



El Paso Empowerment Zone Loan Review

Issued by the
Internal Audit Office
April 18, 2007

Introduction

A review of 20 loans valued at \$2,631,707.63 funded by the Empowerment Zone between the periods of 1/10/2006 through 1/3/2007 was conducted. The objectives of the project were to:

- Verify that the loans were properly approved,
- Verify that a cash flow analysis was conducted of the borrower's business to determine if there was an adequate cash flow to repay loan and meet future obligations,
- Verify that the loan files contain adequate documentation to show evidence that the files comply with the Criteria and Guidelines for the Border Opportunity Fund, Border Opportunity Fund-Policies and Procedures, and the Policies and Procedures Manual for the El Paso Empowerment Zone Corporation Loan Fund,
- Verify that a Uniform Commercial Code (UCC) Financing Statement and/or a Deed of Trust was filed listing the collateral that was used for the loan and listing the El Paso Empowerment Zone as the Secured Party,
- Verify that the borrower's business is located in the Empowerment Zone and met one of the two HUD requirements that: either 51% of business beneficiaries are Zone residents, or that at least 35% of the jobs created or retained due to the Project are held by Zone residents,
- Verify that the borrower obtained adequate insurance coverage depending on the loan type,
- Verify that the monthly payments have been calculated correctly given the amount, interest rate, and term of loan.

Criteria

The loan review was conducted using the following criteria:

- Criteria and Guidelines for Border Opportunity Fund,
- Border Opportunity Fund - Policies and Procedures,
- Policies and Procedures Manual for the El Paso Empowerment Zone Corporations Loan Fund, prepared by Vision Consulting Associates LLC, dated April 2003,
- The five (5) Cs of Lending (Capitalization, Conditions, Character, Cash Flow/Capacity, and Collateral),
- El Paso Empowerment Zone website: www.elpasoez.org,
- August 2005 - February 2006 Board Meeting Minutes used to identify any changes to policy,
- 2005 and 2006 Finance Committee Minutes.

Our review of the El Paso Empowerment Zone's loan files identified the following observations:

Observation 1 Conflict of Interest

One (1) out of the 20 (5%) loans valued at \$99,500.00 is in violation of the Empowerment's Zone Conflict of Interest Policy. The loan was to a Board Member's immediate family member.

Criteria: According to the Conflict of Interest Policy located in the Border Opportunity Fund – Policies and Procedures, “It is the policy of BOF to prohibit financings or loans to any employee or to any immediate family member of the same.”

Impact: Loan funded based on self-dealing practices and not based on sound lending practices.

Observation 2 Authorization of Documents

Three (3) out of the 20 (15%) loans valued at \$1,018,000.00 were not properly authorized.

- Loan EZRLF #74: Loan Agreement and Security Agreement were not signed by Executive Director.
- Loan EZRLF #75: Loan Agreement, Guaranty, and Promissory note were not signed by the borrowers.
- Loan EZRLF #85: Loan Agreement was not signed by Executive Director.

Criteria: According to the Policies and Procedures Manual for the El Paso Empowerment Zone Corporation Loan Fund “documents will be prepared to legally support the EZ’s ability to obtain and liquidate collateral, if necessary.”

Impact: Generally Loan Agreements and similar loan documents do not become binding until all parties have signed, indicating their approval of the loan terms.

Observation 3 High Risk Borrowers

Eleven (11) out of the 20 (55%) loans valued at \$1,575,307.63 were to high risk borrowers. The borrower either had bad payment trends, low credit scores, low commercial scores, and/or limited years in business.

Criteria: According to the Policies and Procedures Manual for the El Paso Empowerment Zone Corporation Loan Fund “credit is only to be granted to reputable borrowers, borrowers with derogatory credit including bankruptcy, charge-offs, repossessions, and foreclosures are discouraged. The EZ procedures also provide broad descriptions of acceptable and unacceptable credits, listing “loans to a new business without an established record of performance” as being unacceptable. Credit risk is only to be accepted with appropriate approval authority and complete documentation.”

Impact: Loans funded to high risk borrowers have a higher chance of defaulting.

Observation 4 Cash Flow Analysis

Eight (8) out of the 20 (40%) loans did not contain a cash flow analysis conducted by the Empowerment Zone.

- Three of the loans totaling \$35,500.00 that did have a cash flow analysis conducted by the Empowerment Zone, indicated that the loans payments would put a strain on the businesses, but the loans were still funded.
- Two of the loans totaling \$21,807.63 that did not contain cash flow analysis show no evidence that the borrowers would be able to make the monthly EZ loan payments.

Criteria: According to the Policies and Procedures Manual for the El Paso Empowerment Zone Corporation Loan Fund “borrower’s cash flow and financial resources should be sufficient to repay all of its term obligations. Historic and projected cash flows are to be analyzed for adequacy and reliability.”

Impact: The Empowerment Zone has incurred the risk of incurring losses of approximately \$57,307.63 due to borrowers not being able to make their loan payments.

Observation 5 Collateral

Twenty (20) out of the 20 (100%) loans reviewed did not show evidence of collateral verification or evaluation in the form of an appraisal for Real Estate loans, physical inspection of equipment and inventory, and/or Accounts Receivable confirmations.

- Four (4) out of the loans were Real Estate loans that did not contain a current appraisal or evaluation of the real estate.
 - Appraisals were ordered for the four Real Estate loans. Based on the market value of the appraisals, 2 out of the 4 (50%) loans were financed above the 80% loan to value limit established by the El Paso Empowerment Zone.
 - A second appraisal was ordered of the property located on 2720 Yandell due to the large variance in “price per square foot” used by the appraiser. The appraiser used comparables that were situated in either East El Paso or West El Paso and were quite a large distance away from the subject property.
- Eleven (11) loans did not contain a Schedule of Collateral with their corresponding values.
- Eighteen (18) loans, totaling \$2,086,707.63, do not contain evidence of sufficient collateral supporting the loan amount.

Criteria:

- According to the Policies and Procedures Manual for the El Paso Empowerment Zone Corporation Loan Fund “all loans and guarantees are to be supported by collateral verifications and/or appraisals. All real estate and real estate-related financial transactions require a documented appraisal or evaluation of the real estate except for those specifically exempted by federal agencies’ appraisal regulations. Equipment financing require a physical inspection, and lending on accounts receivable and inventory requires a careful and complete evaluation and monitoring of the collateral. Unsecured credit facilities should only be extended to the EZ’s most credit worthy borrowers or on a limited exception basis.”
- According to the Border Opportunity Fund Criteria and Guidelines a schedule of collateral must be submitted by every applicant.” Depending on the value of the collateral and the type of loan, the Empowerment Zone only lends out a certain percentage of the collateral value amount. For example equipment financing is limited to 90% of the purchase price of office and technology equipment and for long-term commercial real estate there is limit of 80% loan to value (LTV).

Impact: The Empowerment Zone is over financing its collateral, and does not have recourse for the entire amount of the loan in the event it defaults.

Observation 6 Lack of Documentation

Twenty (20) out of 20 loans (100%) do not contain one or all of the following required documentation: Personal guarantee, loan application, three to five year business forecast, business plan, business financial statements, business budget, personal financial statements, Schedule of business debt, Environmental Review Questionnaire, Accessibility/ Letter of Assurance (ADA questionnaire), Security Agreement, personal tax returns, landlord’s lien waiver, and loan monitoring forms.

Criteria: The above documents are required per the Policies and Procedures Manual for the El Paso Empowerment Zone Corporation Loan Fund, the Border Opportunity Fund - Policies and

Procedures, and/or the Criteria and Guidelines for the Border Opportunity Fund.

Impact: Empowerment Zone is placing its assets at risk and not securing its interests by not adequately documenting its loan files.

Observation 7 UCC Financing Statements

Thirteen (13) out of 20 (65%) loans, valued at \$980,207.63 do not have a current UCC Financing Statement with the Texas Secretary of State.

- Three (3) of these 13 loans had UCC Financing Statements securing their collateral with other lenders.
- Four (4) of the borrowers had UCC filings for prior EZ loans, but the Empowerment Zone did not file a continuation in order to avoid losing the perfected secured interest.
- Two (2) of the 13 loans contained a completed UCC Financing Statement in the loan file, but the Texas Secretary of State does not show the statements as being filed.

Criteria: According to the Border Opportunity Fund – Policies and Procedures “it is the policy of BOF that filings are made to establish and protect perfected security interests in loan collateral. Before a loan is approved, staff is to search for prior liens and security interests in collateral to verify that BOF has or will have an expected priority position. Staff members must maintain a keen interest in filing continuations in order to avoid losing a perfected secured interest.”

Impact: The Empowerment Zone did not adequately secure its interest in loans totaling \$980,207.63.

Observation 8 Empowerment Zone Residency

Eleven (11) out of the 20 (55%) loans, valued at \$1,528,000.00 did not meet the Empowerment Zone residency and/or business requirements.

- One borrower with two (2) loans was not located or relocated within the Empowerment Zone,
- One (1) loan did not comply with Housing and Urban Development (HUD) requirements,
- Ten (10) loans state that at least 35% of the jobs created or retained due to the financing of the project are held by EZ residents, without proving a listing of employees with their corresponding addresses.

Criteria: According to the Policies and Procedures Manual for the El Paso Empowerment Zone Corporation Loan Fund “Businesses assisted through the BOF must comply with United States Housing and Urban Development (HUD) requirements that a majority (over 51%) of the beneficiaries of the business activity are EZ residents or that at least 35% of the jobs created or retained due to the financing of the project are held by EZ residents. Any lending outside the EZ’s designated service area is an exception to policy and must be justified based upon a long-term profitable and safe relationship.”

Impact: These loans were made in violation of the Empowerment Zone’s mission and strategic goals, and are unallowable.

Observation 9 Insurance Documentation

Seventeen (17) out of 20 (85%) loans, totaling \$1,886,207.63, did not contain evidence of the required insurance for the loan type.

Criteria: According to the Criteria and Guidelines for the Border Opportunity Fund, all applicants are required to have commercial general liability insurance. According to the Policies and Procedures Manual for the Empowerment Zone Corporation Loan Fund, the borrower is to provide insurance if the property is located in a designated flood zone, and Real Estate loans require Title and Hazard Insurance naming the El Paso Empowerment Zone as the loss payee.

Impact: The collateral of loans totaling \$1,886,207.63 is not entirely secured from loss or damage.

Observation 10 Loan Payment Calculation

Six (6) out of the 20 (30%) loans had their loan payment calculated incorrectly. Five (5) of the six calculations were in favor of the Empowerment Zone: the five borrowers (EZRLF 81, 82, 83, 84, and 85) are being overcharged a total of approximately \$7,302.60. One (1) loan (EZRLF 70) was calculated in favor of the borrower: the Chama Lounge is required, per the Promissory Note, to make monthly payments to the Empowerment in the amount of \$1,477.52 for five years; these payments correspond to a seven year term, not a five year term; the payments should be \$1,946.83 (a difference of \$469.31 a month).

Criteria: The terms of financing should be accurately disclosed to the borrower.

Impact: The Empowerment Zone will incur a loss of approximately \$28,158.60 ($\469.31×60 payments) from the miscalculation of the Chama Lounge loan.

Observation 11 Processing Fee

Thirteen (13) out of the 20 (65%) loans do not show evidence of being charged a \$400.00 application fee and one (1) out of the 20 loans was charged a \$100.00 processing fee. (for a total loss income of \$5,500.00).

Criteria: According to the Criteria and Guidelines for the Border Opportunity Fund, a non-refundable application fee of \$400.00 must be submitted with completed applications. According to the Policies and Procedures Manual for the El Paso Empowerment Zone Corporation Loan Fund “fees will consist of an application fee (currently \$400.00).”

Impact: The Empowerment Zone lost potential revenue of approximately \$5,500.00.

Additional Observations:

- The Empowerment Zone Board of Directors approved on May 23, 2006 that borrowers no longer have to demonstrate that they abide by HUD’s 2002 Resident Benefit rule.
- A Border Opportunity Fund flyer states that typical loans range from \$5,000.00 to \$250,000.00. Prior to Larry Romero becoming a loan officer, the highest loan amount was for \$250,000.00. After Larry Romero assumed the role of Empowerment Zone’s Loan Officer, the dollar amount of the loans increased to \$810,000.00 and 4 loans were made in excess of \$250,000.00.
- Mr. Larry Romero received a loan commission amount of \$180.00 for an \$18,000.00 loan to Pike Street Market that was worked and closed by the previous loan officer Mr. Javier Almeida. The loan was closed on 1/10/2006, before Mr. Larry Romero assumed the role of Loan Officer.
- The loan payments posted to the DownHome Loan Manager system, for the 20 loans reviewed, were traced to the Empowerment Zone’s general ledger. The principal paid for 2 out of 20 (10%) loans was posted differently to the El Paso Empowerment Zone’s General Ledger than what was posted to the DownHome Loan Manager system. The DownHome Loan Manager system reflects \$371.40 more in “Principal applied than what was posted to the General Ledger.
- Two (2) out of four (4) Real Estate loans had past due property taxes as of 3/20/2007.
- It was observed that the El Paso Empowerment Zone is not specific in its listing of collateral on its UCC Financing Statements, it uses general terms such as “equipment”; other organizations specifically list the collateral such as “1 AC 225 Air Welding Machine.”

Conclusion

Based on the results of our review, it appears there was poor Management of the El Paso Empowerment Zone’s (EPEZ) lending function. The EPEZ had documented Policies and Procedures to offer guidance, but did not adhere to them. The EPEZ did not follow sound business practices and due diligence in securing its liens and documenting its files.

Please review this memorandum at your convenience. If you have any questions please feel free to contact me at extension 4402.

Signature on File
Edmundo S. Calderon, CIA, CGAP, MBA
Chief Internal Auditor

Signature on File
Liz Delao, CIA, CGAP
Senior Auditor

cc: Joyce Wilson, City Manager
William F. Studer, Jr., Deputy City Manager - Financial & Administrative Services
Deborah Hamlyn, Deputy City Manager - Quality of Life Services
Carmen Arrieta – Candelaria, CFO
William Lilly, Director – Community and Human Development