97-23 An Evaluation of the Wisconsin Development Reserve Fund, Wisconsin Housing and Economic Development Authority

Summary

The Wisconsin Housing and Economic Development Authority (WHEDA), a public corporation, was created to provide below-market interest rate loans to homebuyers and housing developers because the State is constitutionally prohibited from incurring debt to fund such loans. Based on WHEDA's lending experience in the housing industry, the State has also provided WHEDA with $19.1 million in state funds to manage various loan guarantee programs for eligible farmers and small businesses that otherwise could not obtain conventional financing. While commercial lenders provide the loans and perform daily loan servicing, the guarantee programs have typically guaranteed 80 to 90 percent of the loans in case of default, and in some cases have provided interest subsidies to borrowers. The first guarantee program, the Credit Relief Outreach Program (CROP), was created in 1985 to guarantee short-term agricultural production loans. In fiscal year (FY) 1991-92, the funding for CROP and other existing loan guarantee programs was consolidated to create the Wisconsin Development Reserve Fund.

Since the Reserve Fund was created, expenses have exceeded revenues and the balance has steadily declined by more than $8.1 million, from $21.1 million at the end of FY 1991-92 to reach its lowest point of $12.9 million as of June 30, 1997. Administrative costs have represented nearly 60 percent of the Reserve Fund's expenses since it was created. In response to concerns about the declining balance, 1995 Wisconsin Act 5 directed the Legislative Audit Bureau to perform an evaluation of the assessments WHEDA made against the Reserve Fund for administration of the loan guarantee programs.

Because the demand for public funds is widespread, organizations that receive these funds, such as WHEDA, must continually strive to manage them properly by minimizing administrative costs and maximizing revenues, when possible, within public programs. While WHEDA has taken recent steps to help improve the operations of the guarantee programs, we identified several areas in which WHEDA needs to improve fiscal accountability and management of the Reserve Fund. In particular, WHEDA's process for allocating administrative costs does not ensure appropriateness and equitability in cost distribution; Reserve Fund staffing expenses are relatively high compared to those of other entities; and improvements in management of the Fund's investments are needed.

Because WHEDA is organized by function, the majority of its administrative costs are at the division level and are assessed to the various programs, including the loan guarantee programs, based on an allocation process. To ensure that costs are allocated in proportion to use and that their appropriateness can be documented, it is important that WHEDA establish a systematic and equitable method of assigning common costs among various programs, especially when multiple or designated sources of funding are involved. WHEDA's cost allocation plan, however, does not ensure that only necessary and appropriate costs are assessed to the Reserve Fund.

First, allocation methods should include measures that ensure the assessed costs are proportional to benefits received. However, WHEDA's allocation process for shared Division of Information Technology costs, which represented 17.5 percent of FY 1996-97 administrative costs, does not appear to reflect any systematic analysis of the use of that division's resources. Instead, WHEDA has chosen to allocate two-thirds of Information Technology costs to its two largest divisions and the remaining one-third to the remaining divisions, based on the number of employes in each division. Since WHEDA staff descriptions of the Division of Information Technology workload do not support this allocation, a more justifiable allocation method is needed. In addition, because nearly 70 percent of the WHEDA staff time allocated to the Reserve Fund comes from these two large divisions, an unsupported allocation method may result in disproportionate Information Technology costs being allocated to the guarantee programs.

Second, an allocation process should maintain documentation to support its appropriateness. However, WHEDA

allocates the majority of its costs to individual programs, such as the loan guarantee programs, based on annualized employe time estimates of future efforts, without periodic time studies or analyses. These estimates are therefore particularly subject to misperceptions of work efforts and inaccurate estimates. For example, because nearly one-third of the employes who work with the loan guarantee programs indicate that the programs require less than 10 percent of their time, and because some employes concentrate their efforts on these programs for a small number of months each year, it may be difficult for staff to assess and develop annualized time estimates accurately. Therefore, periodic time studies or analyses of the program staff's workload are needed to support staff time allocated to the loan guarantee programs.

As requested in the legislation requiring this audit, we compared WHEDA's administrative costs and personnel levels to those within the commercial lending industry and those of similar guarantee programs. While no totally comparable commercial guarantee programs were identified, WHEDA's staffing levels are higher than the average staffing levels within commercial lenders' loan departments. For example, while WHEDA's small business loan guarantee programs have a total guarantee authority of $35.1 million, WHEDA's staffing level is comparable to average staffing of the loan function at a midwestern commercial lender with $50 to $200 million in deposits and over 750 outstanding loans.

WHEDA's staffing and related costs are also relatively high in comparison to comparable organizational units within state agencies. For example, WHEDA and the Department of Commerce have comparable numbers of staff performing information technology functions, but Commerce is over twice the size of WHEDA. In addition, WHEDA has provided the majority of its employes with annual lump-sum bonuses, which are unparalleled in state service. In the past, these bonuses ranged between 2 percent of gross salary for those minimally meeting expectations and 7 percent for superior performance, and they totaled approximately $342,000 in FY 1995-96 and $328,200 in FY 1996-97. Subsequent to our fieldwork, WHEDA discontinued its bonus program and, effective December 1, 1997, instituted a performance award program.

Although administrative costs were a significant factor in the declining Reserve Fund balance, the lack of appropriate investment strategies and policies to guide staff in making investment decisions specific to the Reserve Fund, and the lack of oversight and monitoring of investments, may have limited WHEDA's ability to maximize its investment earnings and to ensure the investment portfolio was appropriate to the objectives and needs of the Reserve Fund. WHEDA took only limited steps to assess or increase its ability to increase Reserve Fund investment earnings for a number of years. In fact, in the nine-year period from FY 1984-85, when CROP was established, the average rate of return earned on the investments of the guarantee loan programs was less than the return on the State Investment Fund, a short-term pool of state and local funds managed by the State of Wisconsin Investment Board.

In addition, we question whether WHEDA, when it realized in FY 1993-94 that it needed to increase investment earnings, adequately evaluated the Reserve Fund's liquidity needs and, correspondingly, the appropriateness of the risks it took with new investment purchases. Of particular concern was the purchase of seven collateralized mortgage obligation bonds, which were sensitive to rising interest rates and represented over 40 percent of the Fund's balance. Within months after the purchase of the bonds, interest rates rose and the market values of the securities declined. Fortunately, WHEDA has not experienced any significant losses from these purchases, but it has been required to hold the securities longer than anticipated, which has limited its flexibility to pursue other investment opportunities. Based on our review of minutes from WHEDA Board and committee meetings and our discussions with members of the Board and its staff, little investment information was provided to the Board prior to February 1995, and little discussion related specifically to the Reserve Fund has occurred since then. WHEDA has recently taken steps to improve its management of the Reserve Fund investments, including contracting with an investment advisory firm in August 1997 to help it develop investment policies and strategies.

In an attempt to meet public development goals, improve the Reserve Fund's financial stability, and increase activity within the loan guarantee programs, several program changes were enacted in the 1997-99 Biennial Budget Act, 1997 Wisconsin Act 27. For example, the Legislature appropriated $4 million from the State's Recycling Fund to the Reserve Fund for a new guarantee program, which will assist in the redevelopment of industrial or commercial sites that are environmentally contaminated. Upon WHEDA's recommendations, the Legislature also eliminated several guarantee programs with narrowly defined eligibility criteria and created a broad small business development guarantee program to help improve efficiency and reduce the costs of the guarantees.

These recent program changes, as well as potential changes identified in this report to better minimize administrative expenses and maximize revenues, may extend the Reserve Fund's life, but they are not likely to be sufficient to sustain the loan guarantee programs in the long term. We estimate that the Reserve Fund balance will be depleted in approximately 10-12 years, but because of required reserves that must be maintained in the Fund for outstanding guarantees, the authority to guarantee loans will be limited by FY 2004-05 under current conditions.

Of special concern, however, is a risk of default on a $7.6 million loan WHEDA provided in October 1993 to the Taliesin Preservation Commission to restore the home of Frank Lloyd Wright. This loan is guaranteed under the Cultural and Architectural Landmark loan guarantee program for $6.8 million. WHEDA entered into a forbearance agreement in August of 1996 to delay principal payments on the loan, and currently is renegotiating the loan to alter the payment structure and eliminate interest on the loan. However, the Commission's financial status suggests that it is unlikely to be able to repay the entire loan in the foreseeable future. At the same time, WHEDA will be required to pay from its general fund annual interest costs of over $300,000 on notes it issued to provide the funding for the loan. Unless there is a major change in Taliesin's financial condition in the near future, the Legislature may need to consider an appropriation of state funds to avoid foreclosure and to eliminate or reduce the costs WHEDA is incurring to maintain the loan.

With uncertainty regarding the Reserve Fund's future financial condition and the likelihood that other additional state funding will be needed to sustain the Fund in the long-term, the activity and effectiveness of the guarantee programs need to be considered when determining whether these programs use state resources optimally. While CROP has been a widely used guarantee program, averaging 1,600 guarantees for $20 million per year, the guarantee programs designed to help small businesses have been used much less frequently; on average, there have been 37 guarantees totaling $3 million annually. The small business loan guarantee programs also are more costly than CROP to administer. In FY 1996-97, the administrative costs allocated to the small business guarantee programs were approximately 72 percent of the total costs assessed against the Reserve Fund.

In response to relatively low program activity in the small business loan guarantee programs, WHEDA has taken steps to improve the attractiveness of the programs and is in the process of taking additional steps. Commercial lenders with whom we spoke indicated that the inability to sell WHEDA guarantees to investors and other lenders in the secondary market deters them from using the Reserve Fund guarantee programs. WHEDA staff are currently analyzing what program or statutory changes, if any, are needed to make its guarantees marketable in the secondary market. WHEDA recently developed a formal underwriting policy to ensure consistency in approving and denying applications. In addition, WHEDA has reduced the average time needed to process guarantee applications by altering the application format and delegating some approval authority from the WHEDA Board to its staff.

While these changes may increase program activity, there remains the question of whether need for this financial assistance is sufficiently met through federal programs and commercial lenders. With the creation of one broad small business development loan guarantee program, WHEDA guarantee programs have lost some of their uniqueness and have become increasingly similar to the federal Small Business Administration (SBA) guarantee programs. However, SBA provided over 40 times more small business guarantees in Wisconsin in federal fiscal year (FFY) 1995-96 than WHEDA did in state FY 1995-96; SBA obtained additional funding in FFY 1996-97 and 1997-98; and because it functions at the national level, SBA has the advantage of some efficiencies not available to WHEDA, such as centralized processing and reporting on guarantees. In addition, the federal Community Reinvestment Act will likely continue to encourage commercial lenders to provide loans that previously would have been provided only with a guarantee of some type.

Even with these options, the need may still exist for small business loan guarantee programs at the state level. However, WHEDA does not maintain data on the effectiveness of these programs, such as the number of jobs created as a result of the guarantees. At a minimum, to help the Legislature better assess the merits of the small business loan guarantee programs, WHEDA needs to monitor and report on the effectiveness of these guarantee programs in the future.

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