PERFORMANCE AUDIT OF THE SAN DIEGO HOUSING COMMISSION

Additional Performance Measures and Benchmarks are Needed to Better Demonstrate Results and Improve the Monitoring and Evaluation of the San Diego Housing Commission's Affordable Housing Efforts

Office of the City Auditor

City of San Diego

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September 2016

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THE CITY OF SAN DIEGO

September 13, 2016

Honorable Mayor, City Council, and Audit Committee Members
City of San Diego, California

Transmitted herewith is a performance audit report on the San Diego Housing Commission. This report was conducted in accordance with the City Auditor's Fiscal Year 2016 Audit Work Plan, and the report is presented in accordance with City Charter Section 39.2. The Results in Brief are presented on page 1. Audit Objectives, Scope, and Methodology are presented in Appendix B. Management's responses to our audit recommendations are presented after page 31 of this report.

We would like to thank staff from the San Diego Housing Commission for their assistance and cooperation during this audit. All of their valuable time and efforts spent on providing us information is greatly appreciated. The audit staff members responsible for this audit report are Luis Briseño, Megan Garth, Chris Kime, and Kyle Elser.

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Results in Brief

The need for affordable housing in the City of San Diego (City) far exceeds the money available for its development. Therefore, it is imperative that the most cost-effective affordable housing is funded to keep cost reasonable while maximizing the number of housing units produced. It is also important to have monitoring procedures in place to ensure loan payments are maximized for reinvestment in affordable housing. With considerable latitude for innovation at the federal level and significant autonomy at the local level, better performance measures are needed to demonstrate results and improve the monitoring and evaluation of the San Diego Housing Commission's (SDHC) affordable housing efforts.

SDHC is a participating agency in the federal Moving to Work (MTW) demonstration program administered by the U.S. Department of Housing and Urban Development (HUD). These agencies have the flexibility to design and test various approaches for providing and administering housing assistance. SDHC reports annually on multiple activities, but HUD has not identified the performance data that would be needed to assess the results of these activities for the City. Improved performance measures would better inform the SDHC oversight body—the San Diego Housing Authority (SDHA)—for monitoring and evaluation purposes.

Specifically, we found that additional performance measures and benchmarks are needed for SDHC housing production goals and housing development cost as well as a better monitoring process to improve loan collections. SDHC has numerous goals, objectives, and outputs reported at the federal and local level. However, a more robust set of indicators that are compared to affordable housing benchmarks would demonstrate the results of SDHC's housing objectives and provide SDHA with relevant information to strengthen its monitoring and evaluation activities.

We made five recommendations for SDHC to establish performance measures that demonstrate affordable housing results and provide SDHA with ongoing monitoring information to evaluate program results. SDHC agreed to implement all of the recommendations.

Background

The affordable housing crisis affects everyone. According to a report by the McKinsey Global Institute, "decent, affordable housing is fundamental to the health and well-being of people and to the smooth functioning of economies. Yet around the world, in developing and advanced economies alike, cities are struggling to meet that need." It has been reported that San Diego is one of the most unaffordable markets in the United States, with nearly 50 percent of San Diegans facing housing affordability challenges.

San Diego Housing Commission's Role in the Production of Affordable Housing

To address the City's affordable housing[1] needs, the City formed the San Diego Housing Commission (SDHC), a governmental agency, to serve low- and moderate-income families by providing rental assistance payments, rental housing, loans, and grants to individuals and nonprofit organizations. To achieve its mission, SDHC conducts work in mainly three areas: providing rental assistance; creating and preserving affordable housing; and addressing homelessness.

To expand the City's inventory of affordable housing, SDHC plays three distinct roles: developer, lender, or bond issuer. As a developer, SDHC operates through Housing Development Partners, its nonprofit affiliate, to develop and preserve affordable housing for low-income San Diegans through the rehabilitation of existing buildings and through new construction. As a lender, SDHC partners with developers and uses various funding sources such as federal HOME funds, Community Development Block Grants, and the City's Affordable Housing Fund to finance affordable housing developments. Finally, as a bond issuer, SDHC is the local government agency responsible for issuing multifamily mortgage revenue bonds for the acquisition, construction, and development of projects within the City of San Diego. These

[1] Affordable housing is targeted specifically for low-income households earning no more than 80 percent of the Area Median Income, as calculated by the U.S. Department of Housing and Urban Development (HUD). The fiscal year 2016 income limits for households in the San Diego area can be found on HUD's website: https://www.huduser.gov/portal/datasets/il/il2016/2016summary.odn?states=6.0&data=2016&inputname=METRO41740M41740*0607399999%2BSan+Diego+County&stname=California&statefp=06&year=2016&selection_type=county

funding sources are often used in conjunction with developers' Low-Income Housing Tax Credits.

When partnering with developers to create affordable housing, SDHC offers a number of incentives, which include:

- Permanent financing in the form of low-interest loans, tax-exempt bonds, and land-use incentives;
- Technical assistance, such as help with securing tax credits; and
- Predevelopment assistance, such as loans and grants to help non-profit developers during the preconstruction phase.

Governmental Oversight of SDHC

Operationally, SDHC has an oversight structure that involves local and federal agencies. At the Commission level, a seven-member board oversees SDHC's operations and makes recommendations to the San Diego Housing Authority (SDHA). At the local level, SDHA governs SDHC and has final authority over SDHC's budget and major policy decisions. At the federal level, the U.S. Department of Housing and Urban Development (HUD) is the oversight agency and has given SDHC a Moving to Work (MTW) designation.

Moving to Work Designation

HUD's MTW program provides SDHC—along with 38 other MTW public housing authorities (out of 3,400 nationwide)—with broad flexibility to better serve and house their residents and broader communities while streamlining their internal operations.

MTW agencies have three statutory purposes:

- Reduce costs and achieve greater cost-effectiveness in federal housing expenditures;
- Give families with children incentives to obtain employment and become self-sufficient; and
- Increase housing choices for low-income families.

With MTW's flexibility, SDHC designs and tests innovative, cost-effective ways of providing housing assistance to low-income families, using a combination of federal funding allocated to SDHC for public housing and the federal Housing Choice Voucher program.

While MTW's ultimate goal is to identify successful approaches that can be applied to public housing agencies nationwide, a HUD report to Congress noted that the demonstrative ability of MTW has been limited since the program's inception because of a lack of built-in evaluation methodology. Furthermore, the United States Government Accountability Office (GAO) published a report in 2012 that raised concerns with oversight of the MTW program. The report found that HUD has not established performance indicators for the program as a whole and has not identified standard performance data and indicators needed to evaluate the MTW program. The lack of performance data has affected HUD's ability to systematically identify lessons learned and, as a result, has limited HUD's ability to promote useful practices that could be implemented more broadly across the MTW program. Though there are limitations to evaluating the outcomes of MTW because of weak initial reporting requirements and a lack of a research design, the ability to learn from these changes is unprecedented.

Proposed Changes to the San Diego Municipal Code

SDHC has proposed changes to the San Diego Municipal Code meant to streamline approvals by making actions by the San Diego Housing Commission Board (Board) final, unless any SDHA member requests a review of the Board's action. The reasoning is that, according to SDHC's proposal, SDHA has not reversed or revised any decision made by the Board since 2009. In addition, the proposed changes would reduce project delays and cut the administrative costs associated with two separate hearings.

Performance Management

To address the affordable housing crisis, government oversight can be more effective when combined with performance management. Performance management in the public sector is an ongoing, systematic approach to improving results through evidence-based decision making, continuous organizational learning, and a focus on accountability for performance. Performance management:

- Is integrated into all aspects of an organization's management and policy-making processes, transforming an organization's practices so it is focused on achieving improved results for the public.

- Comprises the concerted actions an organization takes to apply objective information to management and policy making in order to improve results.
- Uses evidence from measurement to support governmental planning, funding, and operations.

Part of this approach includes the use of performance indicators or measures, which are values, characteristics, or metrics used to track the performance of a program, service, or organization, or to gauge a condition. A benchmark is a level of achievement against which organizations can measure their own progress. Benchmarks may be used for comparisons of organizational process or results against an internal or external standard. Better information enables elected officials and managers to recognize success, identify problem areas, and respond with appropriate actions—in other words, to learn from experience and apply that knowledge to better serve the public.

Audit Results

Finding #1: The San Diego Housing Commission Plays a Significant Role in the Production of Affordable Housing but Has Not Established Targets or Performance Measures to Evaluate the Results of its Efforts

The San Diego Housing Commission (SDHC) has not established overall targets or performance measures for the production of affordable housing. Of the various sources of funding that SDHC may use to finance affordable housing development, production goals are only set for money from the City of San Diego's (City) Affordable Housing Fund. Moreover, SDHC management does not report total production figures or compare them to the City's housing need for the purpose of assessing whether their performance in this regard is acceptable. In addition, SDHC does not report production figures in a readily-accessible, summarized format, making it difficult for its oversight bodies—the San Diego Housing Commission Board (Board) and the San Diego Housing Authority (SDHA)—and other stakeholders to evaluate SDHC's impact and whether its current strategies are effective.

SDHC Contributes Significantly to Affordable Housing Production

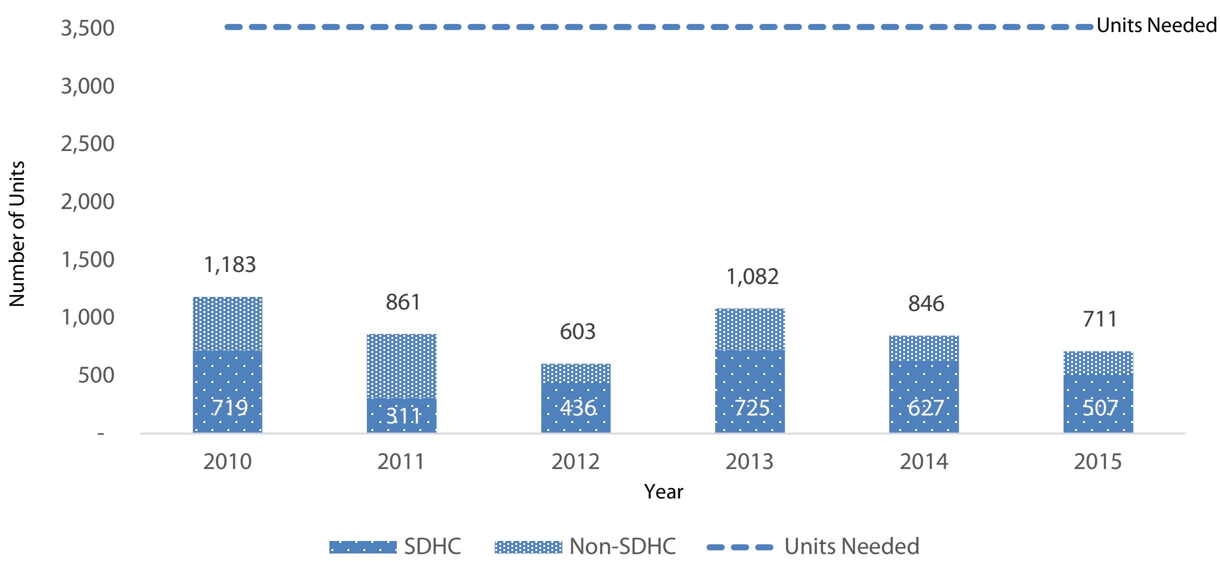
In the last six years, SDHC helped develop 3,325 affordable housing units in the City,[2] which amounts to 63 percent of the low-income units produced and almost 16 percent of the total low-income housing units needed in that same period.[3] As shown in **Exhibit 1**, SDHC has contributed a significant portion of the low-income units produced, but total production still lags far behind need.

[2] This figure includes housing units and developments for which a building permit for new residential construction was issued during the reporting period.

[3] According to the Regional Housing Needs Assessment (RHNA) for 2010–2020, the City of San Diego needed 21,098 affordable housing units in the period between 2010 and 2015. The RHNA is mandated by State Housing Law as part of the periodic process of updating local housing elements of the General Plan. The San Diego Association of Governments (SANDAG) is responsible for preparing the RHNA for the San Diego region under State Housing Law.

Exhibit 1

SDHC Helps Develop a Significant Portion of Low-Income Housing Units, but Total Production Still Lags Far Behind Need



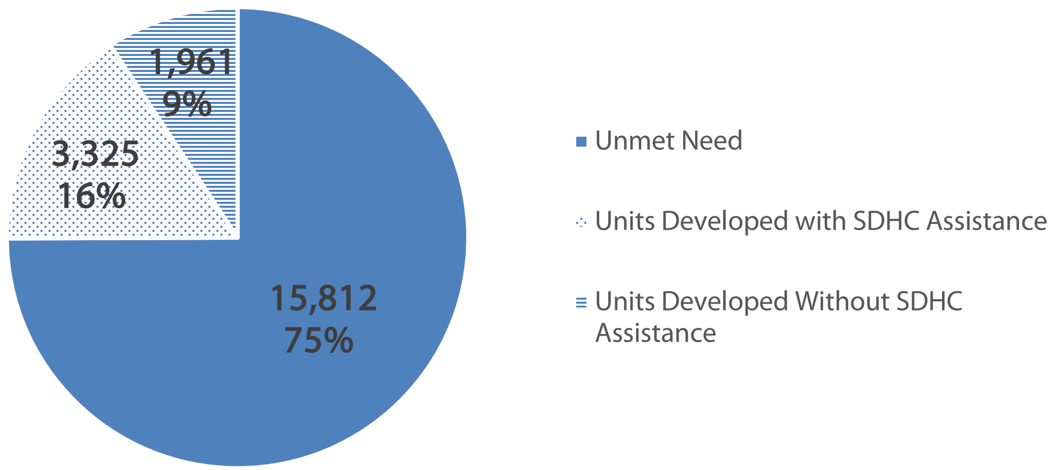
Note: Figures reflect the number of units permitted by the City for construction.

Source: Office of the City Auditor generated based on Regional Housing Needs Assessment, City of San Diego Housing Element Annual Progress Reports, and property data from the San Diego Housing Commission.

Exhibit 2 summarizes SDHC's impact on affordable housing development in the period between 2010 and 2015. While SDHC's impact is significant relative to what has actually been produced, an overwhelming portion of the need has gone unmet. This emphasizes the importance of maximizing affordable housing production.

Exhibit 2

Status of Low-Income Affordable Housing Need, 2010–2015



Note: Figures reflect low-income units needed or permitted for construction in the period 2010-2015.

Source: Office of the City Auditor generated based on Regional Housing Needs Assessment, City of San Diego Housing Element Annual Progress Reports, and property data from the San Diego Housing Commission.

Market Rate Conversion Also Affects Housing Need

In addition to the number of units SDHC helps produce, the need for affordable housing is impacted by the number of units lost to the rental market.[4] According to the Housing Element (2013 – 2020) of the City of San Diego's General Plan, a total of 3,047 affordable housing units in the City are at risk of conversion to market rate rents in the period between July 1, 2009 and June 30, 2020. Of these, 420 will be at risk of market rate conversion between 2014 and 2017. It is unclear if or how SDHC factors the number of units at risk of market rate conversion into their housing development strategies. However, because any loss of affordable housing units to the market would negatively impact the City's progress on the overall need, it is important that these at-risk units also be considered when formulating and carrying out development strategies.

[4] Affordable housing units remain affordable through a restrictive covenant on the property that specifies a length of time for the units to remain affordable; the affordability term for affordable housing units is typically 55 years. Once the affordability restrictions expire, the units are at risk of converting to market rate rent.

SDHC Can Improve its Performance Management by Setting Production Targets

One of SDHC's overarching goals in its 2014–2016 Strategic Plan is to create and preserve quality affordable housing. However, the objectives, strategies, and tactics described in the Strategic Plan for this goal lack specific targets for the number of affordable housing units developed or financed in a given period of time. For example, it is unclear if assisting in the production of 507 units—as was the case in 2015—is acceptable to SDHC and its oversight bodies because there is no target or measure with which to compare. Measurable goals help oversight bodies and elected officials to recognize success, identify problem areas, evaluate cost-effectiveness, and to respond with appropriate actions.

A recent consultant report[5] recommended, among other things, that SDHC take the lead in working with the City Council to set annual housing production goals and to publish an annual scorecard tracking progress toward these goals. The report suggests that this will likely improve government efficiency and incentives related to housing production; help stakeholders work together toward a common and yearly delineated goal; and increase government accountability. With measureable targets, goals become more effective, bolstering SDHC's capacity for performance management.

Other Municipalities Set Targets for Affordable Housing Production

Other municipalities have also taken steps to implement annual affordable housing production goals and targets. For example, Arlington County, Virginia established affordable housing goals and targets in 2003 and publishes an annual report detailing the County's progress towards meeting those goals. Over time, this report has evolved into the County's Affordable Housing Master Plan, which includes policies, goals, objectives, and indicators that address the County's long-range vision for affordable housing needs. Importantly, the plan includes the development of a monitoring and evaluation framework to ensure that goals are met.

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[5] LeSar Development Consultants, *Addressing the Housing Affordability Crisis in San Diego and Beyond*, November 2015. Available from SDHC's website: http://www.sdhc.org/uploadedFiles/Media_Center/Significant_Documents_Reports/SDHC%20Housing%20Affordability%20Study%20Report.pdf

Similarly, the City of Austin, Texas has developed seven goals with specific targets for affordable housing production. Four of these goals focus on creating and preserving affordable housing units and home ownership opportunities; the corresponding targets specify the number of units that the City should strive to produce at each level of affordability. Three of the goals are aimed at family-friendly housing, transit-oriented development, and geographic dispersion. The City and the community share the goals, but each have their own targets, indicating that these goals and targets are a shared effort between the public and private sectors.

Setting production goals and performance measures and regularly reporting the results will help SDHC better communicate its progress toward the production of affordable housing units. In doing so, SDHC can improve its accountability and transparency to oversight bodies and other stakeholders. Moreover, setting production goals would help SDHC to frame strategies and decision-making in terms of maximizing the number of affordable units it develops.

Recommendation #1

To help maximize the number of affordable housing units produced, the San Diego Housing Commission should establish targets and performance measures and annually report on those results. When setting production goals, the San Diego Housing Commission should also consider the number of units that are at risk of conversion to market rate. (Priority 2)

Finding #2: The San Diego Housing Commission Can Better Demonstrate the Cost–Effectiveness of Affordable Housing Developments by Using Performance Indicators and Benchmarks

Affordable housing needs in the City of San Diego (City) far exceed the available dollars and therefore it is imperative that the most cost-effective developments are funded to keep unit cost reasonable. The San Diego Housing Commission (SDHC) does not have performance measures or benchmarks to demonstrate the cost-effectiveness of their affordable housing developments. With the establishment of performance indicators and benchmarks, SDHC can assess their performance in providing cost-effective housing developments while also providing valuable monitoring information to the San Diego Housing Authority (SDHA), its direct oversight body. There are several performance measures and benchmarks SDHC could explore to evaluate cost-effectiveness for their affordable housing developments, such as a comparison of SDHC's development unit cost to:

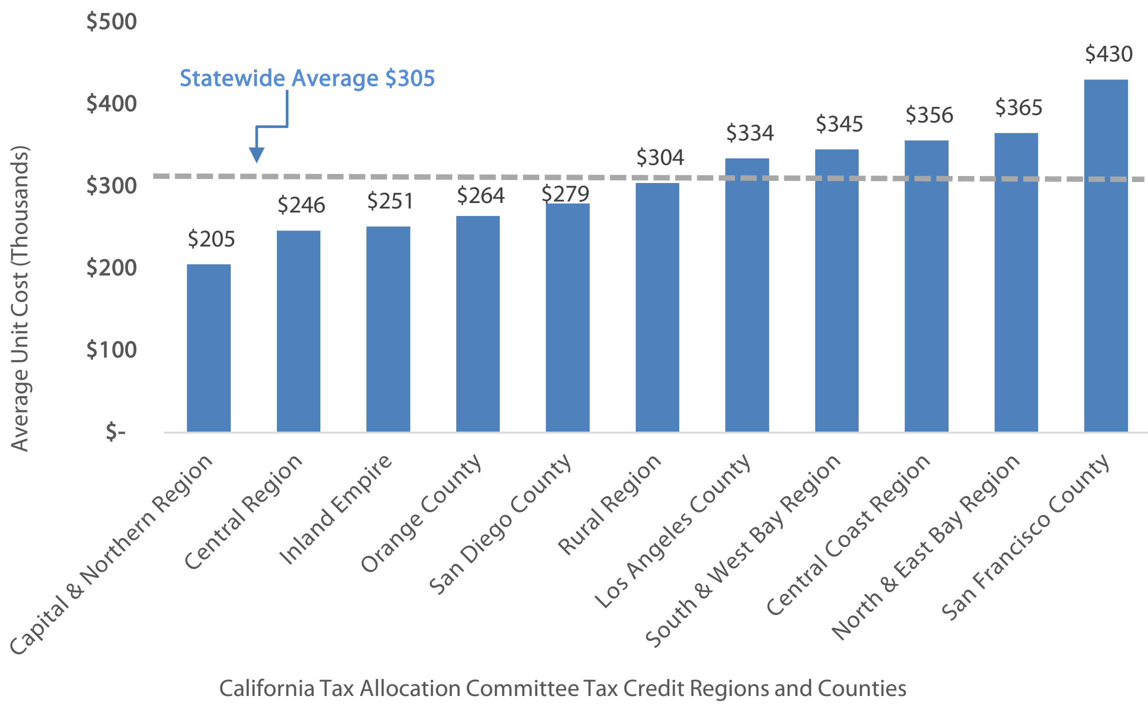
- Statewide or regional averages;
- Similar SDHC Developments;
- Key Performance Indicators; or
- Unit cost developed with cost estimating software.

Comparison Between Affordable Development Costs Across State of California Regions Serve as a Barometer to Ensure Development Costs Remain Within Regional Variations

Affordable housing development unit costs vary considerably within the State of California, as shown in **Exhibit 3** below. While the average cost per unit is most expensive in San Francisco City and County at $430,000, the California Affordable Housing Cost Study determined that the statewide average cost per unit in 2015 is approximately $305,000, excluding the cost of land.

Exhibit 3

Average Unit Costs for New Affordable Housing Construction Projects Vary Widely by California County and Region



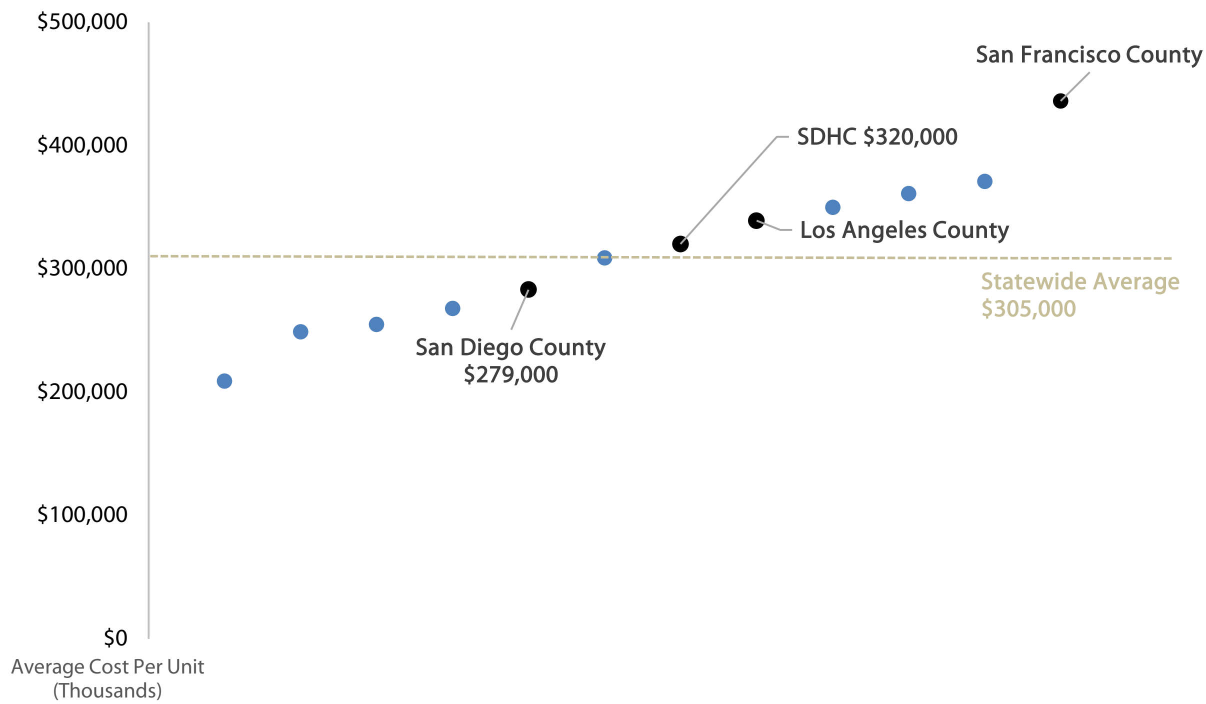
Note: Figures exclude the cost of land. Dollars are converted to 2015 amounts using the California Construction Cost Index.

Source: California Affordable Housing Cost Study, October 2014.

In our comparison of SDHC's average cost per unit for 14 affordable housing developments completed from 2010 to 2015, per SDHC, we found that SDHC's average per unit cost is approximately $320,000. This is higher than the statewide average of $305,000 and approaches the Los Angeles County average of $334,000, as shown in **Exhibit 4**.

Exhibit 4

SDHC's Average Unit Costs are Higher Than the Statewide Average but Comparable to Nearby Los Angeles County

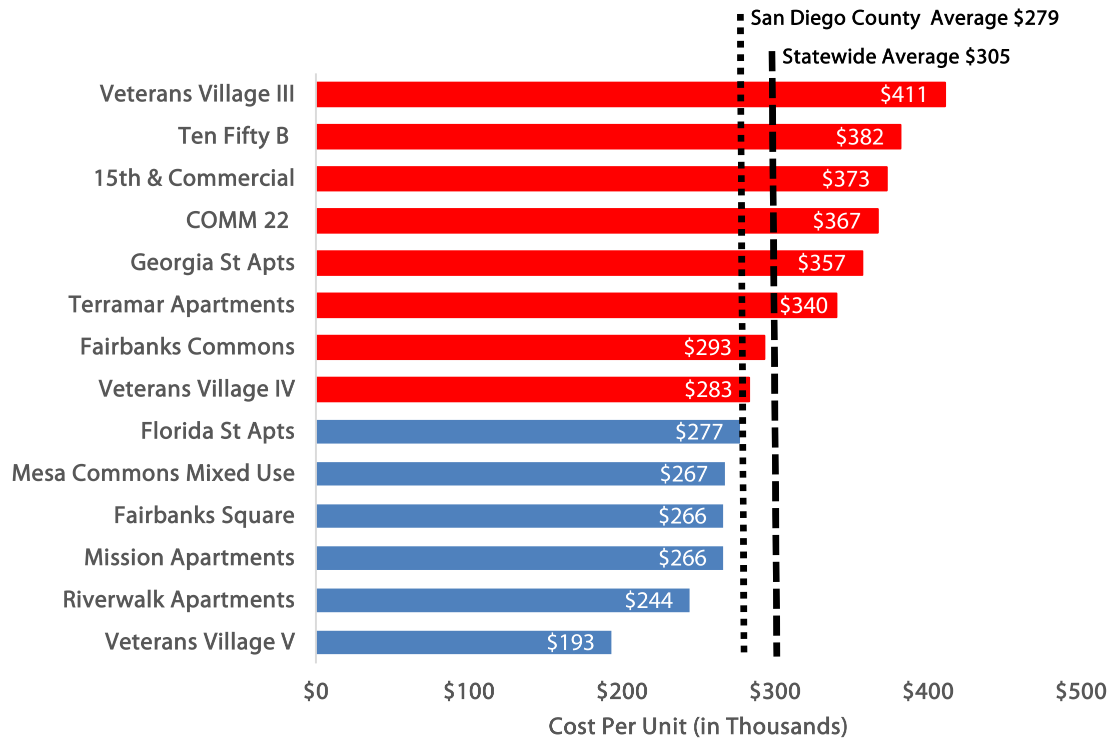


Source: California Affordable Housing Cost Study, October 2014.

However, of the 14 individual developments shown below in **Exhibit 5**, six are above the statewide average. Comparing unit costs locally, eight of the developments are above the San Diego County's average of $279,000, indicating the developments may have not been the most cost-effective or they should be compared to another region with similar development characteristics to the City.

Exhibit 5

The Statewide Average Cost per Unit was Exceeded by 6 of 14 SDHC Developments



Source: Independently audited final cost certifications.

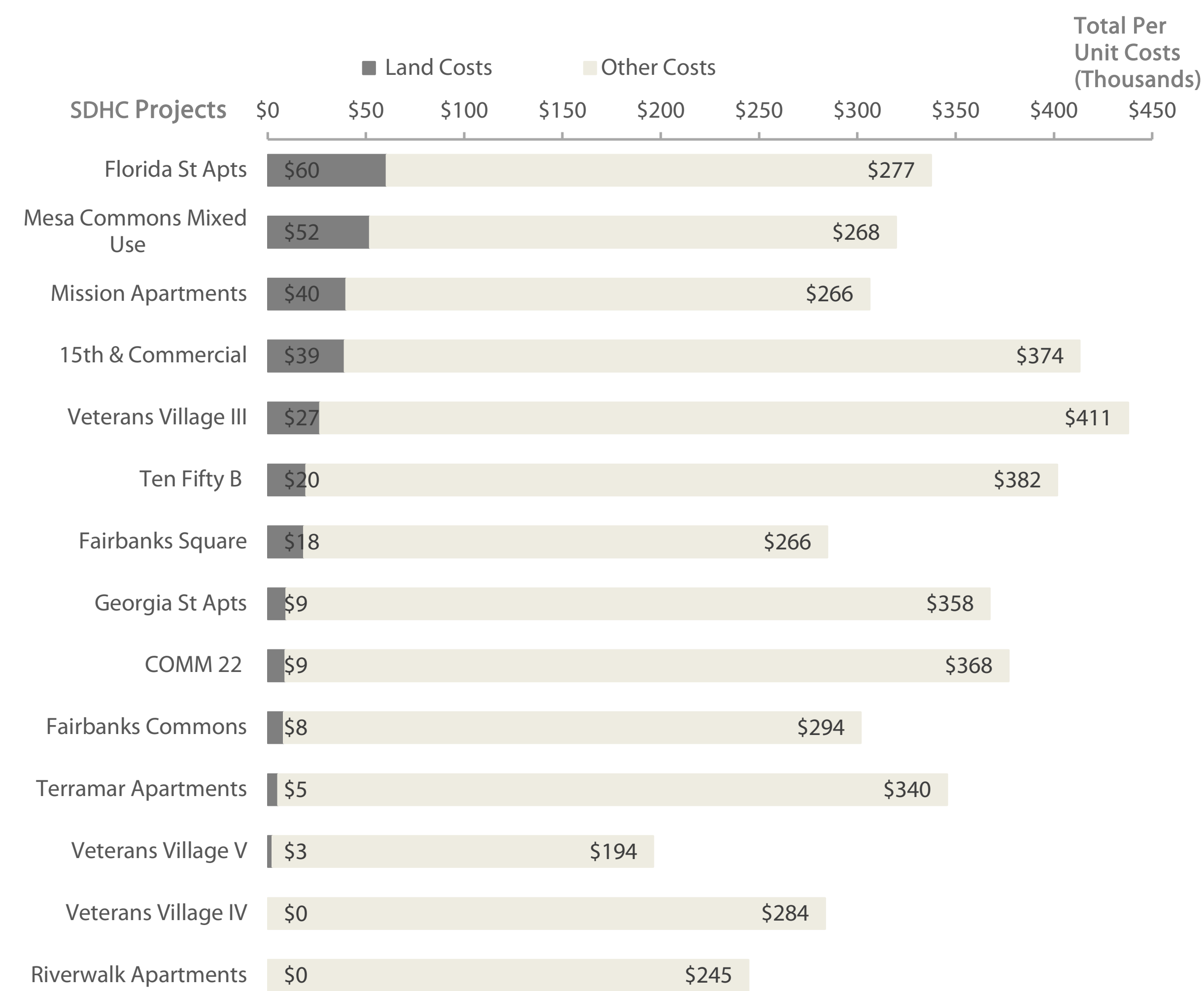
To establish a regional comparison benchmark, SDHC can explore a performance measure methodology similar to that recommended for the City of Sacramento. A September 2015 City of Sacramento audit found that Sacramento shares development characteristics with the more urban areas of the state and not the Capital and Northern Region in which it is located. With Sacramento's average cost per unit at approximately $283,000, the audit recommended that Sacramento set its benchmark to correspond with the statewide average unit cost, which is $305,000. Similarly, SDHC can determine its own benchmark of average unit costs relative to the development characteristics comparable to another region, such as San Diego County or Los Angeles County.

Comparison between San Diego Housing Commission Developments to Ensure Costs Remain within Local Expectations

Comparing unit costs between SDHC's previous, similar developments can also serve as a useful benchmark with which to ensure that developments remain cost-effective. This technique adjusts for factors contributing to project complexity. For example, we reviewed 14 new construction developments sponsored by SDHC from 2010 to 2015, shown in **Exhibit 6** below, and determined an average unit cost including land of $344,000, with a range of $196,000 to $438,000 per unit. While land costs are a contributing factor to development costs, there is considerable variation in land costs locally.

Exhibit 6

Although Land is a Factor, it is Not Always the Primary Driver of Overall per Unit Cost



Source: Independently audited final cost certifications.

However, the variation in land cost does not explain all of the disparity in unit costs among SDHC's developments. In SDHC's Trolley Residential funding proposal, SDHC included an explanation showing factors that increased or decreased unit cost and, in some cases, included a unit cost calculation for that factor as shown below in **Exhibit 7**. Many of these factors were discussed in the California Affordable Housing study and align with SDHC's explanation of how the cost factors affected the Trolley Residential project cost.

Exhibit 7

How Project Factors Affect Project Costs | **Example of SDHC Trolley Residential Proposal with Cost Factors**

Factors Affecting Unit Costs	Description of Project Factors	Trolley Residential Proposal Explanation	Trolley Residential Development Cost Impact (Amount)
Project Size	Larger projects cost less per unit and benefit from economies of scale.	Smaller project with 52 units.	Increase (not shown by SDHC)
Unit Size	Larger units (2-4 bedrooms) are relatively more expensive on a per unit basis.	22 of the 52 units are 3 bedroom units.	Increase (not shown by SDHC)
Local Government Requirements	Permitting and processing fees vary across the State.	City development impact, permit and processing fees.	Increase ($43,707 per unit)
Community Input Process	Community opposition that delays the design/implementation process likely increases costs.	Extensive community input process resulted in the implementation of community-desired design.	Increase (not shown by SDHC)
Building Quality and Durability	Increased quality and durability add to costs.	Soil remediation cost.	Increase ($7,692 per unit)
Construction Wages	Vary by region, and prevailing wage in effect.	Prevailing wages increase construction costs by approximately 16 to 20 percent.	Increase (not shown by SDHC)
Developer Characteristics	Projects built by larger developers are less expensive.	General contractor has ability to leverage subcontractor relationships to receive competitive pricing.	Decrease (not shown by SDHC)
Land Costs	Vary by region, but important part of total cost.	Land sold for less than appraised value.	Decrease ($16,753 per unit)

Source: California Affordable Housing Cost Study, October 2014, and Trolley Residential project proposal.

However, not all of the cost factors are monetized, and the list may not include all of the cost factors that would explain the unit cost disparity in similar projects listed by SDHC in the Trolley Residential proposal. With the variation in project complexity, the factors contributing to unit cost must be added or subtracted in comparison to the other projects to show the unit cost is within an acceptable or benchmarked range. The SDHC chart below shown in **Exhibit 8**, does not fully convey the impact of the cost factors and, therefore, the cost-effectiveness of the Trolley Residential project compared to the other three projects.

Exhibit 8

While Three Projects are Comparable to SDHC's Trolley Residential Project, Details Affecting Project Costs Are Unknown

Project Name	Year	Units	Total Cost	Cost per Unit	SDHC Subsidy per unit	Gross Hard Cost per Sq. Ft.	Prevailing Wages Apply
Trolley Residential	2014	52	$22,963,066	$441,597	$60,000	$225	Yes
Mission Gorge	2014	90	$29,121,428	$323,571	$106,667	$164	No
Villa Encantada	2014	67	$27,952,232	$417,197	$89,533	$202	No
Kalos Apts	2013	83	$28,015,170	$337,532	$87,269	$189	No

Source: Trolley Residential project proposal.

While SDHC shows the impact of some cost factors, a more detailed, in-depth comparison by development and unit cost factor is needed to show whether a particular development unit cost compares favorably to other SDHC developments.

Development Key Performance Indicators can be Useful when Compared to Internal or External Benchmarks

SDHC identified development cost performance indicators that were used to evaluate the Trolley Residential project and make a funding recommendation as shown below in **Exhibit 9**. According to SDHC, key performance indicators are commonly used by real estate industry professionals and affordable housing developers. However, these indicators would be more useful if they could be compared to statewide or local benchmarks.

Exhibit 9

SDHC Trolley Residential Project Key Performance Indicators

Development Cost per Unit	$441,597
Housing Commission Subsidy per Unit	$60,000
Land Cost per Unit	$31,323
Gross Building Square Foot Hard Cost	$225
Net Rentable Square Foot Hard Cost	$279

Source: San Diego Housing Commission Trolley Residential Funding Proposal.

A comparison to an external real estate indicator would help to evaluate the cost-effectiveness of SDHC developments.

Using Cost Estimators to Evaluate Cost-Effectiveness

SDHC could use RS Means or similar cost calculating software to validate proposed development cost and ensure that cost are reasonable and justifiable. The California Affordable Housing Cost Study used the RS Means' Quick Cost Estimator (Estimator) when it compared actual unit cost of 150 affordable housing projects to unit cost estimates generated by the Estimator. The study showed that the actual unit cost of the projects fell somewhere in the medium to high range of the RS estimates, indicating that cost could have been reduced in some cases. Similarly, SDHC could use estimating software to compare developer proposed cost for new construction to estimated cost or compare rehabilitation cost to new construction cost to determine if the cost falls within an expected range.

Recommendation #2

The San Diego Housing Commission should establish an evaluation methodology that includes performance measures and benchmarks to demonstrate that the San Diego Housing Commission's projects provide the best option for achieving cost-effectiveness in affordable housing expenditures. The San Diego Housing Commission should report the results no less than annually to the San Diego Housing Commission Board and also to the San Diego Housing Authority. (Priority 2)

Finding #3: The San Diego Housing Commission Can Improve Monitoring of Developers' Loan Payments to Ensure it is Collecting Amounts Due and Should Regularly Evaluate the Cost-Effectiveness of its Loan Servicing Activities

In our review of 31 of the San Diego Housing Commission (SDHC) developer loans, we found that in most cases the developers were submitting the required documentation. However, we found little evidence of SDHC's reconciliation process needed to ensure the developers' interest payments were correct. As a result, SDHC relies on the accuracy of the developers' calculation of payment amounts. Without a monitoring process that includes reconciliation of the developers' payment calculations to the developments' financial statements, it is difficult to determine if the interest collections are fully realized. A monitoring process will help SDHC determine whether developments produce the cash flow necessary to generate loan payments and justify the time that would be needed to perform the reconciliation process. Therefore, SDHC should conduct periodic analysis of the cost-benefit of the loan servicing activities.

Improved Monitoring Procedures are needed to Determine if SDHC is Maximizing Collection of Loan Interest Payments

One of SDHC's Strategic Plan objectives is to ensure that the most effective and cost-efficient business practices are in place for management of the SDHC loan portfolio. As a lender, SDHC provides some developers of affordable housing residual receipt loans, a very common type of loan in affordable housing lending. These loans provide payment terms in the form of residual receipts which have two scenarios: 1) When projects have annual positive net cash flow (i.e. income minus expense), developers pay a previously agreed-upon percentage of the net cash flow, known as a residual receipt, to SDHC; or 2) If residual receipts are zero or negative, no payment is required but interest accrues and developers can make a balloon payment at loan maturity. To ensure that loans are repaid in accordance with loan terms, SDHC must review developers' annual financial statements and residual receipt statements for accuracy. Payment provides SDHC with continued funds to reinvest in new affordable housing projects.

We found that most developers were submitting their annual financial and residual receipt statements with payment calculations to SDHC. However, we found little evidence of SDHC's reconciliation of these statements to confirm accuracy of developers' payment calculations. We reviewed 31 SDHC loans with residual receipt terms of approximately $14.6 million in accrued interest as of FY2015; of this amount, SDHC has collected only $3.89 million in interest for a collection rate of 21 percent paid as of June 30, 2015. A one percent increase in the collection rate would have yielded an additional $185,000. It is unclear if SDHC is not collecting more money due to the lack of a reconciliation process or because of developments' lack of cash flow.

The loans listed below in **Exhibit 10** are the developer loans with the highest balances in our sample. These loans have a slightly higher collection rate, at 24 percent, but still have a significant amount of interest accrued.

Exhibit 10

SDHC Loan Collection Rate

Borrower	Loan Balance SDHC Annual Report June 30, 2015	Total Accrued Interest as of June 30, 2015	Total Payment as of June 30, 2015
Arbor Terrace, L.P.	$9,794,384	$182,505	$0
Steadfast Villa Nueva	$9,200,000	$285,200	$1,851,731
Mercado Cic, L.P.	$7,000,000	$1,434,514	$0
Florida Street Housing Association	$6,965,583	$1,116,728	$0
City Heights Ten, L.P.	$6,452,364	$15,313	$67,462
Dawson Avenue Senior Apartments	$6,440,111	$81,575	$207,163
Delta Village Housing Association	$6,100,000	$1,830,358	$0
Linc Arbor Village Apartments	$5,460,000	$847,210	$0
Georgia Street, L.P.	$5,110,753	$738,258	$0
San Diego Commons, L.P.	$4,414,500	$160,639	$0
Total	**$66,937,695**	**$6,692,300**	**$2,126,356**
		Collection Rate	**24%**

Source: Office of the City Auditor based on San Diego Housing Commission loan portfolio.

According to SDHC, the reconciliation process is time-consuming and involves the coordination of two departments: the loan servicing department and the asset management department. SDHC staff must review developers' lengthy annual financial statements, which typically contain balance sheets; related statements of operations; changes in partners' capital; and cash flows and compare them to residual receipt statements for accuracy. The residual receipt statements typically contain summarized information such as operating expenses, debt service, deferred developer fee, and reserve contributions.

Since June 2015, SDHC has begun taking steps to streamline the reconciliation process: reviewing properties in the loan portfolio, ensuring collaboration between the two departments, and standardizing the reconciliation process with procedures and training. Reconciliation is essential to determining the accuracy of the information on the residual receipt statements and to ensure that SDHC is collecting all interest that is due at the end of each year. Additionally, with an improved process, SDHC can analyze their loan portfolio to determine whether the most effective and cost-efficient business practices are in place for management of the SDHC loan portfolio.

Recommendation #3 The San Diego Housing Commission should develop loan servicing guidelines that include review timelines, reconciliation procedures, and dispute procedures. (Priority 2)

Recommendation #4 The San Diego Housing Commission should report loan collection results annually to the San Diego Housing Commission Board and the San Diego Housing Authority. (Priority 2)

Recommendation #5 The San Diego Housing Commission should conduct periodic analysis, no less than annually, of the cost-benefit of the loan servicing activities. If the loan servicing activities are not cost-effective, alternatives such as streamlined reconciliation procedures or a simplified payment structure should be considered. (Priority 2)

Conclusion

Performance measures and benchmarks specifically tied to affordable housing production, cost-effectiveness of that production, and increased loan collections for reinvestment in housing production will benefit the City of San Diego. It is important that the most cost-effective developments are funded to keep cost reasonable, generate a return on investment, and maximize the number of housing units produced.

The San Diego Housing Commission plays a critical role in the production of affordable housing. Therefore, performance measures and benchmarks will better demonstrate the results of their efforts while providing the San Diego Housing Authority with much needed monitoring information to strengthen their evaluation capacity. Going forward, this monitoring information can be used to evaluate the effects of the regional, statewide, and federal opportunities identified by the San Diego Housing Commission to boost production and reduce costs for both affordable and market rate housing in San Diego.

Recommendations

We made five recommendations for the San Diego Housing Commission to establish performance measures that demonstrate affordable housing results and provide the San Diego Housing Authority with ongoing monitoring information to evaluate program results. The San Diego Housing Commission agreed to implement all of the recommendations.

Recommendation #1

To help maximize the number of affordable housing units produced, the San Diego Housing Commission should establish targets and performance measures and annually report on those results. When setting production goals, the San Diego Housing Commission should also consider the number of units that are at risk of conversion to market rate. (Priority 2)

Recommendation #2

The San Diego Housing Commission should establish an evaluation methodology that includes performance measures and benchmarks to demonstrate that the San Diego Housing Commission's projects provide the best option for achieving cost-effectiveness in affordable housing expenditures. The San Diego Housing Commission should report the results no less than annually to the San Diego Housing Commission Board and also to the San Diego Housing Authority. (Priority 2)

Recommendation #3

The San Diego Housing Commission should develop loan servicing guidelines that include review timelines, reconciliation procedures and dispute procedures. (Priority 2)

Recommendation #4

The San Diego Housing Commission should report loan collection results annually to the San Diego Housing Commission Board and the San Diego Housing Authority. (Priority 2)

Recommendation #5

The San Diego Housing Commission should conduct periodic analysis, no less than annually, of the cost-benefit of the loan servicing activities. If the loan servicing activities are not cost-effective, alternatives such as streamlined reconciliation procedures or a simplified payment structure should be considered. (Priority 2)

Appendix A: Definition of Audit Recommendation Priorities

DEFINITIONS OF PRIORITY 1, 2, AND 3

AUDIT RECOMMENDATIONS

The Office of the City Auditor maintains a priority classification scheme for audit recommendations based on the importance of each recommendation to the City, as described in the table below. While the City Auditor is responsible for providing a priority classification for recommendations, it is the City Administration's responsibility to establish a target date to implement each recommendation taking into considerations its priority. The City Auditor requests that target dates be included in the Administration's official response to the audit findings and recommendations.

Priority Class[6]	Description
1	Fraud or serious violations are being committed. Significant fiscal and/or equivalent non-fiscal losses are occurring. Costly and/or detrimental operational inefficiencies are taking place. A significant internal control weakness has been identified.
2	The potential for incurring significant fiscal and/or equivalent non-fiscal losses exists. The potential for costly and/or detrimental operational inefficiencies exists. The potential for strengthening or improving internal controls.
3	Operation or administrative process will be improved.

[6] The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher priority.

Appendix B: Audit Objectives, Scope, and Methodology

In accordance with the Office of the City Auditor's Fiscal Year 2016 Audit Work Plan, we conducted an audit of the San Diego Housing Commission (SDHC). This is the second SDHC related audit released in conjunction with the Fiscal Year 2016 Audit Work Plan. The first audit covering the Affordable Housing Fund was released July 21, 2016. For the second audit, we concentrated our efforts in two areas: affordable housing production and the cost of producing affordable housing. Specifically, our audit objectives were to:

1. Determine SDHC's impact on affordable housing production in San Diego, and;
2. Determine whether SDHC is cost-effective in the production of affordable housing.

In order to arrive at these two objectives, we conducted an extensive preliminary review and scoping phase. As part of this process, we met with several stakeholders to discuss affordable housing issues and get their perspectives. In addition to meeting with SDHC management, we met with individuals from the following organizations:

- San Diego County Building Trades Council
- San Diego Regional Chamber of Commerce
- San Diego Housing Federation
- Building Industry Association of San Diego County
- Office of the Mayor, City of San Diego
- Affordable Housing Coalition
- Economic Development Department, HUD Programs Office, City of San Diego
- Circulate San Diego

We also reviewed published studies focusing on affordable housing in California and San Diego, which included the following:

Opening San Diego's Door to Lower Housing Costs

In January 2015, the Business and Economic Institute at Point Loma Nazarene University published an economic study that found regulatory costs represent between 34 and 51 percent of the average cost of housing construction in the City of San Diego. The report makes several recommendations for regulatory reforms that could preserve the objectives of the regulation but at a much lower cost. The report was presented to the City Council's Smart Growth and Land Use Committee on July 1, 2015.

Addressing the Housing Affordability Crisis in San Diego and Beyond

This report was released on November 25, 2015 and contained eleven proposed actions to boost housing production and reduce costs. The study examines:

- Major factors driving affordable housing and development costs;
- Cost containment guidelines; and
- Options to reduce affordable housing costs.

The report was prepared for SDHC by LeSar Development Consultants.

California Affordable Housing Cost Study

In October 2014, four agencies[7] jointly published a large-scale housing development cost study intended to measure the factors that influence the cost of building affordable rental housing in California. The researchers collected and analyzed data from hundreds of multi-family projects completed in California from 2001 to 2011. The study identified several factors correlated with raising or lowering the costs of developing affordable housing in California.

After meeting with stakeholders and reviewing studies, there were still several issues to consider for the audit. We selected the areas to audit by reviewing five broad areas:

- Eligibility for Rental Assistance
- Housing Stock
- Cost
- Financing

[7] The California Department of Housing and Community Development; the California Tax Credit Allocation Committee; the California Housing Finance Agency; and the California Debt Limit Allocation Committee.

- Strategic Planning

We evaluated risks and controls for these areas and, based on this assessment, determined which areas were most vulnerable and have the largest impact on SDHC's ability to provide affordable housing. This formed the basis for focusing on two areas and developing the following audit objectives:

Audit Objectives

The first audit objective was to determine the San Diego Housing Commission's impact on affordable housing in San Diego, including the number of affordable housing units lost or are at risk of being lost through the expiration of affordability covenants. The second audit objective was to determine whether SDHC is cost-effective in the production of affordable housing.

Scope and Methodology

To determine the number of units SDHC has contributed to the affordable housing stock in the City,[8] we relied on property information provided by SDHC. The information included projects completed between 1981 and 2015, but our scope focused on the projects completed between 2010 and 2015. We tested the reliability of this information by taking a judgmental sample of ten recently-completed projects and verifying the project's total development cost, the number of affordable units created by each project, and the affordability level for the units at each project. To verify this information, we reviewed final cost certifications and the Declaration of Covenants, Conditions, and Restrictions for each property. Based on this review, we found the property information provided by SDHC to be accurate and reliable for the purpose of reporting the number of affordable housing units contributed by SDHC.

To understand the overall impact of these figures, however, we needed to contextualize them. We did this first by comparing the number of units developed or financed by SDHC to the total number of units developed in the City. To determine the overall production of affordable housing in San Diego, we totaled the number of affordable units permitted in the City of San Diego, as reported by the City in its Annual Housing Element Progress Reports to the State of California's Department of Housing and

[8] We interpreted this to include the number of affordable housing units developed or at least partially financed by SDHC.

Community Development.[9] We compared the Citywide totals to SDHC's totals by calculating the percentage of the total number of units in the City that were contributed by SDHC. This allowed us to measure SDHC's impact on the total number of affordable housing units being added to the City's stock year after year.

To understand the effect of SDHC's production efforts on the City's need for affordable housing, we reviewed the Regional Housing Needs Assessment (RHNA) produced by the San Diego Association of Governments (SANDAG). We used the RHNA allocations for low-income housing units in the City of San Diego to estimate the number of affordable housing units needed. We then compared this need to both the number of units contributed by SDHC and the total number of units produced Citywide. This comparison allowed us to quantify how SDHC's efforts have impacted the City's need for affordable housing and better understand the magnitude of the affordable housing gap.

We also compiled affordable housing production figures for other California cities to assess whether production and the affordable housing gap in San Diego is significantly different than in other California cities. We did this by reviewing the RHNA produced by each jurisdiction's council of governments along with each jurisdiction's Annual Housing Element Progress Reports.

To determine the number of affordable housing units lost or are at risk of being lost through the expiration of affordability covenants, we reviewed the Inventory and Cost Analysis of "At-Risk" Affordable Units presented in the City of San Diego's Housing Element. This analysis includes an inventory of the number of affordable units eligible for conversion to market rate rents between July 1, 2009 and June 30, 2020 and a comparison of the costs involved in replacing these units.

To determine if SDHC was cost-effective in the production of affordable housing, we interviewed SDHC staff, calculated development unit cost using actual cost from independent cost certifications and compared those to state and regional averages as well as the averages for other SDHC funded developments. We

[9] In the Annual Progress Reports, the number of units permitted is used as an approximation for the number of units built.

also reviewed SDHC development proposals including pro-forma statements to gain an understanding of cost factors and cash flow estimates. For the loan portfolio, we selected a sample of 31 loans and verified the terms from the loan agreements. We compiled residual receipt forms and independent audits to determine borrower submittal per the loan agreement terms. The interest amounts collected were matched to SDHC accounting records and the interest due was reconciled from the SDHC annual report to SDHC accounting records.

In addition to compiling affordable housing production figures, we tested whether SDHC is continuously verifying the eligibility of families receiving rental assistance. To do this, we selected a random sample from the population of households receiving rental assistance as of July 1, 2015, based on data provided by SDHC.[10] We reviewed recertification paperwork for each household in the sample and verified that the rent subsidy was paid to the landlord by reviewing payments in the check register. This review allowed us to confirm that SDHC monitors and regularly verifies participant households' eligibility to receive rental assistance.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[10] We selected a random sample from the population of households receiving rental assistance based on a 90 percent confidence level and a confidence interval of 10.

SAN DIEGO HOUSING COMMISSION

SDHC

MEMORANDUM

Date: September 12, 2016

To: Eduardo Luna MPA, CIA, CGFM
City Auditor

From: Richard C. Gentry
President & CEO
San Diego Housing Commission

Subject: Response to Performance Audit of the San Diego Housing Commission

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The San Diego Housing Commission (SDHC) appreciates the diligence and effort the Office of the City Auditor committed to this performance audit.

Audit Finding #1: *The San Diego Housing Commission Plays a Significant Role in the Production of Affordable Housing but Has Not Established Targets or Performance Measures to Evaluate the Results of its Efforts*

> **Recommendation #1:** *To help maximize the number of affordable housing units produced, the San Diego Housing Commission should establish targets and performance measures and annually report on those results. When setting production goals, the San Diego Housing Commission should also consider the number of units that are at risk of conversion to market rate. (Priority 2)*
>
> **Response: Agree with Recommendation**
> Completion Date: June 30, 2017
>
> As the advisor to the City Council on affordable housing opportunities for low- and moderate-income persons and families in the city of San Diego, we will enhance our efforts to more clearly set performance standards to achieve the goal of evaluating program results.
>
> SDHC reports the results of affordable rental housing units produced and financed in the agency's multimedia Annual Report.
>
> In addition, SDHC supports the preservation of affordable housing at risk of conversion to market-rate housing. Since 2004, SDHC has provided financial assistance or bond

financing to more than 2,000 affordable housing units. SDHC will revise our Notice of Funding Availability (NOFA) to include priority points for projects that preserve "at-risk" housing, and we will include the list of "at-risk" projects from the City's Housing Element in our NOFA.

SDHC recognized the importance of affordable housing production goals in its report released on November 25, 2015, "Addressing the Housing Affordability Crisis: An Action Plan for San Diego." One of the 11 recommended actions in the report to reduce costs and increase production is for the City Council to set annual goals for housing production, with a scorecard to track progress in meeting the goals.

The report was presented on December 9, 2015 to the San Diego City Council's Smart Growth and Land Use Committee, which voted unanimously to direct City staff to work with SDHC to explore how the report's recommendations could be crafted into City ordinances or advocated at the federal or state levels. City Council committee members described the report as a "common sense" way of lowering construction costs.

It is important to note that the number of affordable rental housing units created or preserved with funding invested by SDHC is dependent upon the amount of funds received in any given year and the applications submitted from the development community.

Performance measures and targets should be well-defined; however, the number of units produced will largely be dependent on the annual appropriation of funds at the federal, state, and local levels.

Audit Finding #2: *The San Diego Housing Commission Can Better Demonstrate the Cost-Effectiveness of Affordable Housing Developments by Using Performance Indicators and Benchmarks.*

Recommendation #2: *The San Diego Housing Commission should establish an evaluation methodology that includes performance measures and benchmarks to demonstrate that the San Diego Housing Commission's projects provide the best option to achieve cost-effectiveness in affordable housing expenditures. The San Diego Housing Commission should report the results no less than annually to the San Diego Housing Commission Board and also to the San Diego Housing Authority. (Priority 2)*

Response: Agree with Recommendation
Completion Date: June 30, 2017

There is an opportunity to further enhance, augment, and establish a defined set of performance metrics in addition to the internal benchmarks currently utilized by SDHC staff and the SDHC Board.

SDHC will establish an evaluation methodology that includes performance measures and benchmarks and provide annual reports to the SDHC Board and the Housing Authority.

SDHC will continue to explore and evaluate methods of achieving cost effectiveness. SDHC wants the ability to develop and use standards that take into consideration the different types of construction that are involved, local cost drivers and other factors that are unique to the city of San Diego. RS Means is one tool; however, there may be more effective means of measuring and comparing costs, which SDHC will research and consider implementing.

Currently, the cost per unit and the amount of financial subsidy per unit are among the criteria utilized by SDHC staff and the SDHC Board to evaluate proposed affordable rental housing developments and maximize production.

Also, SDHC utilizes third-party cost estimators that provide an independent review of proposed development costs, which assists with the evaluation of cost-effectiveness and financial feasibility for the purpose of investing an SDHC loan to assist with development financing.

Additional data that guides SDHC decisions regarding acquisitions, developments, and homelessness programs include:

- Location criteria to support the City's Balanced Communities Policy 600-19;
- Location criteria to support reduction of greenhouse gas emissions by locating affordable housing near transit and employment centers;
- Total development costs, cost per unit, SDHC subsidy, and leveraging of other revenue sources;
- The number of individuals and families in need of affordable housing in the city of San Diego [San Diego Association of Governments' Regional Housing Needs Assessment (RHNA) report]
- The diminishing number of Single-Room Occupancy (SRO) hotels in the city of San Diego (City of San Diego SRO Hotel Inventory update); and
- The annual Point-in-Time Count of homeless individuals.

Audit Finding #3: *The San Diego Housing Commission Can Improve Monitoring of Developers' Loan Payments to Ensure it is Collecting Amounts Due and Should Regularly Evaluate the Cost-Effectiveness of its Loan Servicing Activities.*

Recommendation #3: *The San Diego Housing Commission should develop loan servicing guidelines that include review timelines, reconciliation procedures and dispute procedures. (Priority 2)*

Response: Agree with Recommendation
Completion Date: June 30, 2017

In the spring of 2015, SDHC adopted written "Asset & Portfolio Management Policies and Procedures." In July 2015, SDHC created a new loan portfolio asset management group to provide additional oversight of SDHC's multifamily loan portfolio. SDHC loan portfolio asset management staff will review and update the "Asset & Portfolio Management Policies and Procedures" to include review timelines, reconciliation procedures and dispute procedures for the multifamily loan portfolio asset management activities.

Recommendation #4: *The San Diego Housing Commission should report loan collection results annually to the San Diego Housing Commission Board and the San Diego Housing Authority. (Priority 2)*

Response: Agree with Recommendation
Completion Date: Quarterly, beginning October 1, 2016

SDHC is actively working to replace our existing loan servicing software with a fully integrated software database and has formally published a Request for Proposals. SDHC's Real Estate Division and Financial Services Department will use the new loan servicing software to access borrower data, loan documents and dashboards, which report key performance indicators. The new software will enhance SDHC's management of our loan portfolio, increase efficiencies and automate processes, such as account draws, payments and account reconciliation. Borrower data will be integrated with existing performance management software tools, such as Yardi and Tableau, to generate customized reports, monitor performance of the portfolio, track real-time analytics and conduct trend analysis.

Starting with the first quarterly report of this Fiscal Year 2017 (July 1, 2016 – June 30, 2017), we will provide the loan payment information for multifamily, single-family, and rehabilitation loan programs.

Recommendation #5: *The San Diego Housing Commission should conduct periodic analysis, no less than annually, of the cost-benefit of the loan servicing activities. If the loan servicing activities are not cost effective, alternatives such as streamlined reconciliation procedures or a simplified payment structure should be considered. (Priority 2)*

Response: Agree with Recommendation
Completion Date: Annually, beginning July 1, 2017

SDHC will conduct no less than annually, periodic analyses of the cost-benefit of the loan servicing activities. If the analysis deems the loan servicing activities are not cost effective, alternatives will be considered and an improved process will be implemented.

Conclusion

SDHC is committed to providing the Housing Authority, City and the public with pertinent metrics, such as:

- Housing need as reported in the RHNA report;
- The breakdown of City building permits issued (affordable/market rate);
- Actual unit production completions;
- Revenue sources and programs utilized to produce the units (Currently, there is a lot of overlap among a variety of programs, and metrics typically are contained in many different reports);
- A list of all of the annual plans and reports that SDHC produces about the individual programs/revenue sources; and
- Some overall metrics on cost-effectiveness and explanation of public policy goals.

We believe that a comprehensive report with data from all programs and revenues sources and uses would be beneficial in helping track our progress in meeting production and public policy goals with respect to affordable housing in the city of San Diego.

We thank the Office of the City Auditor for its thorough and comprehensive performance audit of SDHC.

In implementing these audit recommendations, SDHC believes this will strengthen our mission and our collaboration with the City of San Diego to provide affordable housing opportunities to our low-income San Diegans and to enhance our efforts to create and preserve affordable housing in the city of San Diego.

Cc:
Jeff Davis, Executive Vice President & Chief of Staff
Debbie Ruane, Executive Vice President & Strategic Officer
Tracey McDermott, Chief Financial Officer
Daniel Brown, Controller