherent defects in the real estate being offered as collateral, it curtailed further loan disbursements, and directed that partial disbursements would no longer be authorized. (Loan L)

These conditions occurred because CDA did not always ensure the sufficiency of collateral. Among other possible reasons, CDA did not obtain updated appraisal reports, allowed borrowers to sell collateral without replacement, and allowed borrowers to substitute new collateral without appraisals. The resulting lack of adequate security has exposed CDA to possible loan losses of about $800,000 as of September 30, 2001.

According to CDA, appraisal reports should be updated after a series of loan revisions. Realizing that the value of real estate properties was decreasing and that CDA's interest needed to be protected, DCD in 2000 began requiring curbstone appraisals for loans with increasing balances.

C. Other Matters - Violations of DCD Rules and Regulations

In OPA's review of 51 loans, it found several other matters involving violations of DCD rules and regulations.

Loan Granted To A Borrower With Less Than Twenty Percent Equity

According to DCD rules and regulations, loan applicants must be willing to provide reasonable equity, either in cash or in-kind, of not less than 20 percent of total project cost. CDA granted a borrower, who had no initial business equity, a $265,000 initial loan in 1993, and a $100,000 supplemental loan in 1994. According to CDA, the issue of the 20 percent equity requirement is brought up for discussion periodically in CDA Board meetings. A board member stated that if a borrower does not meet the equity investment, CDA should also consider the collateral's value as this would assure that the borrower has an appropriate stake in the venture. In addition, the board member stated that CDA can foreclose on the borrower's collateral if the borrower is unable to make his scheduled loan payments; CDA's approval depends not only on the 20 percent equity infusion, but also on the sufficiency of collateral offered. CDA explained that given the value ($600,800) of the security provided, the Board waived the 20 percent requirement. (Loans N.1 & N.2)

Loan Granted To A Relative Of A CDA Official

DCD rules and regulations addressing conflicts of interest prohibit CDA from granting loans to immediate relatives of certain CDA officials. However, we noted that CDA granted several loans totaling at least $1 million to an immediate family member of a past CDA official who was in a position to authorize or approve a loan. (Loan G.2)

According to the Loan Manager, CDA does not require members of the loan committee or the Board to submit written certifications for conflict of interest, and CDA's ability to identify conflict of interest situations is limited. CDA can only identify a CDA official's conflict of interest if the matter is public knowledge or if a concerned CDA official voluntarily recuses himself during deliberations.

Although in the absence of board meeting minutes it initially appeared that the CDA signing official may have participated in the loan deliberation and/or determination to grant the loan, the minutes subsequently provided by CDA show that the individual with contracting authority at that time to have recused himself from loan deliberations as required by law. CDA further explained that the individual signed only because he was the contracting authority under the regulations in effect at the time.

The CDA enabling legislation at 4 CMC §10408 indicates clearly indicates that interested officials should remove themselves from deliberations and determinations where a qualifying relative is involved. More specifically, it states that:

> no board official shall "in any manner, directly or indirectly, participate in the deliberation or upon the determination of any question affecting" a loan where a qualifying relative is involved.

Given the intent of this statute and regulations which grant signature authority to three possible officials, we suggest that, in the future, any concerned relative should not only recuse himself from such deliberations but also allow another official to sign loan documents for him so as to preclude any appearance of conflict.

Granting Of Loan Extensions Over The 20-Year Maximum Term

Although DCD rules and regulations require that borrowers repay loans within 20 years, CDA effectively gave loan extensions of over 20 years to at least two borrowers because of repeated loan revisions. (Loans G.1, G.2, J.1 and J.3)

- When CDA consolidated a 1985 20-year loan with other recent loans, it effectively extended the loan termination to 2011, or about 26 years beyond the loan origination date. CDA acknowledged that the loan term had been extended 6 years over the maximum allowed because two loans were consolidated, with the later 1991 loan becoming the basis for repayment.

- CDA revised a 1986 CDA loan several times with the most recent extending the repayment period to 2013, or 27 years beyond the loan origination date. CDA explained that it had not exceeded the 20-year loan term as the 1998 loan could be considered a new loan to the business which became a corporation.

CDA's Legal Counsel was unaware that DCD had entered into a new loan agreement to pay off an existing loan balance. However, in his opinion, such refinancing does not violate the 20-year limit, and he knows of no provision in the regulations which prohibits DCD from giving another loan to refinance the unpaid portion of an earlier loan. He believes that as a lender, DCD has the flexibility to provide loan work-outs.

Failure to Enforce Insurance Coverage

To safeguard loans, CDA may require that borrowers obtain property and life insurance policies naming CDA as the beneficiary. Of 33 borrowers reviewed, OPA found that CDA had not strictly enforced the insurance requirement. Of the 24 required to maintain life insurance, only 17 had such insurance coverage. Of the *22* required to maintain property insurance, none had such insurance coverage as of September 30, 2001.

Conclusion and Recommendations

DCD loans receivable are at risk because of the high percentage of delinquent borrowers, insufficient and unverified collateral, violations of DCD rules and regulations, and the recent overall economic decline in the CNMI. Accordingly, we recommend that:

1. The CDA Board develop and follow procedures and guidelines that would provide managers and board members sufficient basis to:

    - prohibit the approval of loans to borrowers having no capacity to repay loans. CDA should seriously consider prospective borrowers' past collection problems and defects in credit ratings when evaluating loan applications;

    - prohibit the granting of supplemental loans to highly delinquent borrowers as this circumvents the loan payment process, with the borrower using the additional loan proceeds to update his or her loan;

    - prohibit granting loan remedies to highly delinquent borrowers. CDA should approve loan revisions sparingly, and discourage repeated and routine approval of loan revisions as this practice masks delinquent borrowers by making their loans appear current.

    - help enforce the foreclosure of collateral of delinquent borrowers;

    - prohibit borrowers from substituting or selling mortgaged collateral unless they use the proceeds to repay outstanding loans; and

    - require that updated appraisal reports of collateral be obtained before initial and supplemental loans are granted. Also, appraisals of collateral property should be updated whenever the outstanding loan amounts have increased substantially.

2. CDA issue a policy memorandum reminding management andboard members to strictly enforce DCD rules and regulations concerning the: (a) 20 percent equity requirement, (b) 20-year maximum loan term, (c) conflicts of interest, and (d) insurance requirements, and any civil and criminal penalties for failure to do so.

3. CDA and the Attorney General's Office continue to take necessary legal action to foreclose collateral of borrowers' highly delinquent loans.

CDA Response

CDA responded to OPA's draft report on August 28, 2002, and on September 20 provided a revised response, (**Appendix A**).

Recommendation 1 - CDA agreed that it needs to develop better procedures and guidelines to minimize delinquencies. It advised it has historically relied too much on the underlying security when considering borrower repayment capability, and is now giving greater consideration to business experience, credit history, education and project feasibility. It acknowledged that while it has on occasion provided supplemental loans to highly delinquent borrowers, it is now developing procedures and guidelines that address how such loans will be approved. As concerns prohibiting the granting of loan remedies to highly delinquent borrowers, it said that historically loan revisions were granted on a routine basis, and that CDA staff will develop guidelines for consideration by the Board to address this matter. CDA stated it agrees that it should require updated appraisal reports and will implement them on future loan revisions.

Recommendations 2 and 3 - CDA advised it will distribute a policy memorandum outlining OPA's concerns and a copy of this report to all board members and senior management. CDA also agreed to take legal action to foreclose collateral on highly delinquent loans,

Finally, CDA stated that its management and Board of Directors share OPA's concern as reflected by the following actions it has taken:

- In 2001, the Board of Directors placed a moratorium on all direct loans except MicroLoans until such time as cash reserves increased and the delinquency rate improved. In August 2002, the Board also placed MicroLoans under the moratorium.

- In June 2002, the Board directed that borrowers of all seriously delinquent loans be given a series of options, and if they fail to select an option, they are to be served a 30-day notice that could potentially lead to legal action. As a result, 21 borrowers are now considering providing CDA with a deed-in-lieu-of-foreclosure.

- CDA produced a loan operating manual.

- CDA updated its access to credit agencies and now uses borrowers' credit scores in its loan analysis. Borrowers must take at least four CDA sponsored workshops before CDA will grant a loan.

OPA Comments

CDA has concurred with our recommendations and plans to take needed action, namely to develop procedures and guidance to provide managers and board members with sufficient basis for prohibiting loans and loan revisions to highly delinquent borrowers, and for ensuring that adequate collateral is present. CDA's recent actions show it is committed to correcting the problems.

Based on CDA's updated response, we consider Recommendations 1 to 3 to be resolved. Actions or documents needed to consider these recommendations as closed are presented in **Appendix B**.

Sincerely,

Michael S. Sablan, CPA
Public Auditor

xc: Governor
Lt. Governor
Thirteenth CNMI Legislature
Deputy Attorney General
Special Assistant for Management and Budget
Press Secretary
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September 20, 2002
Revision of August 28, 2002, Response

Mr. Michael S. Sablan
Public Auditor
Office of the Public Auditor
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Saipan, MP 96950

Dear Mr. Sablan,

Subject: ***Formal Response to the Audit of CDA's Loan Receivables as of September 30, 2001***

The following constitutes CDA's formal response to OPA's recent audit. CDA truly appreciates the earlier opportunity to meet with you and your staff to discuss the audit findings. It is our hope that your report and CDA's response will not only educate the leaders and residents of the CNMI, but will also continue the improvements within CDA's operations.

As noted in your report, this is OPA's initial audit of CDA's loan receivables. As such much of what is contained in your report represents actions taken as much as seventeen years ago when CDA was created. We believe that all parties concur that there are true benefits from the audit and that future audits will occur more frequently.

Our response is composed of three sections. The first section deals with items in the report which CDA questions as to the factual accuracy and/or items which CDA feels should be included in the report that mitigate the audit findings. The second section looks at the specific findings cited in the report, primarily the point in time that the loan was made and the value of the security at that time. The third section addresses your recommendations and what CDA proposes to accomplish.

Section 1:

Reference to the Purpose of CDA's Development Corporate Division (DCD)

Your report references the three primary purposes of the DCD. Which is to promote, aid and develop the private sector of the CNMI. The primary tool for this is direct loans by CDA.

However, CDA's enabling legislation (P.L. 4-49) in Section10, (i) and (k) and Section 6, 34 (b), 3 prohibit CDA from competing with commercial banks. As a result of this enabling legislation, CDA's regulations stipulate that any loan processed and funded by CDA must be first denied by a commercial bank.

CDA's position is that these requirements inherently increase the credit risk of CDA's borrowers. In essence CDA is the lender of last resort. CNMI has been fortunate that an active commercial banking industry exists and CDA can only conclude that the denied loans considered by CDA were not submitted from a lack of funds available by the commercial banks, but based on the credit quality of the application. Thus, any borrower that qualifies for a CDA loan has already been rejected by a commercial bank and as such will have a less than sterling credit history.

Additionally, the Covenant specified that funding for Agriculture and Marine loans were to receive a priority in funding (tourism, at that time not having been considered). Historically, because of this special emphasis CDA's Board has offered such loans at a reduced interest rate of 5 percent. This not only reduces the potential revenue of CDA, but the underlying security is generally non-revenue producing when faced with foreclosure. As seen in some of your examples both commercial Marine and Agriculture projects suffer a high rate of failure.

Further, CDA is prohibited from making more lucrative "consumer" loans. These loans generally have a shorter term and a higher interest rate than commercial loans. These mandated restrictions have placed CDA in the unenviable position of requiring economic stimulus to borrowers that have reduced credit worthiness. CDA shares OPA's stated concerns about the existing delinquency rate and the Board of Director's actions in recent history reflect that shared concern.

Delinquency of Loans

As discussed, all parties acknowledged the reference of a stated percentage, while perhaps quantified by mathematical calculations; it is not necessarily the best way to report OPA's concerns. CDA does share the same concern over the percentage of the provision for doubtful accounts. As referenced in Section Three, CDA's Board of Directors have enacted several policy changes in the past two years to address this problem.

CDA concurs that the delinquency problems can not be defined down to one specific reason. Rather in was a confluence of several factors, some of which are controllable and some which are not. As stated in CDA's annual audit response to the same concern raised by CDA's outside auditors, "the staff and Board of Directors of CDA are exploring alternatives, including appropriate legal action to help resolve this situation. **However, full recovery has and will be dependent upon the improvement of the overall economy",** (Emphasis added).

The CNMI Economy

The report references the fact that a significant percentage of the current delinquencies predated the economic decline. CDA believes there is evidence to dispute this analysis. Primarily the significant drop of the tourism industry during the 1991-92 Mid-East crisis. Irrespective, what is not shown is the corresponding decline in the value of real property.

When the majority of these delinquent loans were made, CNMI was unknowingly enjoying a bubble economy fueled by Japanese investments. In particular this artificially and dramatically increased the value of real property. Historically, the CDA Board could maintain the policy of revising loans because the underlying security of the loan was so great. Some borrowers in the mid-nineties in fact sold their properties and paid off their loans. What has only become apparent in the last three to four years is that real property values have decline significantly and it will be many years (baring a major Asian re-investment) before prices return to these old levels.

This has placed many delinquent borrowers in the position to either give up the security (deed-in-lieu-of-foreclosure) or pay a non-amortizing amount on their debt and hope that a turnaround will occur soon. Historically, the Board of Directors of CDA has been willing to work with borrowers with reduced payment plans.

Two months ago, the Board of Directors authorized a series of options to its delinquent borrowers. One of the options was the deed-in-lieu-of-foreclosure, of the initial 86 clients contacted, 21 are seriously considering this option. Given that fact, CDA is now aggressively pursuing delinquent accounts. All parties, however, must remember the foreclosure of property does not provide any immediate funds for CDA, in fact the opposite can occur.

Missing Insurance Documents

CDA has an ongoing project that will allow for the computerization of certain basic annual reporting requirements, including insurance renewals. It is believed that when this system is completed such omissions will be greatly decreased.

Repeat of Findings of the Report

It appears that several findings referenced in the report repeat the same findings on other pages. Additionally, it appears that the context of some of these finding is also the same. CDA believes that a casual reader might interpret these as additional findings.

Violation of DCD Rules and Regulations

Twenty Percent Equity Requirement

The report references the fact that a loan was made to a client with less than 20% equity. As discussed, this does not take into account the security pledged by the client. In the case of the example cited, the borrower had property pledge that totaled $600,800.00. Given the total of the value of the security to the loan, the Board waived the 20% requirement. As previously discussed, when this loan was initiated and increased the CNMI was enjoying record high in real estate values, which justified the loan.

Conflict of Interest

CDA has forwarded the minutes of the Board meetings of May 10, 1985 and May 23, 1991, for your review. Because of the origination date of the loan in question, these were in storage and were not readily available to your auditor. As shown, the Board member in question excused himself during the deliberation of this loan.

While it is true that a related party's signature is on the borrower's loan document, the signing of the document was purely an administrative function of the Board member reflecting an action properly approved by the Board of Directors.

CDA's management will present OPA's suggestion to CDA's Board of Directors for consideration and adoption that a non-conflicted Board member sign future loan documents in this situation.

Section Two:

The following Section of CDA's Response presents more details and explanations to the examples given in the audit report.

Loan A:

Loan A was not granted a 90 percent guaranty with the intention to bail the borrower out of financial trouble. The debts that were consolidated were permitted as the funds where used to purchase vehicles and equipment related to the business. Given the reduced monthly debt repayments as a result of the consolidation of business debts into one loan, the revenue projections, the added fleet, and secured collateral position by the bank and CDA, the borrowers capacity to repay the loan would appreciate ensuring proper loan servicing. It is upon evaluating these factors that the Board granted Loan A, the intention was never to bail out the borrower out of financial trouble but rather stimulate his business.

Loans B1 and B2:

Loan B was granted a $665,000.00 in October of 1996 based on its revenue projections and the socio-economic benefits it contributed to the Rota community. At the time, Loan B was a vital shipping source for the neighboring island. Unfortunately, a catastrophic event overturn the allied vessel in 1997 greatly reduced their projected revenue being that the vessel was a main income source. CDA was aware of the risks associated with this particular business, however, after thorough review and consideration of the economic and social benefits derived from this business operation, the Board granted Loan B. Recognizing the necessity to protect its risk exposure, the Board imposed a requirement to obtain and secure a 1st Mortgage lien on a real estate valued at $1,841,000.00 which was executed upon loan consummation.

Loans C1, C2 and C3:

Loan C was granted $263,000.00 in August of 1999 based on the improved security position of CDA by acquiring three additional real properties surrounding the business. Prior to this loan, CDA had in its possession only two real properties wherein the bar and grill and the main building were erected. The acquisition of the three properties had added improvements that include the extension of the main building, the function hall and the parking and staff barracks facility. In aggregate, by acquiring all 5 contiguous real properties with a total value of $3,195,000.00 in 1999, CDA's loan to value ratio was at 67%, 13 percent below the allowable 80 percent loan to value ratio.

Loans D1, D2, D3 & D4:

The loan granted to Loan D in July 1998, was to assist the borrower improve its revenue source at the same time establish a viable market center for agricultural and fishery producers. Based on modified revenue projections, it was determined that this market center will enhance the borrowers revenue projections at the same time contribute to the underserved agricultural and fishery entrepreneurs in the establishment of an outlet for resale of agricultural and fishery products. The review of the borrowers income potential and socio benefits were deliberated upon the granting of Loan D.

Loan E:

Loan E was granted a $250,000.00 loan in June, 1983, to establish a viable agricultural business. The set-up and outfit of the business took a little over a year. By the time the borrower had situated the set-up of the business, the USDA approved slaughterhouse was established. The borrower fully utilized the services of the USDA slaughterhouse until its closure in 1986. The loan was granted as a result of the awareness that the slaughterhouse would be in place and the viability of this business venture during the time. Its untimely closure in 1986 was unforeseen by CDA or the borrower.

Loan F:

Loan F was granted a marine loan based on the potential viability of the business to explore an untapped large-scale fisheries industry. The impediment of the success of this business was due to a lack of information available at the time. The borrower and CDA were advised by local United States Coast Guard representatives that only the captain of this marine venture had to comply with citizenship requirements. It was, thereafter, during the initial business operation that citizenship requirements were clearly determined which included crew members to meet such citizenship requirements. Given this stiff requirement, the borrower was unable to meet this requirement due to increased costs. Research of marine requirements for this type of business venture were verified by CDA and the borrower. Unfortunately, the information obtained was not clearly defined by authorized officials.

Loan G1:

As stated earlier with regards to G1 and the issue of conflict of interest, minutes of the Board meeting are attached that document the Board member in question recused himself during the deliberation of this loan.

Loan G2:

It is acknowledged that this loan has been revised numerously. The revisions were granted as a result of documentation indicating a reduced rental income due to excessive vacancies. Upon a recent review of this particular loan and the continued poor performance in May, 2002, CDA commenced legal action against the borrower by issuing a demand letter through our legal counsel on June 19, 2002.

It is further acknowledged that the loan term was extended 6 years over the maximum 20-year term stipulated in the DCD Rules and Regulations. The 6-year extension was not intended to exceed the maximum term allowed, but rather was a result of a consolidation of two loans. The original loan in 1985 and the supplemental loan in 1991, where consolidated in 1993 into one loan. As approved by the Board and concurred by the legal counsel, the 20-year maximum term allowed for the supplemental loan in 1991 was the basis for the repayment period, thus, resulting in the maturity of 2011, 20 years from 1991.

Loans H1 & H2:

The approval of loan revisions of Loan H were not intended to bring the loan status to current but were approved as a result of documentation indicating a reduced revenue income as a result of economic disparities in the early 1990's affecting the retail industry. In 1996, the commercial building of the borrower was completely damaged due to a fire. Due to the shortage of water supply in the Garapan area at the time, the Department of Public Safety was unable to contain the fire. The Board granted this borrower the supplemental loan of $75,000.00 identified as a disaster loan to enable the borrower to rebuild the business establishment that was the only source of income to repay the loan.

Noted in the draft report, that Loan H was granted the supplemental loan of $75,000.00 with only an appraisal report on file dated 1984 valuing the property at $179,000.00 is inaccurate. The appraisal on file was dated June of 1994 that valued the real property at $357,000.00. The appraisal on file dated 1994 did not include the appraised value of additional studio type units erected around the commercial building. As a result of the financial difficulty of the borrower due to the severe damages of the fire, the borrower was granted to utilize the appraisal report dated June 1994 to determine the value of the real property. Evaluating the collateral to be secured and existing liens to the property, the loan to value ratio was within the 80 percent allowable for real estate (refer to attached collateral evaluation for Loan H).

Loan I:

CDA had deferred a notice of sale of Loan I due to the recovery attempts in the form of a loan workout situation. Although, the notice of sale was deferred, CDA secured a writ of execution from the court and maintained its legal rights to pursue foreclosure should the value of real property appreciate. In May, 2002 upon review of this loan and clear evidence of poor performance, CDA issued a notice from our legal counsel to avail of alternative options to address this loan. Failure of the borrower to provide CDA a feasible payment plan will require a Notice of Sale by CDA.

Loans J1, J2, & J3 :

In 1986, Loan J was originally obtained by two borrowers as a sole proprietorship. Subsequently, in 1998, a corporation involving only one of the borrowers and other shareholders acquired the business operation under a new corporate name. The 1998 "new loan" that was granted to Loan J was approved as a corporate loan. In this sense, the 1998 loan was determined to be that of a new loan making it eligible to avail of the maximum 20 years allowed from the closing of the new loan under the corporate name in 1998.

Loan J4 :

Loan J was revised as a result of documentation indicating a reduced revenue stream impacted by the downturn of the economy.

Loan K:

It is acknowledged that Loan K is currently inadequately secured due to the increase of the loan balance and the depressed value of real estate. However, upon the consummation of the loan in 1987, the loan was fully secured by the collateral on file inclusive of a subsequent lien from another institution. Recognizing the deficiency of the collateral upon a review of this loan in June, 2002, the borrower has been advised to provide additional collateral to secure the deficiency.

Loan L:

It is acknowledged that Loan L was partially disbursed without the receipt of a title opinion or an appraisal report. Due to the urgent need of the loan proceeds to commence the business venture of the borrower, CDA conditionally approved a partial disbursement securing the fishing boat as collateral for the proceeds disbursed and prohibited subsequent disbursements until the completion of all loan requirements relating to the real property to be secured for this request. Recognizing the inherent defects of the real estate to be offered as collateral, further draw down's were immediately seized. As a result of this situation, the Board of Directors sanctioned a strict directive that there will be no longer authorized partial disbursements under any circumstance until all loan documents and securities are in place. As of 1994 to date, no loans have been disbursed without proper loan documentation and security agreements.

Loans N1 & N2:

It is acknowledged that Loan N did not provide a 20 percent equity in cash, however, they pledge real property valued at $600,800.00 as security for the initial loan of $265,000.00 in 1993 and the supplemental loan of $100,000.00 in 1994 as an added security to the fishing boats also held by CDA. As stated earlier, given the total value of the security to the loan, the Board waived the 20 percent equity requirement.

<u>Section Three:</u>

This section is CDA's formal response to your recommendations. Once the final report is issued CDA will provide you with a schedule of implementation for those items discussed below.

Recommendation #1, CDA should develop and follow procedures:

CDA agrees with your finding that better procedures and guidelines need to be developed. However, some modification to your findings may need to be considered. We address them as follows:

-Prohibit loans to borrowers that have no capacity to repay the loan.

CDA can assure you that it is not in the business to intentionally give loans to borrowers who cannot repay. The question is, how can this be determined. All of CDA's loans are for the purpose of business enterprise. That may include the startup of a new business or the construction of rentals that generate income. That is, the business enterprise being financed, is expected to repay the loan. If CDA initiated a policy that income unrelated to the business project must be sufficient to repay the loan it would defeat the purpose of economic stimulus as required by our enabling legislation.

Without a doubt, historically CDA has relied too much on the underlying security as the ultimate repayment capability. Greater consideration of business experience, credit history, education and feasibility of the project is now being given.

As additional information, the Board of Directors previously issued a moratorium on direct loans except for the MicroLoan Program. On August 23rd, the Board extended this moratorium to the MicroLoan Program, until such time as CDA's staff completes an analysis and prepares recommendations to the Board to reduce the delinquency rate.

-Prohibit Supplemental loans to highly delinquent borrowers:

As previously mentioned in Section two, on occasion this action has taken place. Generally, such action is for an economic reason, such as paying off a preferred creditor to CDA's position or the borrower's revised plan that projects greater efficiencies and profitability from the new loan. However, we concur that procedures and guidelines be developed that specifically address how such supplemental loans will be approved.

-Prohibit the granting of loan remedies to highly delinquent borrowers:

CDA agrees that historically, revisions were granted on a routine basis. CDA staff will develop guidelines for consideration of the Board of Directors to address this concern. Primary in these recommendations would be consideration of an immediate economic gain by CDA (significant payment), additional collateral and a payment schedule that is truly realistic.

-Prohibit borrowers from substituting or selling collateral:

CDA is unaware of any specific situation where this has occurred. Current policy is that any sale or substitution is only allowable where there is a corresponding economic benefit to CDA.

-Require updated appraisal reports:

CDA concurs with this finding and will implement on future loan revisions.

Recommendation #2, CDA's Executive Director should issue a policy memo:

A policy memo outlining OPA's concerns and a copy of OPA's audit report will be distributed to all Board members and senior management when OPA's final report is issued.

Recommendation #3, CDA should consider legal action to foreclose collateral:

CDA concurs and the implementation of this is ongoing.

Conclusion

CDA's comments are not meant to suggest that there are no concerns regarding the loan delinquency rate or the known problems cited in your audit report. On the contrary, our comments are meant to place the transactions in the timeframe and economic environment at the point in time the transaction occurred.

CDA's management and Board of Directors share OPA's concerns and the following recent actions confirm that the CDA is aggressively pursuing proper solutions and actions.

-Moratorium: In 2001, the CDA Board placed a moratorium on all direct loans except MicroLoans, until such time that cash reserves increased and the delinquency rate improved. Prior to this the Board had issued changes to the loan to value ratio analysis stating that only 50% of the appraised value would be considered (a reduction from the 80%). In August 23, 2002, the Board also placed MicroLoans in moratorium.

-Alternative Options: In June 2002, the Board directed that all seriously delinquent loans be given a series of options. If no option was selected, this notice also served as a 30 days notice potentially leading to legal action. As previously stated, 21 borrowers are considering deed-in-lieu-of-foreclosure. From this review, a total of 121 loan files have been forwarded to the CDA's legal counsel for action.

-Loan Operating Manual: For the first time CDA has produced (in 2000) a Loan Operating Manual. Additionally CDA's loan staff has been stabilized and well trained (the Saipan Loan Department thru retirement had a 100% turnover in the past 3 years).

-Updated Credit Analysis & Education: CDA updated its access to credit agencies and now utilizes the borrowers credit scores in its loan analysis. Borrowers are now required to take a minimum of four CDA sponsored workshops before a loan will be granted.

It is hoped that these examples will show the seriousness which CDA takes the delinquency problem and that in spirit and in action support the overall recommendations of your good office.

Again, we would like to thank you and your staff for this enlightened report. As always we have found you and your staff to uphold the highest level of professionalism. It is our sincere hope that the outcome of this report will not only give CDA a fresh view of its operations, but also inform the public in a non-inflammatory, transparent manner.

Respectfully yours,

FoR Maria Lourdes S. Ada
Executive Director

cc: CDA Board of Directors
Comptroller
DCD Loan Manager