Office of Statewide Health Planning and Development:

The Cal-Mortgage Program Does Not Minimize the State’s Financial Risk When Insuring Health Facility Debt

October 1998

97108
The first copy of each California State Auditor report is free. Additional copies are $3 each. You can obtain reports by contacting the Bureau of State Audits at the following address:

California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814
(916) 445-0255 or TDD (916) 445-0255 x 248

OR

This report may also be available on the worldwide web
http://www.bsa.ca.gov/bsa/

Permission is granted to reproduce reports.
October 14, 1998

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the Cal-Mortgage Loan Insurance Program (Cal-Mortgage), a division of the Office of Statewide Health Planning and Development (OSHPD), that guarantees loans for health facility construction. This report concludes that although many of Cal-Mortgage’s clients are high-risk borrowers, it has not used all available information to assess an applicant’s financial viability, nor has it established its maximum level of acceptable risk when insuring a borrower. Further, Cal-Mortgage does not effectively monitor its borrowers. Weaknesses in its monitoring include inconsistent methods to oversee borrowers, a lack of formal procedures for this oversight, and insufficient supervision. Finally, because Cal-Mortgage does not have criteria for identifying problem borrowers that require executive management intervention, the director of OSHPD may not be fully aware of the risk present in Cal-Mortgage’s portfolio.

Respectfully submitted,

KURT R. SJOBERG
State Auditor
## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Summary</td>
<td>1</td>
</tr>
<tr>
<td>Introduction</td>
<td>3</td>
</tr>
<tr>
<td><strong>Chapter 1</strong></td>
<td></td>
</tr>
<tr>
<td>Cal-Mortgage Is Not Managing Its Program to Minimize Risk of Financial Loss to the State</td>
<td>11</td>
</tr>
<tr>
<td>Recommendations</td>
<td>21</td>
</tr>
<tr>
<td><strong>Chapter 2</strong></td>
<td></td>
</tr>
<tr>
<td>Cal-Mortgage’s Monitoring of Insured Borrowers Is Neither Thorough nor Consistent+</td>
<td>23</td>
</tr>
<tr>
<td>Recommendations</td>
<td>39</td>
</tr>
<tr>
<td><strong>Response to the Audit</strong></td>
<td></td>
</tr>
<tr>
<td>Office of Statewide Health Planning and Development</td>
<td>R-1</td>
</tr>
<tr>
<td>California State Auditor’s Comments on the Response From the Office of Statewide Health Planning and Development</td>
<td>R-15</td>
</tr>
</tbody>
</table>
SUMMARY

Audit Highlights . . .

The Cal-Mortgage program does not minimize the State’s financial loss because it:

☑ Does not adequately screen applicants for financial viability nor establish a maximum level of acceptable risk.

☑ Fails to monitor insured borrowers thoroughly and consistently.

As a result, Cal-Mortgage has insured a number of financially unstable applicants, some of which have defaulted on their loans.

The director of OSHPD may not be fully aware of the risk present in Cal-Mortgage’s portfolio because staff lack clear criteria for identifying borrowers that may need executive management intervention.

RESULTS IN BRIEF

The Cal-Mortgage Loan Insurance Program (Cal-Mortgage) is administered by the Office of Statewide Health Planning and Development (OSHPD). It insures loans for health facility construction in California, including hospitals, primary care clinics, and elderly care facilities. Many of Cal-Mortgage’s clients are high-risk borrowers that could not obtain loans without this insurance because their projects are deemed too risky. Accordingly, the likelihood of default for Cal-Mortgage clients is significantly higher than it is for clients of larger, private insurers. When its borrowers default and are unable to continue payment on their debt, Cal-Mortgage must pay off the insured debt. Although the very nature of dealing with high-risk borrowers increases the likelihood of defaults, Cal-Mortgage further increases its risk of client defaults with its ineffectual application process, vague guidelines, and incomplete and inconsistent monitoring.

Our audit revealed that Cal-Mortgage does not adequately screen applicants because it does not adhere to objective guidelines in its application process. It does not use all available information or standard procedures to assess its applicants’ financial viability, nor has it established procedures for determining its maximum level of risk when insuring a client. Due to this inadequate process, Cal-Mortgage has insured a number of financially unstable applicants, some of which have defaulted on their loans.

Cal-Mortgage does not consistently require that borrowers submit information about their financial condition, and it does not consistently conduct timely or structured site visits with borrowers. As a result, Cal-Mortgage may have little notice of financial difficulties before a borrower defaults on its debt. Weaknesses in its monitoring include inconsistent methods to oversee borrowers, a lack of formal procedures for this oversight, and insufficient supervision by Cal-Mortgage management.

Moreover, it cannot effectively monitor the risk in the borrower portfolio because the portfolio database is unreliable, contains numerous errors, and is not properly maintained. Finally, because Cal-Mortgage does not have benchmarks or standard
criteria for identifying problem borrowers that require executive management intervention, the director of the OSHPD, which oversees this insurance program, may not be fully aware of the risk present in Cal-Mortgage’s portfolio.

RECOMMENDATIONS
To improve consistency and minimize the risk of financial loss to the State, Cal-Mortgage should develop a more rigorous process to determine the financial viability of applicants and should define a maximum level of risk that it will accept when insuring a borrower.

The Legislature should consider changing the law to require that Cal-Mortgage develop a maximum level of insurance risk acceptable for loan insurance approval. The new law should ensure that Cal-Mortgage sets the risk level to minimize the potential of loan defaults and the resulting default payments from the Health Facilities Construction Loan Insurance Fund, while still being able to accomplish its statutory mission.

To ensure that Cal-Mortgage adequately oversees its borrowers and is sufficiently warned of those experiencing financial difficulties, it should establish a standard monitoring system for tracking and analyzing borrowers’ financial information.

To improve its management information for monitoring and oversight, Cal-Mortgage should periodically review the portfolio database for errors and develop procedures for maintaining and ensuring the integrity of the database.

To ensure that OSHPD management has the information necessary to assess the level of risk in the portfolio, Cal-Mortgage should develop benchmarks and standard criteria for calling an at-risk borrower’s financial status to OSHPD’s attention.

AGENCY COMMENTS
The Office of Statewide Health Planning and Development generally concurs with our findings and believes it has made considerable progress in implementing most of the recommendations. However, the OSHPD believes that the Cal-Mortgage program has had few defaults and that its historical record would seem to indicate effective management of the program.
INTRODUCTION

BACKGROUND

The Cal-Mortgage Loan Insurance Program (Cal-Mortgage) was established in 1968 to provide low-cost financing for the construction of health facilities in California. The intent of the program is to provide, without cost to the State, loan insurance for health facility construction, improvement, and expansion projects, thus stimulating the flow of private capital into health facilities. When health facilities borrow money, Cal-Mortgage guarantees payment of the loan using the full faith and credit of the State. The program is administered by the Office of Statewide Health Planning and Development. As of December 31, 1997, Cal-Mortgage guaranteed about $1.7 billion in health facility bonds and loans.

Loan insurance is a promise by a third party, the insurer, to meet the principal and interest payments on a borrower's debt if the borrower is unable to do so. This commitment lasts the life of the debt, is unconditional, and is not subject to cancellation by the insurer. Insurance can cover various types of debt obligations but is primarily used for bonds. In addition to Cal-Mortgage, several other private and government organizations also insure bonds.

Insurance Reduces Borrowing Costs

Bond issues covered by insurance receive the insurer's credit rating; therefore, by purchasing insurance a borrower can obtain an improved credit rating on its debt, and thus pay a lower interest rate. The investment community uses credit ratings to assess the relative risk of a borrower defaulting on a specific debt. Large private insurance companies have the reputation of being very stable, and debts they insure have traditionally received the Standard and Poor's AAA rating, the highest credit rating available. In contrast, the credit rating of debt that Cal-Mortgage insures is dependent on California's credit rating, which is currently A+, two levels lower. The actual amount of savings depends on the interest rates the market offers, but by reducing the interest rate, bond insurance can allow a borrower to significantly reduce its cost to borrow funds. For example, an AAA rated bond maturing in 20 years currently commands an
interest rate of 4.90 percent, whereas if that bond was A rated, it would have an interest rate of 5.15 percent, 0.25 percentage points higher. Cal-Mortgage insures a variety of health facilities, including hospitals and specialized health facilities, such as mental health clinics, primary-care clinics, substance abuse treatment centers, group homes, and elderly care facilities.

A major difference between Cal-Mortgage and the large private insurers is the riskiness of the borrowers they insure. Large private insurers require that borrowers meet certain credit standards and have less risk. Conversely, most of the borrowers that Cal-Mortgage insures are unable to obtain insurance from private insurers because their projects are deemed too risky. Thus, most of the borrowers in the Cal-Mortgage portfolio are less financially stable than borrowers in the portfolios of private insurers.

The Size of Bond Insurers’ Portfolios Varies

Currently, several large private insurance companies dominate the bond insurance market. For example, two of the largest insurance companies, MBIA Insurance Corporation and Ambac Assurance Corporation, insure different types of borrowers and have portfolios totaling $277.1 billion and $165.6 billion respectively. In contrast, insurers that specialize in certain areas, such as Cal-Mortgage, have much smaller portfolios. Specifically, Cal-Mortgage only insures health facilities located in California, while the large insurance companies guarantee bonds for all types of borrowers throughout the nation, including those planning health facilities construction. As shown in Table 1, the amount of health facilities bonds that large companies guarantee dwarf the amount Cal-Mortgage insures.

<table>
<thead>
<tr>
<th>Insurer</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>MBIA Insurance Corporation</td>
<td>$33,321</td>
</tr>
<tr>
<td>Ambac Assurance Corporation</td>
<td>18,545</td>
</tr>
<tr>
<td>Cal-Mortgage</td>
<td>1,668</td>
</tr>
</tbody>
</table>
Borrowers Must Meet Specific Terms for Insurance Coverage

Insurers require that each borrower agree to certain terms. In fact, borrowers insured by Cal-Mortgage must sign a regulatory agreement requiring them to periodically submit financial information. As compensation for taking on the relative risk, insurers charge a premium based on the dollar value of the bond issue. Private insurance companies generally charge a one-time fee between 0.1 percent and 2 percent of the total principal and interest payable over the life of the bonds. The premium rate varies depending on the competition with other bond insurers and the riskiness of the borrower. In contrast, Cal-Mortgage charges an annual fee of 0.5 percent of the average principal balance outstanding each year. Although the Cal-Mortgage fee is often initially less than premiums charged by private insurers, over the life of the debt its fees will eventually exceed those that a private insurer charges.

Cal-Mortgage deposits the fees it collects in the Health Facilities Construction Loan Insurance Fund (fund). These fees pay for the administration of Cal-Mortgage and also for any defaults on insured debt. As of December 31, 1997, the fund had a balance of approximately $126.2 million and guaranteed approximately $1.7 billion of bonds.

The laws require that every two years Cal-Mortgage contract with an actuary to determine the adequacy of the fund balance. The actuary is required to examine the portfolio of insured loans and estimate the amount of reserve funds Cal-Mortgage should have available to respond to potential risks, including extraordinary administrative expenses and actual defaults. The latest actuarial study performed for the fund balance as of June 30, 1996, found that on a cash-flow basis, the fund will maintain a positive balance in the short term; however, at some point in the future, it could have a negative balance depending on the frequency and severity of extraordinary events, such as catastrophes, economic or legislative changes that adversely affect the health care industry, or unexpected large defaults. Nevertheless, the actuary also concluded that even under the worst-case scenario, the fund balance would be positive at least until the year 2005. The actuarial study of the June 30, 1998, fund balance is currently underway.
The Cal-Mortgage Portfolio
Has Been Decreasing in Value

The size of the Cal-Mortgage portfolio peaked in January 1994 at almost $2.1 billion and has been decreasing since. Figure 1 shows the size of the portfolio over the past 10 years.

Several circumstances contribute to this decrease in value of projects insured. One is that fewer borrowers are requesting insurance from Cal-Mortgage for new projects. For example, during 1997, Cal-Mortgage approved 17 borrowers for insurance; however, only 7 were insuring new loans, and the remaining 10 were refinancing existing loans. In fact, over the past four years, Cal-Mortgage has insured 57 borrowers, but 24 of these have refinanced existing debt.

Refinancing of debt also resulted in 25 borrowers leaving the Cal-Mortgage portfolio over the last 18 months. A primary reason that borrowers refinance is to obtain a better interest rate, thus reducing their borrowing costs. As noted previously, private insurers provide a better investment rating than Cal-Mortgage, which results in a lower interest rate. Thus, if

* Projected based on Cal-Mortgage estimates.

Source: Cal-Mortgage Loan Insurance Division.
borrowers are able to qualify for private insurance, they may refinance to obtain a lower interest rate and reduce their borrowing costs.

Another circumstance that is contributing to the decline of the portfolio value is that Cal-Mortgage implemented a policy to, in most instances, only insure individual applicants borrowing less than $40 million. This policy change took place in December 1995, but prior to this date, Cal-Mortgage had no such limit. This change was meant to minimize the risk that a single project could place on the portfolio. As a result, Cal-Mortgage has insured only one project greater than $40 million since 1995, which was a refinancing of an existing loan.

Several Borrowers Have Defaulted on Debts Insured by Cal-Mortgage

Over the past several years, Cal-Mortgage has been stung by several major defaults on debt that it has insured. When a default occurs, Cal-Mortgage must honor its commitment to insure the principal and interest payments until the borrower is able to resume them. However, in most instances, the borrower is unable to continue payments, leaving Cal-Mortgage responsible for the remainder of the debt.

Triad Healthcare Corporation comprised the single largest default. In 1993, Triad defaulted on an insured loan with a balance of $167 million, the largest loan in the Cal-Mortgage portfolio. Triad went into bankruptcy reorganization, and Cal-Mortgage had to take over its payments. This default was significant enough to cause Cal-Mortgage to place a moratorium on new loans until it could assess the risk of other borrowers in its portfolio. During this moratorium, Cal-Mortgage also implemented several procedures it believed would better manage the risk of the portfolio, including restructuring an advisory committee that reviews insurance applications, changing the procedures to make payments faster when a default occurs, and strengthening the laws to provide Cal-Mortgage more control over borrowers and to prevent borrowers from defaulting on their debt.

Los Medanos Health Care Corporation defaulted on another significant bond issue in 1994. In April 1990, Los Medanos issued bonds totaling $11.1 million to renovate and expand its hospital facility, pay off existing debt, and provide funds
for future capital projects. Los Medanos purchased bond insurance through Cal-Mortgage to obtain a lower interest rate. Within a few months after issuing the bonds, Los Medanos began experiencing financial difficulties. It finally defaulted on the bonds in 1994 and was unable to make further payments. Thus, Cal-Mortgage became responsible and paid $9.2 million to retire the debt. As of May 31, 1998, five other defaults totaling $8.4 million, have occurred over the history of the portfolio; all have occurred since 1992. One of these five borrowers is completely insolvent, while the remaining four continue to operate.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee asked that we review Cal-Mortgage’s operations and its actions in handling the defaults of Los Medanos and other borrowers. To understand Cal-Mortgage’s responsibilities, we reviewed state laws and regulations relevant to its activities. In addition, we examined Cal-Mortgage manuals and procedures. Further, to learn about its operations, we interviewed Cal-Mortgage project officers, who are primarily responsible for reviewing applications for loan insurance and monitoring insured borrowers.

We also evaluated its process for approving loans for insurance. Specifically, we selected a sample of loans Cal-Mortgage has insured since 1996 and assessed the adequacy of the insurance approval process. Since some of the borrowers in our sample were in various stages of default on their loans, we assessed whether Cal-Mortgage’s process for approving loan insurance would detect borrowers that may experience future financial difficulties.

To determine the effectiveness of Cal-Mortgage’s oversight of insured borrowers, we reviewed how it monitors borrowers to receive advance notice of those that are experiencing financial difficulties. We also selected a sample of borrowers to determine if Cal-Mortgage was adequately assessing their financial condition. Furthermore, we analyzed the current portfolio of insured loans to determine if Cal-Mortgage has identified all borrowers that are experiencing financial difficulties.

In addition, we assessed Cal-Mortgage’s actions in the default by Los Medanos. Specifically, we examined how Cal-Mortgage determined that Los Medanos was eligible for bond insurance,
and once insured, how it monitored Los Medanos. Further, we reviewed the actions of Cal-Mortgage after Los Medanos went into bankruptcy, including its monitoring of the court-appointed bankruptcy receiver. A receiver is an individual appointed by a court to take control of an organization to protect the financial interests of all parties, which in this case includes Cal-Mortgage.

Further, we reviewed Cal-Mortgage’s efforts to collect from borrowers that have defaulted. Finally, we determined if all assets and liabilities of defaults were recorded in the financial statements of the fund.
CHAPTER 1

*Cal-Mortgage Is Not Managing Its Program to Minimize Risk of Financial Loss to the State*

**CHAPTER SUMMARY**

Although Cal-Mortgage screens applicants’ eligibility for loan insurance, the process is not rigorous enough to assure that the risk of applicants defaulting on their debt is minimized. Specifically, Cal-Mortgage does not take advantage of all the information available to adequately review an applicant’s financial viability. In addition, the laws governing Cal-Mortgage allow it too much discretion when deciding whether to insure applicants. Moreover, Cal-Mortgage has neither established benchmarks for assessing an applicant’s financial viability nor a maximum level of risk it is willing to accept when insuring an applicant. As a result, Cal-Mortgage has made several ill-advised decisions to approve applicants for loan insurance that are financially weak, some of which have since defaulted on their debt.

We also found that Cal-Mortgage on occasion has waived the requirement for earthquake insurance, which further increases the risk of loss to the State. In addition, Cal-Mortgage is not consistently requiring applicants to demonstrate they are meeting a statutory requirement to make services available to all persons residing or working in the area the facility serves. Finally, Cal-Mortgage approves loan insurance to troubled borrowers for working capital funds, which infuse cash into the facilities’ daily operations, with the intent to help them resolve their financial difficulties. However, this practice has not been fully successful because these troubled borrowers generally have been unable to resume full payment on their debt.
CAL-MORTGAGE’S CURRENT APPLICATION REVIEW PROCESS IS INSUFFICIENT

Even though Cal-Mortgage has specific steps for applicants to follow when applying for loan insurance, its process for reviewing and approving applicants lacks substance and does not result in a sufficient assessment of applicants’ financial viability. Furthermore, the loan approval process does not provide Cal-Mortgage with a sound basis for approving loan insurance. Moreover, the process allows Cal-Mortgage too much discretion in approving applicants without sufficient screening.

In addition, the laws governing Cal-Mortgage require the Office of Statewide Health Planning and Development (OSHPD) to operate the program at no cost to the State, however, they do not compel Cal-Mortgage to operate the program prudently. Specifically, the laws provide that Cal-Mortgage have a separate fund to pay for its operations and any defaults, but if the fund does not have a sufficient balance to pay all the defaults, then the State’s General Fund must pay for any shortfalls. Therefore, as long as Cal-Mortgage believes that its fund has sufficient money to cover the potential defaults, it can make ill-advised decisions to insure financially unstable borrowers. Moreover, by approving some of these loans, Cal-Mortgage may jeopardize a portion of the State’s General Fund. A more appropriate restriction in the law would require that Cal-Mortgage only approve applications for loan insurance that meet an acceptable level of risk.

Cal-Mortgage Analyzes Applicants’ Financial Statements Minimally

Although Cal-Mortgage requires applicants to submit three years of financial statements, it does not critically evaluate those statements to assess their financial viability. For example, while reviewing the files of nine applicants, we saw no evidence that the project officers completed a thorough analysis of the financial statements to help support the decision to approve the applications. This lack of financial analysis is particularly disturbing since seven of the nine applicants experienced financial losses prior to applying for loan insurance.

The lack of financial analysis is particularly disturbing since seven of the nine applicants had experienced prior financial losses.

The Cal-Mortgage policy is to only insure projects that are “unequivocally, financially viable.” Financial losses are an indication that an applicant may default on its debt. Of the nine applicants we reviewed, four had losses from their operations in
each of the previous three years; another three had at least one loss in those years. Considering that seven of the nine applicants were having financial difficulties, we expected that Cal-Mortgage would have performed a thorough analysis of the applicants’ financial statements to determine the cause of these losses and to assess the likelihood that the applicants could repay the money they intended to borrow. Although four of the nine applicants’ files contained a high-level trend analysis of financial statement amounts and ratios, we found no evidence that Cal-Mortgage had performed a substantive review of the applicants’ financial viability. Rather, the only in-depth financial analysis we found was the financial feasibility studies the applicants prepared and submitted to sell their projects to the investment community.

By not completing thorough analyses of applicants’ financial statements, Cal-Mortgage did not have a basis to sufficiently assess the applicants’ financial viability. As a result, Cal-Mortgage approved all nine applications for loan insurance, and six of these nine borrowers are in various stages of default on their debt. One of the six is in default because it has made late monthly payments to the bond trustee. Three of the six borrowers failed to meet a specific level of financial stability as designated in their loan agreements, and two failed to submit required information, such as financial statements, to Cal-Mortgage. While these six defaults did not require Cal-Mortgage to make payments on the borrowers’ debts, they may be warnings of future financial crises requiring Cal-Mortgage intervention. The other three borrowers are not currently in any financial difficulty, according to Cal-Mortgage records.

We noted a similar problem with Cal-Mortgage’s analysis of the Los Medanos Health Care Corporation. Specifically, the financial statements of Los Medanos showed that for each of the three fiscal years prior to applying for loan insurance, Los Medanos had total operating losses of $8.4 million; however, when taking into consideration its tax subsidies of $1.7 million, it had net losses of $6.7 million. This was a clear indication that Los Medanos could have difficulty repaying the bonds. Although Cal-Mortgage was aware that Los Medanos was losing money, it recommended approval of loan insurance based on the hospital district’s financial feasibility study and because Los Medanos had made $280,000 during the four-month period prior to issuing the bonds. In its analysis, Cal-Mortgage stated that Los Medanos “has demonstrated a turnaround” in its finances. Nevertheless, if it had reviewed the financial...
statements during the remaining months of the year that Los Medanos issued the bonds, as another insurer does, Cal-Mortgage may have learned that the hospital district was still losing money. In fact, according to the financial statements for the fiscal year that ended two months after the bond issue, Los Medanos showed a net loss of $1 million. Moreover, in the three fiscal years after issuing the bonds, Los Medanos had experienced total net losses of $10.7 million. It defaulted on the bonds after the third fiscal year.

**Cal-Mortgage Failed to Use Management Letters When Assessing Insurance Applicants**

Management letters, reports that typically accompany audited financial statements, are another tool that Cal-Mortgage fails to use when evaluating applicants for loan insurance. Although Cal-Mortgage requires applicants to submit their auditors’ management letters as part of the application package, we found that project officers did not ensure that the applicants submitted them. The nine application files we reviewed contained no management letters.

In management letters, auditors discuss weaknesses in an applicant’s system of internal control and any other fiscal problems identified during their review. Thus, management letters can provide key insights on financial operations and could highlight applicants with serious fiscal problems. If it had reviewed the management letters, Cal-Mortgage may have identified factors that contributed to the losses of the seven applicants and determined whether these factors were significant enough to deny approval. By not obtaining and reviewing the management letters, Cal-Mortgage approved loan applications without complete information and possibly ignored advance warnings of potential defaults.

When we asked the project officers why they did not obtain management letters for these applicants, some responded that they assumed that the letters did not exist. Others stated they were aware that the applicant did not submit the letters, but felt it was unnecessary or not the policy to obtain them. In July 1998, in response to our inquiries, Cal-Mortgage implemented a procedure to require applicants to authorize their auditors to send the management letters directly to Cal-Mortgage. However, this procedure did not address how project officers should use and follow up on the information included in
the management letters. As a result, Cal-Mortgage cannot assure that weaknesses identified by independent auditors are considered when evaluating insurance applicants.

**Lack of Risk-Related Benchmarks Allows Too Much Discretion in Loan Application Approval**

Although Cal-Mortgage project officers consider an applicant’s financial viability, the program has not established an acceptable level of risk to use when deciding whether to approve an application. Further, the laws governing Cal-Mortgage require that OSHPD operate the program at no cost to the State; however, this requirement is not restrictive enough to ensure that Cal-Mortgage operates the program prudently. As a result, the process allows too much discretion; therefore, Cal-Mortgage cannot assure that it minimizes the risk that its borrowers will default on their debt.

For example, the Los Angeles County Department of Health Services (county) had reviewed the finances of one applicant within our sample and concluded that the organization had accumulated too much debt and had an extremely high probability of going bankrupt. Further, the county believed the applicant was in no position to take on additional debt. The county reached these conclusions because the applicant did not have enough cash to pay its debts, causing it to be delinquent on its lease payments and state payroll taxes, and to pay its employees late. Although the county reviewed the applicant just nine months before it was insured, Cal-Mortgage approved the application. Currently, this borrower is in default on its bonds because it has been late in making payments to the bond trustee.

According to the deputy director of Cal-Mortgage, he was aware of the county’s concerns regarding the applicant’s financial difficulties, but insured the loan anyway because of several considerations. These considerations include the belief that the applicant, who had been in business for 26 years, was providing an important service, and the fact that the applicant was selling a portion of its property to the California Department of Corrections (CDC) and expected to provide services to CDC. He also noted that the applicant has since obtained one contract with CDC. Furthermore, he stated that he realized the applicant would be a financially weak borrower but believes Cal-Mortgage can take more risk with smaller loans, such as this loan for only $15.

*In one case, Cal-Mortgage ignored warnings that an applicant could not take on additional debt.*
$1.3 million. In other words, he felt Cal-Mortgage could sustain the loss if the applicant defaulted.

However, we believe the deputy director is inappropriately applying his personal views as criteria rather than following the laws governing Cal-Mortgage that require it to operate the program at no cost to the State. He also does not take into account Cal-Mortgage policy that requires it to only insure financially viable applicants. Without guidelines or benchmarks establishing acceptable levels of risk, Cal-Mortgage may exercise too much discretion in deciding to approve loan applications.

**Other Insurers Have Established Risk Criteria**

In contrast to Cal-Mortgage's general guidance for loan approvals, other health facility insurers we contacted have stringent requirements and conduct more structured analytical reviews of applicants for loan insurance. We contacted both private and government insurers of health facilities to inquire about the guidelines they use to assess the credit-worthiness of an applicant. We found that private insurers set a maximum level of acceptable risk for insuring a project. This risk level considers various factors, including the borrower's investment rating, cash flow, asset base, and economic history. For example, larger private insurers set the minimum at the Standard & Poor's BBB rating, which defines a borrower as possessing an adequate capacity to repay its debt.

Private insurers use other criteria for approving loan insurance. One major private insurer does not require applicants to submit a feasibility study because it has never received one that states the project is not feasible. Instead, this insurer requires that the organization must be at least five years old, with a positive fund balance for three of the last five years, and have total cash and liquid assets equal to at least half the amount of its long-term debt.

A second private insurer we contacted is unlikely to insure an applicant that experienced financial losses within the five years prior to applying for loan insurance. Its criteria provides that the circumstances can be mitigated if the applicant can show a reliable source of nonoperating income, or that the losses were caused by a nonrecurring event. Further, this insurer also requires the applicant to have a minimum of 40 days of cash available for its operations. Finally, the applicant’s financial
performance must compare favorably to similar organizations in the insurer’s portfolio and in the nation.

A governmental insurer we contacted also has a loan insurance program for health facilities. Unlike private insurers, this governmental insurer does not use the investment rating of an applicant when approving loan insurance. However, it has guidelines to mitigate the risk of an applicant that has had financial losses. Specifically, it has a three-tier review process consisting of two levels of review of specific financial criteria and one level of review of subjective criteria. The two levels of financial criteria review include comparing the applicant’s financial ratios to industry averages published by a national accounting firm. Further, the government insurer reviews the applicant’s financial statements to determine whether it has enough stability and reserves to survive hard economic times. If the applicant survives the first two levels of review, the government insurer then reviews it using subjective criteria, such as utilization of its facility by patients, market share, and economic factors specific to the area.

Although Cal-Mortgage by design insures more risky borrowers, it still needs to establish specific criteria to assess applicants’ credit-worthiness and establish the level of risk it will accept. For example, if an applicant has not quite met predetermined financial viability standards, the criteria may include predetermined public benefits factors, such as whether the facility gives residents access to health care in remote locations, which would allow Cal-Mortgage to insure it. Since Cal-Mortgage’s mission places it as the insurer of last resort for many borrowers, its criteria would not be as stringent as that of private insurers. However, Cal-Mortgage should develop guidelines fitting its likely clientele to ensure all applicants have appropriate consideration, and that those approved have been fully analyzed and meet minimum criteria. Setting an appropriate level of risk will allow Cal-Mortgage to meet its mission, but still protect its program and the taxpayers.

WAIVER OF EARTHQUAKE INSURANCE MAY EXPOSE CAL-MORTGAGE TO UNNECESSARY RISK

Our review also found that on occasion, Cal-Mortgage waives the requirements for earthquake insurance after approving an applicant for loan insurance, and therefore, may unnecessarily increase the State’s risk of loss. Specifically, Cal-Mortgage waived
the requirement of earthquake insurance for four of nine applicants we reviewed. The four were located in San Francisco, Oakland and San Diego, which are areas prone to earthquakes. Cal-Mortgage granted these waivers because the applicants believed that earthquake insurance was too expensive.

The laws governing Cal-Mortgage require that applicants insure their facilities. Even though it is reasonable to allow Cal-Mortgage discretion in implementing this requirement, Cal-Mortgage should not waive requirements that will increase the risk to its program without careful consideration of the consequences. Since the facility is usually the primary collateral of the loan insurance, Cal-Mortgage needs to ensure that its decision to waive earthquake insurance does not substantially increase its risk.

According to the deputy director of Cal-Mortgage, the risk is reduced since the locations of Cal-Mortgage’s applicants are scattered throughout California. The deputy director also believes that the earthquake insurance would result in some loss recoveries from the Federal Emergency Management Agency (FEMA). Specifically, when a disaster occurs, FEMA may pay a portion of the loss to a borrower, but FEMA reduces the amount it pays by the amount of any private insurance payments. Thus, the deputy director is implying that borrowers could forgo purchasing earthquake insurance and simply rely upon FEMA to pay for any damage they incur. However, it is unwise for borrowers to rely solely upon the federal government for assistance after a natural disaster, particularly because the FEMA reimbursement process is labor intensive and can take years to complete. Moreover, FEMA generally pays 75 percent and the State generally pays 19 percent of a loss, but the remaining 6 percent is the borrower’s responsibility.

In addition, the deputy director notes that the high cost of earthquake insurance may cause a borrower to go into economic default. Therefore, under certain circumstances, he believes that waiving the requirement for earthquake insurance may result in less risk to Cal-Mortgage than requiring borrowers to pay high premiums for earthquake insurance. However, if the cost for earthquake insurance would cause a borrower to default, then we question why Cal-Mortgage would insure a borrower that was so financially weak.
As a result of our audit, in May 1998, Cal-Mortgage implemented a new process for reviewing and approving requests for earthquake insurance. We did not have the opportunity to evaluate this process since Cal-Mortgage did not inform us of it until September 1998. Based on our cursory review, this new process appears to contain most of the appropriate elements for deciding whether to waive earthquake insurance. However, we are still concerned that Cal-Mortgage continues to consider possible FEMA funds as one of the criteria in its decision.

CAL-MORTGAGE HAS NOT CONSISTENTLY REQUIRED APPLICANTS TO ASSURE THAT THEY MEET THE COMMUNITY SERVICE OBLIGATION

Cal-Mortgage does not consistently require an applicant to demonstrate that it will make its health facilities available to the entire community served. To qualify for loan insurance, the laws governing Cal-Mortgage require the applicant to provide reasonable assurance that it will make the services of the health facility available to all persons residing or employed in the area served by the facility. The intent of this requirement is to ensure that the facilities, which will be supported by a state program, treat Medi-Cal and Medicare patients in a proportion that reflects the communities they serve. For instance, if an applicant is located in a low-income neighborhood where 75 percent of the residents are on Medi-Cal and Medicare, then approximately 75 percent of its patients should also be Medi-Cal and Medicare patients. The law also requires the applicant to provide ongoing assurance by submitting an annual report of its compliance with this requirement that includes the total patients served, total Medi-Cal and Medicare patients served, and the dollar value of services provided to each type of patient. By not requiring applicants to comply with such conditions, Cal-Mortgage cannot assure that their facilities are serving the population as required by state statute.

In our sample of nine applicants, Cal-Mortgage did not ensure that three applicants complied with the requirement. Upon our inquiry, the project officer for one stated that she did not request this assurance from the applicant. In the second instance, the project officer felt that the applicant had substantiated the requirement by submitting a list of services it provided to the community, such as free annual influenza shots and

The law requires applicants to treat Medi-Cal and Medicare patients in a proportion reflecting the communities they serve.
HIV screenings. The list also mentioned that the applicant contracted, or was negotiating to contract, for Medi-Cal managed care. However, this list did not substantiate that the applicant had actually served Medi-Cal recipients nor did it include statistical information to demonstrate that the applicant was making its facility available to all persons in the area served. Finally, for a third applicant, the project officer contends that the applicant does serve all people in its community because it receives a mix of federal, state, and county funding. However, the law still requires the applicant to demonstrate that it meets the community service obligation.

After we broached the issue, Cal-Mortgage updated its standard loan insurance application in July 1998 to include the sections of the law that the applicant must follow as they pertain to community service requirements. Unfortunately, the new application instructions merely ask the applicant to describe the community services it intends to provide, which is not the same as demonstrating compliance by including statistics. As a result, Cal-Mortgage still cannot assure that applicants serve all persons residing or employed in the area served by the health facility as the law requires.

CAL-MORTGAGE INSURES SOME LOANS TO PROVIDE WORKING CAPITAL FUNDS FOR BORROWERS IN DEFAULT

Although not specifically allowed in the laws governing the program, Cal-Mortgage occasionally insures loans for borrowers that are in default and not paying on their current debt. These “working capital” loans provide a borrower cash that it can use for any purpose. The deputy director of Cal-Mortgage believes that insuring working capital loans for troubled borrowers may allow them to resume payment on their original debt.

Cal-Mortgage has not fully achieved the desired results with this practice. We noted two instances where the borrowers receiving such a loan have not been able to resolve their financial difficulties. For example, Cal-Mortgage was unsuccessful when it insured a $1.5 million working capital loan to the bankruptcy receiver for Los Medanos. The receiver was unable to take Los Medanos out of bankruptcy, nor was it able to repay the loan, and Cal-Mortgage ultimately had to pay $1.5 million to the lender. In another instance, Cal-Mortgage insured a working capital line of credit for $2 million to a borrower that is...
experiencing severe financial difficulties. Although this borrower is still in business and, as of July 1998, had repaid almost all of the $2 million working capital loan, it had not resumed payment on its debt of $13.6 million that Cal-Mortgage insured. In September 1998, the borrower made its full debt-service payment, but has not repaid Cal-Mortgage the $1.3 million it owes for previous missed debt-service payments. Cal-Mortgage is working with the borrower to identify a solution to its financial problems.

Similarly, Cal-Mortgage insured a $4 million working capital loan to Triad. This loan helped stabilize the corporation, which was able to repay the $4 million loan. Triad has also agreed to repay some of the costs Cal-Mortgage incurred as a result of the default; however, it will not be able to resume full payment on its original debt of $317.2 million. (Triad is discussed in more detail in Chapter 2.)

CONCLUSION

The application process that Cal-Mortgage uses is not effective in screening out applicants that are financially unstable. Moreover, Cal-Mortgage has neither established benchmarks for assessing an applicant’s financial viability nor a maximum level of risk it is willing to accept when insuring an applicant. As a result, Cal-Mortgage clients have defaulted on debt that it has insured, and may have more defaults in the future. Furthermore, its policy of waiving the requirement for earthquake insurance unnecessarily increases its risk. Finally, Cal-Mortgage has been relatively unsuccessful when insuring working capital loans for borrowers that have defaulted on their debt.

RECOMMENDATIONS

Cal-Mortgage should develop a more rigorous process to determine the financial viability of applicants for loan insurance. Specifically, Cal-Mortgage should take the following steps:

- Establish guidelines and perform a more in-depth review of applicants’ financial viability to better assess their ability to repay debts.
• Request, review, and analyze both the management letters and their actions on the recommendations in the letters.

Although the law requires OSHPD to operate the Cal-Mortgage program at no cost to the State, the Legislature should consider changing the law to require that Cal-Mortgage develop a maximum level of insurance risk acceptable for loan insurance approval. The new law should ensure that Cal-Mortgage set the risk level to minimize the potential of loan defaults and the related default payments from the Health Facilities Construction Loan Insurance Fund, while still being able to accomplish its statutory mission.

Cal-Mortgage should define an acceptable maximum level of insurance risk that may use a system of ranking or weighting the risk of each applicant. It should also consider specific elements related to public benefit, location, affected population, and types of services rendered.

Cal-Mortgage should ensure that it fully implements its new process for earthquake insurance waivers. However, it should eliminate the possible availability of funds from the Federal Emergency Management Agency as a factor in this decision process.

Cal-Mortgage should also require applicants to demonstrate that the proportion of Medi-Cal and Medicare patients to the total number of patients they serve is equal to the proportion of Medi-Cal and Medicare patients in the community.

To minimize the risk of insuring working capital loans for troubled borrowers, Cal-Mortgage needs to establish the circumstances under which it will provide this insurance and the level of risk that it will accept.
CHAPTER 2

Cal-Mortgage’s Monitoring of Insured Borrowers Is Neither Thorough nor Consistent

CHAPTER SUMMARY

Weaknesses in monitoring its borrowers may result in Cal-Mortgage having little notice before these borrowers experience severe financial difficulties and default on their debts. These weaknesses include inconsistent methods Cal-Mortgage staff use to oversee borrowers, the lack of formal procedures for this oversight, and insufficient supervision by management. For example, Cal-Mortgage does not consistently require that borrowers submit information about their financial condition, nor does it consistently conduct timely or structured site visits with borrowers. Another factor that contributes to the weaknesses in Cal-Mortgage’s ability to monitor borrowers is that its portfolio database contains many errors that make it unreliable. Because it cannot rely on information in its database, Cal-Mortgage’s ability to monitor the portfolio and the financial condition of its borrowers is limited.

In addition, because Cal-Mortgage does not have a clear understanding of the conditions that require reporting problem borrowers to the Office of Statewide Health Planning and Development (OSHPD), which oversees the loan insurance program, the director of OSHPD may not be fully aware of the risks in Cal-Mortgage’s portfolio. Further, Cal-Mortgage’s own methods for evaluating risk in the portfolio are inadequate. Finally, although several borrowers defaulted in past years, Cal-Mortgage has failed to properly bill these borrowers for amounts owed and has failed to account for assets and liabilities related to those defaults.

CAL-MORTGAGE DOES NOT MONITOR BORROWERS RIGOROUSLY

Cal-Mortgage does not have a formal process to ensure that project officers adequately monitor borrowers. Instead, each project officer must develop a system to ensure that
borrowers submit the required information. However, these individual systems cannot consistently ensure that borrowers comply with the terms of the regulatory agreement. Further, project officers perform inadequate analyses of borrower financial statements because Cal-Mortgage does not provide any formal guidance regarding how the project officers should perform them. In addition, although project officers conduct some site visits, no procedures exist to explain what project officers should examine, and what they should report after conducting a site visit. Finally, Cal-Mortgage did not adequately monitor the Los Medanos bankruptcy receiver.

The regulatory agreement that borrowers sign as a condition of receiving loan insurance requires them to submit certain information to Cal-Mortgage, such as financial statements. Effective monitoring of borrowers’ financial status through the information required by the regulatory agreement is critical to identifying those having problems paying their debts. The lack of a formal system increases the risk that Cal-Mortgage will not be aware of problems early enough to assess the situation and help the borrower before it defaults. Further, since the borrowers Cal-Mortgage insures are not as financially stable as those that private corporations insure, we would expect Cal-Mortgage to have a stringent monitoring system to offset the increase in risk.

Project Officers Do Not Always Ensure That Borrowers Comply With Regulatory Agreements

Cal-Mortgage’s lack of procedures and inconsistent monitoring methods result in borrowers failing to submit required documentation on time, or in several cases, at all. Specifically, in a sample of 15 borrowers, we found that the project officers did not ensure the prompt submittal of information required under the regulatory agreement. In addition, project officers did not consistently address repeated violations of the regulatory agreement even when a borrower was in default.

As Figure 2 demonstrates, the borrowers’ files we reviewed had significant omissions of data. For instance, project officers did not ensure that 11 borrowers submitted quarterly financial

---

**Required Borrower Data**

- **Annual Audited Financial Statements**—Provides verified financial information about the borrower during the past fiscal year.
- **Quarterly Unaudited Financial Statements**—Provides ongoing financial information that can reflect changes in the borrower’s financial status during a given time period.
- **Annual And Quarterly Debt Service Coverage Ratio Certifications**—A calculation commonly used by the finance industry reflecting the borrower’s ability to pay its debts.
- **Annual Budget**—Provides data about future financial plans and allows comparison of expected revenues and expenditures to actual.
- **Annual Insurance Certification**—Indicates the borrower’s level of insurance and ensures that if a fire or other catastrophe damages a facility constructed with funds insured by Cal-Mortgage, the borrower could replace it.
statements. Specifically, 11 files lacked at least 4 of 12 quarterly financial statements; 4 did not contain any of the 12 quarterly financial statements. Further, 6 files lacked at least one annual insurance certification, annual budget, and annual debt service coverage ratio (DSCR) certification. While it is reasonable that active borrower files may not include one or two documents, most of the files we examined did not contain a substantial number of these records.

In our review of borrowers’ files we noticed no difference in the project officers’ level of monitoring between defaulted and non-defaulted borrowers; the files lacked information regardless of the financial status of the borrower. For instance, one borrower we tested has been in default since August 1994, but the project officer’s files did not indicate that Cal-Mortgage consistently monitored the borrower’s activities. This is particularly disturbing since the borrower failed to make monthly payments to the bond trustee and also failed to submit quarterly payments.

**FIGURE 2**

**Documents That Cal-Mortgage Failed to Obtain From Borrowers**

<table>
<thead>
<tr>
<th>Required Documents</th>
<th>Did not submit required documents</th>
<th>Submitted required documents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Budgets*</td>
<td>11</td>
<td>2</td>
</tr>
<tr>
<td>Insurance Certifications</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Quarterly DSCR*</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Annual DSCR*</td>
<td>11</td>
<td>3</td>
</tr>
<tr>
<td>Quarterly Financial Statements</td>
<td>11</td>
<td>4</td>
</tr>
<tr>
<td>Annual Audited Financial Statements</td>
<td>1</td>
<td>14</td>
</tr>
<tr>
<td>Management Letters</td>
<td>13</td>
<td>2</td>
</tr>
</tbody>
</table>

* These documents were not contained in all 15 files we reviewed because some regulatory agreements did not require the borrowers to submit this information.
financial statements, annual budgets, or DSCR certifications to Cal-Mortgage. Furthermore, this borrower has depleted its debt-service reserve fund, potentially forcing Cal-Mortgage to make an upcoming payment to bondholders. Even though this borrower failed to meet so many conditions of the loan insurance, we saw very little correspondence or documented contact informing the borrower that it was in violation of the regulatory agreement. We find the relative absence of correspondence between the borrower and Cal-Mortgage to be troubling considering the extent of the borrower’s poor financial condition and the continued lack of compliance with its regulatory agreement.

The file of another borrower, also in default, did not contain 8 of 12 quarterly financial statements, one of three annual DSCR certifications, any quarterly DSCR certifications, or annual insurance certifications. This borrower is in default for not maintaining the required DSCR, but the file did not demonstrate any concerted efforts to track the DSCR since most of the documents necessary to monitor that ratio were not present in the file.

We noted similar weaknesses in the monitoring of Los Medanos. Specifically, we found only one of eleven quarterly DSCR certifications, one of four annual DSCR certifications, and no insurance certifications present in the Los Medanos files. Moreover, in one instance, Los Medanos submitted its annual audited financial statements more than 19 months late.

Further, we noted that only one of four annual audited financial statements submitted by Los Medanos contained a copy of an auditor’s management letter, which was marked “draft.” As explained in Chapter 1, typically, the auditor’s management letter accompanies the audited financial statements. Although Cal-Mortgage had all the audited financial statements, it did not have all the management letters. The private and governmental insurers we surveyed stated that they regularly request auditors’ management letters with the audited financial statements because a management letter could specify weaknesses in internal controls that may affect a borrower’s ability to repay its debts. For example, one of the many concerns the auditor expressed in the one draft management letter was that the number of patients using the hospital was declining while the number of employees was rising. This may indicate that Los Medanos overestimated its budgeted revenues or underestimated its expenses, resulting in a deficit. Because the management
letter listed a number of other similar issues that may have warned of Los Medanos’ potential default, reviewing them may have given the project officer advance notice that a problem existed within the accounting or budgetary systems, or within the management of Los Medanos.

**Inconsistent Methods Result in Ineffective Monitoring**

Because Cal-Mortgage lacks guidelines or procedures for project officers to follow, monitoring of borrowers’ compliance with the regulatory agreement is poor. Since Cal-Mortgage has no formal procedures, the project officers use their own methods to monitor borrowers. Unfortunately, their methods are neither consistent nor thorough enough to properly analyze a borrower’s financial condition. Specifically, four of the nine project officers we interviewed do not have a system to track the receipt of financial statements and DSCR certifications. Instead, they periodically review their files to determine whether borrowers submit the required information. Further, the other five project officers have “tickler” systems to track borrower’s submissions of financial statements and DSCR certifications; however, these systems are not adequate since they do not include automatically sending reminder letters to borrowers who submit late financial statements or other required documents.

In addition, project officers do not routinely request or track the receipt of other important information that would be useful in monitoring a borrower’s financial condition. For example, at least seven of nine project officers do not request or track the receipt of the auditor’s management letters, annual budgets, or insurance policy certifications. Therefore, by not consistently requesting or tracking receipt of such information, project officers limit their ability to appropriately monitor borrowers.

**Project Officers Inadequately Analyze Borrower Financial Statements**

Cal-Mortgage does not require project officers to thoroughly review borrowers’ financial statements or to prepare written analyses of the reviews. Lacking guidance, most of the project officers merely input the financial statement information into a summary spreadsheet that calculates financial ratios. The project officers then visually compare financial statement data and a handful of financial ratios with data and ratios of prior fiscal years. Unfortunately, Cal-Mortgage has neither developed its own nor adopted industry or median standards to compare with
these financial ratios. In contrast, one of the private insurers we surveyed compares its borrowers’ ratios to national, state, and internally generated median ratios to gain a perspective on how well one borrower is doing compared to others.

Further, in our review of Los Medanos, we found very little evidence of analyses of monthly, quarterly, or annual audited financial statements. Although Cal-Mortgage requested monthly financial statements, indicating concern over Los Medanos’ financial status, we found little evidence of analyses performed. Without using analytical techniques, it is unlikely that Cal-Mortgage was aware of the full extent of the difficulties at Los Medanos.

Lending institutions, such as banks, use financial statement analysis to determine a company’s financial position. The primary objective of financial statement analysis is to identify major changes or turning points in trends, amounts, or relationships and investigate the reasons underlying those changes. A turning point may provide an early warning of a significant change in the future success or failure of a business. Proper analysis of financial statements requires a much broader approach than the mere computation of a few ratios. Such analysis should include an organized approach of examining relevant data taken from the financial statements.

Because Cal-Mortgage relies exclusively on high-level trend analyses of ratios and financial statements, its ability to diagnose problem borrowers early enough to assist the borrower prior to default is limited. By not requiring its project officers to create written analyses of borrowers’ annual or quarterly financial statements, Cal-Mortgage also eliminates an important measure for supervisors to use in determining how completely project officers perform their work. As a result, Cal-Mortgage relies primarily on the judgment and experience of project officers.

**Essential Steps of Financial Analysis**

- Review the auditor’s opinion and management letter to assess the borrower’s financial condition and any major concerns identified during the auditor’s examination.
- Analyze significant accounting policies to gain a fundamental understanding of the borrower’s selection of acceptable accounting alternatives or those specific to a particular industry.
- Examine the overall financial statements, including the notes and supporting schedules, to identify trends and changes in sales, earnings, liabilities, asset structure, and cash flow.
- Apply analytical techniques, such as comparative statements, horizontal and vertical percentage analysis, and ratio analysis, to determine trends and relationships between specific amounts represented on the financial statements.
- Review important information not included in the financial statements, such as periodic reports filed with the Securities and Exchange Commission.
Project Officers Do Not Always Conduct Timely or Effective Site Visits

Cal-Mortgage’s project officers do not always conduct timely site visits, and they do not consistently consider key aspects of the borrower’s operation when they do visit a site. Specifically, when we began our audit, Cal-Mortgage did not have a formal policy for frequency of visits nor did it track site visits by project officer. As a result, Cal-Mortgage could not assure that project officers were visiting borrowers regularly. For example, during our testing we noted that project officers had not visited 44 percent of the borrowers Cal-Mortgage insures within the last 12 months. Also, even though one of the 15 borrowers we tested was in default, Cal-Mortgage still had not visited that borrower since March 1996. See Figure 3 regarding site visit frequency.

FIGURE 3

Elapsed Time Since Last Site Visit for Borrowers
(As of December 1997)

As Figure 3 demonstrates, Cal-Mortgage has not visited 40 borrowers for at least two years, 12 of which are in various stages of default, and it does not know when it last visited 33 borrowers, 9 of which are in various stages of default. A site-visit log and clear criteria regarding frequency of visits would give the supervisors the tools necessary to ensure that project officers visit borrowers as often as needed.
Management has failed to develop site visit procedures, so project officers design their own methods.

Although we recognize that the reasons for visiting borrowers may vary, Cal-Mortgage needs some structure to ensure that borrowers comply with the regulatory agreement. Site visits create goodwill between the borrower and Cal-Mortgage, which is essential to forming a good working relationship in the event the borrower experiences financial difficulties in the future. Site visits also allow project officers to gain a personal perspective on how borrowers conduct business. Thus, a structured format that requires the project officer to consider key aspects of a borrower's financial and business situation would make such visits more useful. These key aspects may include reviewing certain accounting records, touring building or construction sites, and discussing financial trends and budgets with management. The large private insurers review specific aspects of a borrower's business each time they perform a site visit. For example, one private insurer expects its staff to review each of the following items when visiting a hospital: the corporate structure, the management, the relationship between management and the medical staff, the financial performance and utilization trends, and competitors within the service area.

In February 1998, Cal-Mortgage implemented a policy to visit all borrowers at least every other year, and to visit borrowers that it deems risky on a more frequent basis. In addition, as of September 1998, Cal-Mortgage was considering a procedure to structure how its project officers conduct site visits.

Cal-Mortgage Did Not Adequately Monitor the Bankruptcy Receiver for the Los Medanos Health Care Corporation

Cal-Mortgage did not adequately monitor the court-appointed receiver for Los Medanos because it lacks appropriate policies and procedures governing this oversight. Without monitoring, Cal-Mortgage has no clear understanding of how a receiver is
managing the assets of the insured facility. Although it does not need receivers often, Cal-Mortgage should have policies and procedures in place to address the issue when necessary.

When Los Medanos went into bankruptcy, Cal-Mortgage petitioned the court to appoint a receiver to manage the hospital’s affairs and protect its financial interests. The court anticipated that oversight was necessary and required the receiver to report monthly to Cal-Mortgage on the financial condition of the hospital. In addition, the receiver was to furnish monthly statements of his expenses. However, Cal-Mortgage performed minimal monitoring of the financial activities of the receiver.

Specifically, Cal-Mortgage did not obtain monthly financial reports while the receiver was in control of Los Medanos. Cal-Mortgage also failed to monitor the use of a working capital loan it insured after the receiver took control. As a condition of insuring this loan, Cal-Mortgage precluded the receiver from using the funds to pay for expenses incurred before he took control of Los Medanos. However, unlike other loans that it insures, Cal-Mortgage did not require the receiver to submit periodic financial reports so that it could monitor the use of these funds. The receiver was unable to repay the $1.5 million working capital loan; therefore, Cal-Mortgage had to pay off the loan.

The deputy director stated that he and his staff received one- to two-hour verbal reports, either by telephone or in meetings, perhaps every week or every other week from the receiver. He contends that Cal-Mortgage provided sufficient oversight through these periodic discussions with the receiver. However, we question how well Cal-Mortgage could have monitored the receiver if it was not obtaining and reviewing the receiver’s required monthly financial reports.

**CAL-MORTGAGE FAILED TO IDENTIFY ALL BORROWERS WITH FINANCIAL PROBLEMS**

Cal-Mortgage failed to identify all of the borrowers in its portfolio that were having financial difficulty. In March 1998, we reviewed information contained in the portfolio database, and determined that Cal-Mortgage had identified 33 of 209 insured borrowers, or 16 percent, as having problems. However, after our initial review and inquiries about inconsistencies in the data,
Default Categories (in order of severity):

- **Fund Payment Default**—Indicates Cal-Mortgage had to make a payment from the Health Facilities Construction Loan Insurance Fund to the bondholders on behalf of the borrower.

- **Debt Service Reserve Fund (DSRF) Invaded Default**—Indicates Cal-Mortgage authorized the bond trustee to access the borrower’s DSRF fund to make a payment to bondholders.

- **Late Payment Default**—Indicates a borrower’s failure to make a timely payment to the bond trustee.

- **Debt Service Coverage Ratio (DSCR) Default**—Indicates a borrower’s failure to maintain the required DSCR.

- **Technical Default**—Indicates a borrower’s failure to submit required reports or assurances.

Cal-Mortgage updated the database and, as of July 1998, identified an additional 64 problem borrowers, raising the amount to 46 percent. Although some of the changes in the status of those borrowers may be due to timing differences, we believe that the majority of the changes are the result of Cal-Mortgage’s failure to identify problem borrowers. Weaknesses in Cal-Mortgage’s database limit its ability to assess the risk present in its portfolio of insured borrowers. Furthermore, without an accurate database, Cal-Mortgage cannot effectively address problem borrowers or report them to management.

We noted that Cal-Mortgage identified borrowers with certain types of problems more consistently than others. For example, as Figure 4 shows, Cal-Mortgage identified a significant portion of the borrowers that defaulted either because the bond trustee had to make a payment from the borrower’s reserve account or Cal-Mortgage had to make a payment to bondholders on behalf

-------

**FIGURE 4**

Change in the Number of Defaults Identified by Cal-Mortgage Before and After Our Review

<table>
<thead>
<tr>
<th>Type of Default</th>
<th>Before the bureau’s review</th>
<th>After the bureau’s review</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund Payment (most severe)</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>DSRF Invaded</td>
<td>2</td>
<td>15</td>
</tr>
<tr>
<td>Late Payment</td>
<td>2</td>
<td>11</td>
</tr>
<tr>
<td>DSCR</td>
<td>8</td>
<td>43</td>
</tr>
<tr>
<td>Technical (least severe)</td>
<td>5</td>
<td>23</td>
</tr>
</tbody>
</table>

Before the bureau’s review  After the bureau’s review
of the borrower. Although we acknowledge that these two categories of default are the most serious threats to Cal-Mortgage, the borrowers in other default categories also are a significant threat, and Cal-Mortgage should have identified them.

Cal-Mortgage’s Unreliable Portfolio Database Hampers Identifying Problem Borrowers

We found numerous errors in Cal-Mortgage’s portfolio database that resulted from project officers not consistently updating the system and failing to understand the data fields. While reviewing the portfolio database, we obtained a report from Cal-Mortgage that contained key information about the borrowers listed in the database. We re-sorted the data and concentrated our review on borrowers that appeared to be in default but were not shown as such by Cal-Mortgage.

We found 59 errors within the database, including information that was incorrect, in conflict, or out-of-date. Specifically, we found 35 instances where the key information indicated that the borrower was in default yet the project officer had failed to identify it as a problem borrower in the database. We also found 9 instances where the database information, which is supposed to be current, was more than a year old and sometimes up to two-and-a-half years old. Since we concentrated only on the borrowers that appeared to be in default, it is reasonable to assume that the same type and number of errors could also be present in the rest of the database. If Cal-Mortgage cannot rely on the information in its database, its ability to monitor the portfolio and the financial condition of the borrowers becomes severely limited.

A weakness that contributes to inaccuracies in the database is project officers’ lack of a clear understanding of how to use the fields and what information to include. For example, we asked the project officers about apparent inconsistencies and errors in the database, such as why certain information was not current. In response to our inquiries we did not receive consistent answers. Some of the project officers said the information came from annual audited financial statements, while others told us that the information came from quarterly unaudited financial statements.

Database errors may also be the result of Cal-Mortgage’s failure to create an operations and procedure manual for its portfolio database. Project officers could use the procedure manual as a
CALIFORNIA STATE AUDITOR

resource when they do not understand how or when to complete a task within the database. A procedure manual would also help answer any questions regarding inconsistencies between project officers.

CAL-MORTGAGE USES INADEQUATE METHODS TO EVALUATE PORTFOLIO RISK

Before 1998, Cal-Mortgage did not effectively use its system for determining the risk of default by its borrowers, but recently it began regularly evaluating and assessing the risk present in its portfolio. Cal-Mortgage developed its previous system of assessing risk shortly after the Triad Healthcare’s default in 1993. Because it was concerned about the risk present in the portfolio, management placed a moratorium on new loans from September 1993 to May 1994, and assessed the risk of all its borrowers. After Cal-Mortgage lifted the moratorium in 1994, only one of its project officers continued to use the risk rating system; consequently, we questioned its usefulness in assessing the risk of all the borrowers in the portfolio.

During the course of our audit, in an apparent attempt to respond to our concerns, Cal-Mortgage created a new risk rating system to work with its portfolio database. The new system includes descriptions of the criteria for each of the different categories of risk. Generally, the project officers apply the criteria to each of their borrowers and assign a risk rating, which they then enter into the database.

Although this system is an improvement, it does not have clear enough descriptions of the risk categories to ensure that project officers consistently assign the proper risk rating to borrowers. For example, some of the descriptions include vague or undefined terms, such as “cash is low” or “cash is inappropriately low.” Cal-Mortgage should require in the description an explanation of how the project officers determine what is “inappropriately low.” For instance, the project officer could use a percentage of funds necessary to do business, a specific cash balance, or a combination of the two to determine what is “inappropriately low.” Also, the descriptions do not include important aspects of risk, such as net losses or operating losses. The lack of specific criteria to assess risk limits Cal-Mortgage’s ability to appropriately evaluate the risk present in its portfolio.
CALIFORNIA STATE AUDITOR

CAL-MORTGAGE CAN IMPROVE FINANCIAL ANALYSIS WITH ITS NEW SOFTWARE

Cal-Mortgage recently purchased credit analysis software that can help its staff thoroughly and consistently analyze financial statements to determine a borrower’s financial position. This software creates analysis reports of financial statements, financial ratios and trends, and compares similar entities within a particular industry. It also describes the strengths and weaknesses of the company, and suggests areas that need further investigation. A public accounting firm created this software to allow financial institutions to thoroughly evaluate borrowers’ financial statements.

If used properly, this software can assist Cal-Mortgage in monitoring its borrowers. However, Cal-Mortgage must properly implement the system and train its employees to ensure that they maximize its usefulness. As of August 1998, Cal-Mortgage implemented two stages of a three-stage training plan. In the first stage, each project officer received a copy of the manufacturer’s operations and training manual. Two staff members experienced with the software conducted the second stage, which included hands-on training for the other staff members. The third stage will entail assessing project officers’ abilities to determine whether additional training from the manufacturer is necessary.

OSHPD MANAGEMENT MAY NOT BE FULLY AWARE OF CAL-MORTGAGE’S PORTFOLIO RISK

Cal-Mortgage does not consistently report all defaults to the management of the Office of Statewide Health Planning and Development (OSHPD). As a result, OSHPD may not be fully aware of the current risk in the Cal-Mortgage portfolio of borrowers. Although Cal-Mortgage submits a monthly report that includes problem projects to the director of the OSHPD, project officers have no benchmarks or standard criteria for determining what types of problems warrant reporting a financially troubled borrower.

The deputy director stated that Cal-Mortgage staff have instructions to report borrowers with financial or other problems, as well as to report other significant events, such as payments from the fund and transfers from the DSRF for payments to bondholders. However, when we asked the project officers what they understood to be reasons for Cal-Mortgage to report a borrower
to OSHPD, their perspectives differed. For example, one project officer told us that he would report a borrower if the borrower had a large loss or was depleting its DSRF. Another project officer stated that she would report a borrower whose DSCR was too low, who missed a payment to the trustee, or who had depleted its DSRF.

Because the project officers do not have a consistent method for identifying and reporting troubled borrowers, and since the deputy director primarily relies on the project officers, two projects with similarly high risks may not be consistently reported to the director of OSHPD, whose department oversees Cal-Mortgage. As a result, the director may not be fully aware of the portfolio’s overall risk or the specific conditions of borrowers facing financial crisis. Since Cal-Mortgage is a division of OSHPD, the director should be aware of any condition that may cause his department to pay on behalf of a borrower—or ultimately, that causes the State to pay on the behalf of OSHPD.

**CAL-MORTGAGE DOES NOT BILL DEFAULTED BORROWERS OR PROPERLY ACCOUNT FOR THE DEFAULTS ON ITS FINANCIAL STATEMENTS**

Although several borrowers have defaulted on their insured debt, Cal-Mortgage does not bill or properly account for these defaults. When a borrower is unable to make payment, Cal-Mortgage, as the insurer of the debt, is legally required to make the payment. As noted previously, all borrowers sign a regulatory agreement stating that they are responsible for repaying Cal-Mortgage if they default on their insured debt. Under this agreement, Cal-Mortgage is allowed to charge 10 percent annual interest until the borrower repays the amount owed.

Since 1992, seven borrowers have defaulted on debt, causing Cal-Mortgage to make payments from its Health Facilities Construction Loan Insurance Fund (fund). Only one of the borrowers, Lytton Gardens Health Care Center, has been able to resume payment on its debt, but it has not repaid the payments Cal-Mortgage covered. Another borrower, Villa View Community Hospital, was able to repay part of its default but missed several debt-service payments totaling $1.3 million. The remaining five borrowers have not been able to fully repay the amounts they owe. Table 2 shows the amount of defaulted bonds and their insurance payments.
These seven defaults have cost Cal-Mortgage $52.7 million through May 1998 and have been a significant drain on the fund. However, no process exists for billing these borrowers to remind them of the amounts owed. In two instances, this issue is moot because in one case, the borrower is no longer in existence and in the other, Cal-Mortgage does not intend to pursue collection because it foreclosed on the borrower’s property. In addition, Cal-Mortgage settled with Triad Healthcare and other parties. Thus, Cal-Mortgage will receive a partial repayment on the amount it has already paid and its future payments on the default. The remaining four borrowers still owe Cal-Mortgage, yet it has not billed them. Reminding borrowers that they still owe the debt is a good business practice and continues to establish that the debt is legally owed.

**TABLE 2**

Borrowers That Have Defaulted on Debt Cal-Mortgage Insured

<table>
<thead>
<tr>
<th>Borrower (County)</th>
<th>Date Insured</th>
<th>Current Status of the Borrower</th>
<th>Principal Outstanding to Bondholders</th>
<th>Total Cal-Mortgage Payments Through May 1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Triad Healthcare Corporation (Los Angeles)</td>
<td>9-2-92</td>
<td>Reorganized and out of bankruptcy</td>
<td>$182,320,000</td>
<td>$35,162,000</td>
</tr>
<tr>
<td>Los Medanos Health Care Corporation (Contra Costa)</td>
<td>4-5-90</td>
<td>In bankruptcy; facility is now leased by Contra Costa county</td>
<td>0</td>
<td>9,162,000</td>
</tr>
<tr>
<td>Community Adult Care Centers of America (Los Angeles)</td>
<td>12-14-90</td>
<td>No longer in existence</td>
<td>0</td>
<td>4,585,000</td>
</tr>
<tr>
<td>Health Care Delivery Services (Los Angeles)</td>
<td>9-30-92</td>
<td>Cal-Mortgage foreclosed on its property and will not pursue further collection</td>
<td>9,455,000</td>
<td>1,848,000</td>
</tr>
<tr>
<td>Villa View Community Hospital (San Diego)</td>
<td>9-17-91</td>
<td>In operation, but missed several debt-service payments</td>
<td>13,625,000</td>
<td>1,308,000</td>
</tr>
<tr>
<td>Lytton Gardens Health Care Center (Santa Clara)</td>
<td>12-30-86</td>
<td>In operation and making debt-service payments</td>
<td>13,015,000</td>
<td>409,000</td>
</tr>
<tr>
<td>The Third Floor (Fresno)</td>
<td>10-29-91</td>
<td>In operation and making partial debt-service payments</td>
<td>3,210,000</td>
<td>226,000</td>
</tr>
<tr>
<td>Total Cal-Mortgage Payments</td>
<td></td>
<td></td>
<td></td>
<td>$52,700,000</td>
</tr>
</tbody>
</table>
Furthermore, Cal-Mortgage is not tracking the interest owed on these defaults, even though the regulatory agreement allows it to charge 10 percent annually. The amount of interest can be significant, especially given the dollar amounts involved. For instance, when Villa View Community Hospital defaulted on its bonds, Cal-Mortgage made debt-service payments of approximately $1.3 million. In the 12 months since Cal-Mortgage began making payments, the interest on this amount has grown to $110,000.

Although the likelihood of full collection of the amounts defaulted borrowers owe, let alone the interest on these amounts, may be remote, if Cal-Mortgage does not track or bill for the interest, it neither reminds the borrower of the debt owed nor gives an accurate record of the amount due. Without a complete record, Cal-Mortgage may believe that it received full payment on a debt when in reality it only recovered the principal owed. Cal-Mortgage is currently developing procedures to bill some of the defaulted borrowers.

**THE FINANCIAL STATEMENTS DO NOT INCLUDE ALL DEFAULT ASSETS AND LIABILITIES**

Another concern we have is that the financial statements of the Health Facilities Construction Loan Insurance Fund (fund) do not reflect all activity for these defaults. The fund is one of many the State uses to account for activities of state departments and programs. State laws and regulations require each department to prepare annual financial statements for each fund and submit them to the State Controller’s Office for inclusion in the State’s annual financial reports. However, since the fund’s financial statements do not include the financial information of borrowers that default on Cal-Mortgage insurance, they do not accurately reflect all of the fund’s financial activities.

As noted above, these defaults have resulted in borrowers owing Cal-Mortgage for payments it has made under the insurance. Since the borrowers generally have not repaid these amounts, the fund’s financial statements should show that four of the five borrowers still in existence owe Cal-Mortgage approximately $11.1 million, along with interest, for defaults. However, the fund’s financial statements for fiscal year 1997-98 do not include any of the amounts defaulted borrowers owe Cal-Mortgage.
In addition, the settlement for Triad Healthcare has resulted in Cal-Mortgage being primarily responsible for repayment of bonds with principal and interest totaling $317.2 million over the next 24 years. In this settlement, Cal-Mortgage initiated a refinancing of the original debt and insured the new debt. The refinancing lowered the annual interest on the bonds and saved approximately $8.7 million on the cost of the original bond issue. Although Triad (now known as Sherman Oaks Health System) may pay Cal-Mortgage up to $72.5 million, Cal-Mortgage is responsible for paying at least $244.7 million over the 24 years these bonds are outstanding. Since Cal-Mortgage knows the amount it will pay and it must pay this amount under the insurance agreement, the fund’s financial statements should reflect a liability of $244.7 million.

CONCLUSION

Cal-Mortgage’s monitoring of insured borrowers is not sufficient to ensure that it has early warning of problem borrowers before the problems become serious. Further, Cal-Mortgage’s portfolio database is not reliable enough to produce accurate reports for management to appropriately assess the risk in the portfolio. Currently, Cal-Mortgage cannot accurately assess the risk for borrowers either individually or collectively. Also, OSHPD’s executive management may not be fully aware of the risk in the insurer’s portfolio because Cal-Mortgage has not established benchmarks or standard criteria for reporting troubled borrowers to management. Finally, Cal-Mortgage does not bill or properly account for the assets and liabilities connected with defaulted loans.

RECOMMENDATIONS

To ensure that it consistently monitors borrowers it insures and is aware of borrowers’ financial difficulties before it has to take over payments of insured debts, Cal-Mortgage should follow these procedures to guide project officers in their monitoring efforts:

• Create a system of tracking compliance with various requirements of the regulatory agreement that includes automatically contacting or sending letters to borrowers that are late in submitting the required information.
• Create a standard process of thoroughly reviewing financial statements and utilization trends. As part of this review, Cal-Mortgage should develop internal standards for ratio analysis, use industry standards, and make comparisons with other borrowers.

• Develop a system of formal review by supervisors to ensure consistent monitoring by project officers.

• Continue with its training on the new financial software and develop procedures regarding the proper use of the software.

• Develop procedures to provide timely and structured site visits of insured borrowers.

• Develop policies and procedures to properly monitor bankruptcy receivers appointed by the court.

Cal-Mortgage should periodically review the management reports from its portfolio database to ensure the accuracy and completeness of information and to ensure that project officers are appropriately maintaining the database.

To ensure that management receives consistent reports on the borrower portfolio, Cal-Mortgage should develop benchmarks or standard criteria for bringing a borrower’s financial problems to the attention of OSHPD.

Cal-Mortgage should regularly bill defaulted borrowers for the amounts it pays on their behalf, plus calculate interest on these amounts.

Cal-Mortgage should ensure that the financial statements of the Health Facilities Construction Loan Insurance Fund include all assets and liabilities related to the defaults.
We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

[Signature]

KURT R. SJoberg
State Auditor

Date: October 14, 1998

Staff: Elaine M. Howle, CPA, Audit Principal
       John Baier, CPA
       Phillip Burkholder, CPA
       Kathryn Lozano
Blank page inserted for reproduction purposes only.
Agency’s response to the report provided as text only:

October 2, 1998

Mr. Kurt R. Sjoberg  
State Auditor  
Bureau of State Audits  
555 Capitol Mall, Suite 300  
Sacramento, California 95814

Re: Audit of the Cal-Mortgage Loan Insurance Program

Dear Mr. Sjoberg:

Thank you for the opportunity to comment on the preliminary Audit Report concerning the Cal-Mortgage Loan Insurance Program administered by the Office of Statewide Health Planning and Development. We appreciate the conscientious work of your audit team in their review of the Cal-Mortgage Program, and their helpful suggestions.

Some comments might be useful, at the outset, to place the Audit Report in context for the general reader. The Cal-Mortgage Loan Insurance Program was created by the Legislature to assist health facility construction throughout California, without cost to the taxpayer. The program has been operating successfully for 30 years, insuring over $4 billion in loans to more than 400 health care facilities, many in rural and underserved areas of the State. Cal-Mortgage is entirely self-supporting from its insurance premiums and related incomes; it has amassed reserves, through prudent management, of $130 million. In all 30 years, only six defaults have occurred that required payment of the insured loan from Cal-Mortgage funds. This is quite a remarkable record.

Contrary to some of the characterizations in the audit findings, the historical record would seem to indicate exceptionally effective management of the public-private partnership envisioned by the Legislature when it created Cal-Mortgage to meet community need for health facilities: “The purpose of this chapter is to provide, without cost to the state, an insurance program for health facility construction, improvement, and expansion loans in order to stimulate the flow of private capital into health facilities construction, improvement, and expansion and in order to rationally meet the need for new, expanded and modernized public and nonprofit health facilities necessary to protect the health of all the people of this state. The provisions of this chapter are to be liberally construed to achieve this purpose.”

Of the six claims, the most significant by far, in size of loss, resulted from guarantee of a loan to Triad Healthcare, in 1990, in a previous Administration. The Triad case was unique, involving misrepresentations, false claims and conflict of interest issues for which the State is seeking remedy through legal action. Substantial recovery appears likely. The Triad experience led to a number of measures to strengthen Cal Mortgage and protect against such a problem ever again occurring. (They are summarized in the introductory section of our response to your audit report.)

*California State Auditor’s comments on this response begin on page R-15.
Another of the six claims was for Los Medanos Hospital (Your audit report was, as I understand it, requested by Assemblyman Torlakson of Contra Costa County, in which Los Medanos is located). Again this loan was insured in 1990, during a previous administration, and I am not aware of all the considerations which led to approval of the application. However, I would note that Los Medanos is a district hospital, governed by an elected board. Many of the issues described in the audit report, and many of the factors which led to its bankruptcy, resulted from actions taken by the duly elected board of directors for the hospital. The Cal-Mortgage Program has no direct authority over such an elected board, representing the community which it serves.

The Audit Report comments on Cal-Mortgage oversight of the receiver assigned to handle the affairs of Los Medanos while in bankruptcy. I would observe that the receiver was an officer of the court, not an agent of our Office. While perhaps the Office might have done more to monitor his activities (as suggested in the report), it is important to understand that the receiver was directly responsible first to a Superior Court Judge, and then to the Federal Bankruptcy Court. Cal-Mortgage was only one of many creditors seeking funds from the bankrupt Los Medanos estate.

It now appears that the issues surrounding Los Medanos are coming to a successful conclusion through the bankruptcy process. Los Medanos and Cal-Mortgage have reached a mutually agreed upon settlement which will allow the hospital to be rented by Contra Costa County for use as an outpatient clinic and urgent care center. Assemblyman Torlakson’s helpful role is acknowledged.

The other four claims, also dating to an earlier administration, will result in relatively minor losses to the Cal-Mortgage fund. Frankly, were it not for the Triad case, Cal-Mortgage would have an altogether remarkable record of insurance underwriting.

To be sure, Cal-Mortgage insures somewhat “riskier” investments than those a bank or commercial lender would find preferable. The statutory mission of the program is to enable smaller health care facilities in undeserved areas to have access to capital for construction and remodeling – in order to improve access to healthcare throughout California. Nevertheless, I must emphasize that Office staff conducts a critical financial review of all applicants.

In addition to staff review, all applications are carefully reviewed, in a public forum, at noticed meetings of our Advisory Loan Committee. The members of this pro-bono citizen advisory body are recognized experts in the fields of health facility financing, construction, and operations management. They provide independent, objective evaluation of the advisability of any particular application for loan insurance. In addition to careful consideration of the numbers that drive financial analysis, the Committee and staff are sensitive to issues of need for health services in the community. Banks and other commercial lenders might not give such careful consideration to the question of community need when they make their financial decisions, but that is the whole purpose of Cal-Mortgage. In the final analysis, one must apply experience and sound judgement to weigh all the financial data, the facility’s management capacity and the community’s healthcare needs.
Finally, I would caution readers of the Audit Report to note that the term “default” is used in the report in a somewhat imprecise way. Use of the term “default” and its various gradations of severity is not fully explained until the very end of the report. “Default” is a word charged with very significant meaning to most people in our society – it means, “you’re not paying your debts”. However, within the context of the Cal-Mortgage program, the term also has many technical definitions – for example, a report being submitted late is considered a “default” even though all debt service payments are being made. Insured projects may, from time to time, experience such technical defaults. However, as I have pointed out, in the 30 years of the program’s existence, there have only been six defaults, which resulted in claims made against the Cal-Mortgage insurance reserves.

In conclusion, let me observe that every program in state government can be improved - and should incorporate continuous quality improvement as a way of doing business. In that spirit, let me express appreciation for the constructive suggestions of your staff. With very few exceptions, we accept the recommendations offered in the Audit Report. In fact, Cal-Mortgage has already made considerable progress in implementing most of them, as described in the attached formal response.

Sincerely,

Signature of David Werdegar, MD, MPH

David Werdegar, MD, MPH
Director

Enclosures

cc: Sandra R. Smoley, RN
Secretary
Health and Welfare Agency
Introduction

Since 1991, the Office of Statewide Health Planning and Development (OSHPD) has implemented many improvements to the Cal-Mortgage Loan Insurance Program (Cal-Mortgage). These improvements were made, partly, in response to earlier significant problems with several projects. They included establishing clear lines of accountability and authority, focusing the program on areas of greatest community need for health care, standardizing the review of applications for loan insurance, enhancing coordination with other state and federal health care programs, and applying current information technologies to program administration. Specifically, the improvements implemented in the past 7 years include:

**Adopted Two Cal-Mortgage State Plans.** OSHPD published its first Cal-Mortgage State Plan in July 1992. This Plan set forth the priorities of the program and established new policy and procedural safeguards, several of which were focussed on preventing the kinds of problem projects which had occurred in the past. The Plan was updated in December 1995 to respond to changing priorities in the health care industry.

**Expanded the Application Package.** In 1995, the application package was expanded to include: (1) requiring the applicant’s property be appraised by a State Certified Appraiser, (2) requiring district hospitals to provide a first deed of trust on its property, and (3) having applicant’s properties surveyed by the Department of Toxic Substances Control. Other documents required in the application package included: audited financial statements for the prior three years and the latest available unaudited report; a description of how the project will meet health-care needs in its community; chart of the corporate structure with affiliates; licenses to operate; articles of incorporation; by-laws; facility master plan; financial feasibility study; grants, contracts, financial guarantees, and other information that support revenue forecasts; property appraisal; zoning approvals; environmental impact report; and security agreements for the benefit of OSHPD.
Sponsored Legislation to Strengthen the Program. At the suggestion of Standard and Poor’s, OSHPD sponsored Senate Bill 1705 in 1994. This bill required that applications be signed under penalty of perjury, and added a series of alternative default remedies available to OSHPD. In 1996, OSHPD sponsored Senate Bill 1922 to add additional improvements.

Restructured the Advisory Loan Insurance Committee. In 1995, Cal-Mortgage amended its regulations to increase advisory committee membership from seven to nine, so that additional experts could sit on the committee. The regulations were amended also to strengthen conflict of interest provisions.

Reorganization of Cal-Mortgage. In 1992, OSHPD implemented recommendations from the Department of Finance to reorganize Cal-Mortgage as a separate division, giving it its own Deputy Director, supervisors, and professional support staff.

Strengthened Communications with Other State and Federal Departments. In 1994, Cal-Mortgage commenced meeting quarterly with the Department of Health Services to improve communication, especially regarding healthcare reimbursement. Also in 1994, Cal-Mortgage entered into an agreement with the Department of Finance, the Controller’s Office and the State Treasurer to clarify how payments would be made from its Trust Fund in the event of future claims. That same year Cal-Mortgage entered into an agreement with the Department of Toxic Substances Control whereby DTSC would perform the environmental site assessment for each new applicant. Later Cal-Mortgage began meeting regularly with the Department of Alcohol and Drug Programs in order to review reimbursement and certification issues that affect applicants and borrowers. Communication linkages were also established with the Department of Social Services, the Rural Health Policy Council, the U.S. Public Health Service and other agencies to review issues of mutual concern relating to health care facilities.

Recovery on Claims. Cal-Mortgage has vigorously pursued recovery actions on the six loans that required payment from the Trust Fund. While certain legal actions are still pending, these recovery actions may result in substantial sums being returned to the program.

Computerization. Cal-Mortgage has implemented sophisticated information technology to assist with administration of the program. In 1996, Cal-Mortgage identified “Tracker” as an excellent method of monitoring and generating reports on the loans administered by the program. While this software is sufficiently developed to allow current use, it still requires continuing development and refinement. In 1996, Cal-Mortgage also determined that purchase of a financial statement analysis software program would be advantageous. In early 1998, Cal-Mortgage chose Crowe Chizek’s “Financial Analyst’s Management and Authoring System” (FAMAS) and began use
later in the year. In 1997, Cal-Mortgage ordered a XEROX document scanner (XEROX reported it was the first for State government in Sacramento), to assist in document control and management.

While Cal-Mortgage is proud of its accomplishments to improve administration of its program, we also appreciate recommendations made by the California State Auditor for further improvements of the program. Each recommendation listed in Chapters 1 and 2 of the State Auditor’s report is discussed below. Many of these recommendations have been fully or partially implemented.

I. Chapter 1 Recommendations

A. Develop a More Rigorous Process to Determine the Financial Viability of Applicants for Loan Insurance by doing the following:


As described earlier Cal-Mortgage has required that applicants provide annual audited financial statements and various other pertinent documents. From this information, staff conducts a credit analysis for each application.

The Cal-Mortgage portfolio necessarily includes loans that have a greater business risk than those made by private banks or insured by private loan insurance companies. This is especially true for loan guarantees to small community based non-profit health care providers and smaller rural hospitals. Nonetheless, OSHPD does take great care in making its decisions to insure the loans. Prior to insuring any loan, all applicants are critically reviewed by, and must demonstrate appropriate financial viability to, the Project Officer, the Project Officer’s Supervisor, the Deputy Director, OSHPD’s Advisory Loan Insurance Committee, and the Director of OSHPD.

In response to the State Auditor’s recommendation, Cal-Mortgage will:

· Establish written guidelines to organize the project officers’ review of the loan applications.

· Establish guidelines and provide continuing education in the use of FAMAS to maximize its benefits in assessing financial viability of applicants and ability to repay their debt.

· Include comparison of the financial performance of similar types of facilities for purposes of analysis.
2. **Request, Review, and Analyze Both the Management Letters and Applicants’ Actions on the Recommendations in the Letters.**

In response to this recommendation of the State Auditor, Cal-Mortgage amended its form Regulatory Agreement on April 27, 1998, to clarify that borrowers must provide to Cal-Mortgage any management letter submitted to the borrowers by an accountant in connection with each annual or interim audit of their financial statements. Additionally, Cal-Mortgage amended its Application Package to include a form letter requesting that the applicant’s auditor send copies of all management letters to Cal-Mortgage.

Cal-Mortgage Project Officers received initial training in April 1998 on the use of management letters and the applicant’s responses as part of their review process.

In response to the State Auditor’s recommendation, Cal-Mortgage has and will:

- Amend its form Application Package and form Regulatory Agreement to require that an applicant or borrower provide to Cal-Mortgage a copy of all corrective action letters it prepared in response to any auditors’s management letters it may have received.
- Provide continuing training for Cal-Mortgage Project Officers in the review and analysis of management letters and corrective action letters.

B. **Define an Acceptable Maximum Level of Insurance Risk that May Use a System of Ranking or Weighing the Risk of Each Applicant.**

Cal-Mortgage already considers many factors when assessing the risk it will accept, included statutory and regulatory requirements, management, assets, financial condition and community need. Cal-Mortgage normally requires that the total loans insured for the applicant be less than $40 million.

In response to the State Auditor’s recommendation, Cal-Mortgage will:

- Review guidelines used by private and government lenders and insurers to determine their applicability to Cal-Mortgage.
- Undertake to develop more explicit risk assessment criteria that may be applicable for the program.

C. **Ensure that Cal-Mortgage Fully Implements its New Process for Earthquake Insurance Waivers; and Eliminate the Possible Availability of Funds from Federal Emergency Management Agency as a Factor in this Decision Process.**
In developing its policy regarding earthquake insurance waivers over the last several years, OSHPD has been in consultation with the Office of Insurance and Risk Management of the Department of General Services, the Office of Emergency Services, the Department of Insurance, and insurance consultants. Those consultations included discussions concerning the recoveries available from Federal Emergency Management and Assistance Administration (FEMA). In response to those consultations, Cal-Mortgage amended its form Regulatory Agreement requiring the applicant confirm that it will provide essential governmental services, so that the borrower meets the requirements to be eligible for relief from FEMA. OSHPD understands that FEMA benefits are reduced by the amount of the borrower’s earthquake insurance. The 1989 Loma Prieta and January 1994 Northridge earthquakes damaged three Cal-Mortgage insured facilities; and each received significant benefits from FEMA.

Those discussions also noted that following the Loma Prieta and Northridge earthquakes, earthquake insurance generally was not commercially available and not economically practicable. Cal-Mortgage is reluctant to require that insured projects spend vital financial resources to purchase insurance which may be of no real value to them, nor provide any real value to Cal-Mortgage.

We believe the availability of funds from FEMA should continue to be a consideration in the decision process regarding earthquake insurance.

In response to the State Auditor’s recommendation, Cal-Mortgage will:

- Continue to consult with the above entities as Cal-Mortgage deals with the issues surrounding the requirements of earthquake insurance, including the availability of recoveries from FEMA, and under what circumstance it will require or waive earthquake insurance. Cal-Mortgage will implement its new process based on those consultations.

D. **Require Applicants to Demonstrate that the Proportion of Medi-Cal and Medicare Patients in the Total Number of Patients They Serve Is Equal to the Proportion of Medi-Cal and Medicare Patients in the Community.**

Cal-Mortgage has required that applicants demonstrate that they meet the “community service obligation” described in the Health Facility Construction Loan Insurance Law located at Health and Safety Code sections 129050 through 129085, which include the provisions to provide services to Medi-Cal and Medicare patients. To that end, Cal-Mortgage will continue to review relevant statistical reports submitted to the Healthcare Information and Health Policy and Planning Divisions of OSHPD. In response to concerns raised by the State Auditor, Cal-Mortgage amended its Application Instructions in February 1997 to clarify that each applicant is required to provide Cal-Mortgage with the following:

“A description of how this project will meet identified health care needs of the community or of an underserved population, including how the project will
provide culturally competent care. Include a list of what bilingual services, if any, are or will be offered at the facility.”

In response to the State Auditor’s recommendation, Cal-Mortgage will:

· Seek to obtain relevant statistical information concerning the applicant’s service to Medi-Cal and Medicare patients to determine the applicant’s compliance with its community service obligation.

E. Establish the Circumstances Under which OSHPD Will Provide Insurance for Working Capital Loans for Troubled Borrowers and the Level of Risk that OSHPD Will Accept.

OSHPD insured working capital loans for Triad Healthcare Corporation (Triad) in Sherman Oaks, Los Medanos Health Care Corporation (Los Medanos) in Pittsburg, and VillaView Community Hospital (VillaView) in San Diego. Each was for a very different purpose. Triad’s loan allowed it to exit bankruptcy. The Los Medanos loan paid salaries to allow enough time to assess whether it was economically feasible to keep Los Medanos open or not. VillaView’s loan has allowed VillaView to stay operational, to collect disproportionate share funds, and, ultimately, to enter into a letter of intent to sell.

These work-out loans were made, basically, either to maintain the business as a going concern or to preserve assets.

In response to the State Auditor’s recommendation, Cal-Mortgage will:

· Establish written guidelines concerning the circumstances under which OSHPD will provide such loans in the future.

II. Chapter 2 Recommendations

A. Develop Procedures to Guide Project Officers in Their Monitoring Efforts, Including the Following:

1. Create a System of Tracking Compliance with Various Requirements of the Regulatory Agreement that Includes Automatically Contacting or Sending Letters to Borrowers that are Late in Submitting the Required Information.

Cal-Mortgage has always been concerned that borrowers comply with all aspects of their Regulatory Agreement. While making their debt service payments is obviously the most important requirement, it also is important that borrowers supply the following documents: annual audited financial statements, including management letters and corrective action letters; quarterly unaudited financial statements; annual and quarterly debt service coverage ratio
certifications; annual budgets; and annual insurance certifications.

To assist borrowers in that compliance, Cal-Mortgage has provided borrowers with a list of the documents that they are to provide.

To monitor compliance, Cal-Mortgage in 1996 included new data fields in its Tracker computer program to show receipt of the required documents.

In response to the State Auditor's recommendation, Cal-Mortgage will:

- Continue to implement use of its new “Tracker” computer monitoring program.
- Add additional data fields to Tracker, as needed, to indicate when required documents have not been received.
- Request that the Tracker be programmed, if possible, to “automatically” generate letters to borrowers when documents have not been received when due.
- Design reports that can be generated periodically from Tracker and distributed to the Project Review Officers.

2. Create a Standard Process of Thoroughly Reviewing Financial Statements and Utilization Trends; and Develop Internal Standards for Ratio Analysis, Use Industry Standards, and Make Comparisons with Other Borrowers.

Cal-Mortgage has examined various processes for reviewing financial statements and utilization trends, and acquired FAMAS to assist project officers in these analyses. The Tracker program is also useful in this regard, especially for generating certain ratios for analysis. Use of these computer programs will enable staff better to develop internal standards in relation to industry standards and comparisons with other borrowers.

In response to the State Auditor’s recommendation, Cal-Mortgage will:

- Finish development of procedures by which project officers use FAMAS and Tracker to enhance their financial analyses so as to develop a standardized process for reviewing financial statements and utilization trends.

3. Develop a System of Formal Review by Supervisors to Ensure the Consistency of the Monitoring that Project Officers Perform.
In response to this recommendation, Cal-Mortgage will:

- Undertake to develop a uniform protocol by which supervisors review the performance of staff to ensure consistent monitoring of projects.

4. **Continue with Cal-Mortgage’s Training on the New Financial Software (FAMAS) and Develop Procedures Regarding the Proper Use of FAMAS.**

In response to the State Auditor’s recommendation, Cal-Mortgage will:

- Continue training staff on the proper use of FAMAS and develop appropriate procedures.

5. **Develop Procedures to Provide Timely and Structured Site Visits of Insured Borrowers.**

Cal-Mortgage has always acknowledged the value of site visits and staff generally have conducted site visits as necessary, based on the degree of problems a borrower may have. Recently Cal-Mortgage has adopted uniform procedures for periodic site visits to all projects, taking into account project status.

In response to the State Auditor’s recommendation, Cal-Mortgage will:

- Implement the uniform procedure for scheduling site visits.

- Develop a structured outline for use by staff when visiting project sites that has sufficient flexibility to meet varying needs and situations.

6. **Develop Policies and Procedures to Properly Monitor Bankruptcy Receivers Appointed by the Court.**

Since the start of the program 29 years ago only two receivers have been appointed in projects relating to Cal-Mortgage. One was appointed in the action of Cal-Mortgage against the Los Medanos Health Care Corporation; another in Southern California for a very limited, temporary purpose. Therefore, Cal-Mortgage has only limited experience with receivers. The use of receivers appears to be a rare occurrence.

Receivers are appointed by the courts and act as officers of the courts to protect the interest of all the parties. As such, the actions of receivers are controlled by the court, and not the parties in the litigation. The parties may intervene only through formal motion before the court.

In response to the State Auditor’s recommendation, Cal-Mortgage will:
· Ask the Attorney General, in any cases where a receiver is appointed, to request the court that the receiver report periodically to Cal-Mortgage on their activities.

B. **Periodically Review the Management Reports from Cal-Mortgage’s Portfolio Database (Tracker) to Ensure the Accuracy and Completeness of Information and to Ensure that Project Officers Are Appropriately Maintaining the Database.**

Cal-Mortgage has already initiated efforts to generate its Monthly Activity Report using the “Tracker” system.

In response to the State Auditor’s recommendation, Cal-Mortgage will:

- Once Tracker is capable of generating reports, supervisors will review them for timely entry of data.
- Supervisors will periodically “spot-check” the accuracy and completeness of information in the Tracker database.
- Continue staff training, as needed, on maintaining the database appropriately.

C. **Develop Benchmarks or Standard Criteria for Bringing a Borrower’s Financial Problems to the Attention of OSHPD.**

Since 1995, Cal-Mortgage has provided weekly e-mail reports to the Director’s Office on significant issues including potential payments from the Trust Fund or from a borrower’s debt service reserves fund. Cal-Mortgage also provides to the Director updates on the above information as well as information on loans that have financial or other problems or other events of significance, site visits, closing of new loans, termination of old loans, or more confidential information. A published “Monthly Activity Report” on the status of all borrowers reports all payments from the Trust Fund and debt service reserve fund expenditures (This report is publicly available).

Based on recommendations from the State Auditor’s staff, Cal-Mortgage recently implemented new procedures in a memo to staff entitled “Events to Report. The new procedures outline events to be reported and the appropriate individuals to whom the reports are to be sent.

In further response to the State Auditor’s recommendation, Cal-Mortgage will:

- Review the existing procedures with the Director to determine whether they
adequately keep OSHPD management informed, with special attention to borrower’s financial problems.

D. **Regularly Bill Defaulted Borrowers for the Amounts Cal-Mortgage Pays on Defaults and Calculate and Bill Interest on these Amounts.**

Based on recommendations from staff of the State Audit Bureau, Cal-Mortgage has commenced this process.

In further response to the State Auditor’s recommendation, Cal-Mortgage will:

- Complete the calculations of amounts due in all instances possible and provide the calculations to the Administration Division of OSHPD for billing.

E. **Ensure that the Financial Statements of the HFCLIF Include All Assets and Liabilities Related to the Defaults.**

In response to the State Auditor’s recommendation, Cal-Mortgage will:

- Provide the Administration Division a list of potential liabilities from the HFCLIF at a minimum, annually.
To provide clarity and perspective, we are commenting on the Office of Statewide Health Planning and Development’s (OSHPD) response to our audit report. The numbers correspond to the numbers we have placed in the response.

1. OSHPD’s numbers are incorrect. As shown on page 37 of our report, the Cal-Mortgage program has experienced seven defaults requiring payment from the Health Facilities Construction Loan Insurance Fund (fund). All seven have occurred since 1992.

2. The success of the Los Medanos default resolution is questionable considering that Cal-Mortgage will recover substantially less than the $10.7 million it paid for both the default and the receiver’s working capital loan. Specifically, in a proposed settlement agreement, approved by the bankruptcy court on August 20, 1998, Cal-Mortgage would receive up to approximately $4.4 million or $6.3 million less than the amounts it has paid on this default. Moreover, while Cal-Mortgage would receive the $4.4 million over the next 22 years, it would immediately loan $3 million to Los Medanos under the proposed settlement agreement.

3. We disagree. As stated on page 12 of our report, we found little evidence that Cal-Mortgage performed a critical review of applicants’ financial condition.

4. OSHPD exaggerates the value of the Advisory Loan Committee. The committee is advisory in that it can only recommend an applicant for approval by the director of OSHPD. In addition, during our audit, we noted that the committee only meets for one day up to six times a year to discuss potential applicants. Furthermore, based on our review of attendance records, the committee rarely has full attendance.
We disagree with OSHPD’s contention that we have misused the term “default.” We made a conscious effort to distinguish between the different types of default and believe that we have used the term in the appropriate manner in our report. Specifically, when referring to a default requiring payment from the fund, we use the term alone. Conversely, when referring to defaults not requiring payment, we use the phrase “various stages of default.” Moreover, we made this distinction despite the fact that Cal-Mortgage, in its regulatory agreement, does not distinguish between the types of defaults and simply uses the term “default” to describe any violation of the agreement.

OSHPD’s reluctance to require borrowers to purchase earthquake insurance places too much reliance on assistance from the federal government, and ultimately, the taxpayers, after a natural disaster. As we state on page 18 of our report, it is unwise for OSHPD to allow borrowers to rely solely upon the federal government for assistance after a natural disaster, in lieu of obtaining earthquake insurance. Moreover, Cal-Mortgage should already know that receiving federal disaster funds is a lengthy process. For example, as we found in a previous report, one of Cal-Mortgage’s insured borrowers, Watsonville Community Hospital, was damaged during the Loma Prieta earthquake in 1989 and it took more than four years to approve the federal disaster funds.

Contrary to OSHPD’s assertion that it has provided the list of required documents to all borrowers, we found evidence that Cal-Mortgage only began providing the list to all new borrowers beginning in December 1997. Before this date, according to the project officers, most only provided the list to those borrowers who specifically requested this information.

This statement is misleading. Although Cal-Mortgage is now using several new data fields in its portfolio database, it did not activate these data fields until early 1998.

OSHPD is distorting the capabilities of the portfolio database. The database collects information on the status of insured borrowers, such as general information on the borrower; debt service reserve fund balance; receipt dates of financial reports; dates of Cal-Mortgage insurance; contact persons for the borrower and financing team; facility description; premium and fee
payments; loan description, balance, and payments; and project officer notes. Thus, the portfolio database can generate few, if any, relevant financial or utilization ratios.

OSHPD is obscuring the facts surrounding its poor monitoring of the Los Medanos receiver. The court order appointing the receiver for Los Medanos already required the receiver to submit monthly financial statements and expense reports to Cal-Mortgage, yet as stated on page 31, Cal-Mortgage failed to obtain and review these reports. Cal-Mortgage could have used these reports as an additional element in its monitoring of the receiver and should do so in the future.
Blank page inserted for reproduction purposes only.