

City of Detroit

OFFICE OF THE AUDITOR GENERAL



Audit of the Casino Development Fund National Regional Retail Restaurant Chain and Non-Affiliated Retail/Restaurant Loan Projects October 2019



Office of the Auditor General


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MEMORANDUM

DATE: December 17, 2019

TO: Honorable City Council
Honorable Mayor Mike Duggan

FROM: Mark W. Lockridge, CPA 
Auditor General

RE: **THE CASINO DEVELOPMENT FUND (CDF) AUDIT - National Regional Retail Restaurant Chain Loan and Non-Affiliated Retail/Restaurant Loan Projects**

CC: Glen Long, COO, DEGC/EDC
Stephanie Washington, Esq., City Council Liaison
David Whitaker, Director, Legislative Policy Division
Casino Representatives

Attached for your review is our report on the Audit of the Casino Development Fund National Regional Retail Restaurant Chain Loan and Non-Affiliated Retail/Restaurant Loan projects. This report contains our audit purpose, scope, objectives, methodology and conclusions; background; our audit findings and recommendations; and the response from the Economic Development Corporation.

Responsibility for the installation and maintenance of a system of internal control that minimizes errors and provides reasonable safeguards rests entirely with the Economic Development Corporation.

Copies of all of the Office of the Auditor General reports can be found on our website at <http://www.detroitmi.gov/Government/Office of the Auditor General>.

**Audit of the Casino Development Fund
National Regional Retail Restaurant Chain and Non-Affiliated Retail/Restaurant
Loan Projects**

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AUDIT PURPOSE, SCOPE, OBJECTIVES, METHODOLOGY AND CONCLUSIONS

AUDIT PURPOSE

The audit of the Casino Development Fund – National Regional Retail Restaurant Chain Loan and Non-Affiliated Retail/Restaurant Loan projects were performed in accordance with the Office of the Auditor General's (OAG) charter mandate as noted in Section 7.5-105(1) which states:

Make audits of the financial transactions, performance and operations of City agencies based on an annual risk-based audit plan prepared by the Auditor General, or as otherwise directed by City Council and report findings and recommendations to City Council and the Mayor.

City Council requested that the Office of the Auditor General (OAG) perform an audit of the Casino Development Fund in relation to a Legislative Policy Division report dated October 11, 2016.

AUDIT SCOPE

The scope of this audit was an independent review and assessment of the National Regional Retail Restaurant Chain Loan Program. Our audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States, except for the completion of an external peer review of the Office of the Auditor General within the last three years.

AUDIT OBJECTIVES

The overall audit objectives were:

- Review financial reports and audited financial statements from each sub-grantee to ensure the Casino Development Funds are properly accounted for and spent in accordance with program objectives and guidelines as stated in the casino agreements, Economic Development Corporation (EDC)/City of Detroit and EDC/sub-grantee funding agreements.
- Conduct a performance audit of each sub-grantee to ensure the Casino Development Funds are effectively and efficiently received and spent in accordance with best practices and in support of program objectives and guidelines.

AUDIT METHODOLOGY

To accomplish our audit objectives, our audit work included:

- Reviewing the Casino Development Agreements, project funding agreements, City Charter, the project budget reports, and organization charts.
- Gathering policies and procedures of core operations and similar data.
- Conducting an audit-planning meeting to determine the scope and audit objectives, and to determine the financial transactions and/or areas to audit.

- Identifying risks relative to financial transactions and mitigating controls with appropriate personnel.
- Developing questions regarding the Casino Development Fund project's transactions, controls, functions, records, and personnel.
- Interviewing appropriate personnel, reviewing documentation, and making observations to aid in developing audit programs.

CONCLUSIONS

As a result of our audit we have concluded that Economic Development Corporation (EDC):

- Did not have an application process for the National Regional Retail Restaurant Chain and Non-Affiliated Retail/Restaurant Loan projects resulting in the inability to determine if proper documentation was submitted and reviewed for the loans approved.
- Reprogrammed and used \$339,632.55 of the National Regional Retail Restaurant Chain Loan project funds for administrative cost.¹
- Did not charge late fees or report late payments to credit reporting agencies which is a standard business practice.

Project Objectives National Regional Retail Restaurant Chain Loan Project

- EDC approved and distributed a total of \$2,350,000 in loans towards the project.
- Seven recipients received loans to fund retail/restaurant project in various locations in the City.
- One recipient received more funding than the maximum allowed per the Funding Agreement.
- Two projects were outside of the geographical area specified in the Funding Agreement.
- As of June 2019, this project lost a total of \$470,848.75 in loan repayments due to business failures.

Project Objectives Non-Affiliated Retail/Restaurant Loan Project

- EDC approved and distributed a total of \$1,725,000 in loans towards the program.
- Nine recipients received loans to fund 10 retail/restaurant projects in the Downtown Detroit area.

¹ Under the funding agreement between the Economic Development Corporation and the City of Detroit, EDC is allowed to draw funds from programs to cover administrative services if they do not earn enough interest to cover their administrative cost.

- One recipient received more funding than the maximum allowed per the Funding Agreement.
- One project was outside of the geographical area specified in Attachment 1 of the Funding Agreement.
- As of June 2019, this project lost a total of \$567,677 in loan repayments due to business failures.

NOTE: The Economic Development Corporation of the City of Detroit Credit Policy Manual, Credit Authority, reads "*Authority to extend credit resides solely with the EDC Board of Directors.*" While we understand this policy, use of this authority may deprive Detroit resident's the opportunity to obtain funding for their business ventures.

BACKGROUND

Origination of Casino Development Fund

The Casino Development Fund is a commitment made by the three Detroit casinos (MGM Grand Detroit, MotorCity, and Greektown) and the City of Detroit, to contribute money for the purpose of assisting minority business development in a specified area within the City. The assistance to business development focuses on: financing façade improvements, GAP financing, loan guaranties, rehabilitation, equipment and working capital for existing and new businesses.

The City received \$2.5 million from MotorCity Casino during the period of the initial Casino Development agreements (1998-1999). The City received \$30 million from the three casinos (\$10 million from each casino) in accordance with the revised Casino Development agreements. The Casino Development Fund is \$32.5 million.

Economic Development Corporation

EDC is a public body corporation created by the City Council of the City of Detroit by enactment of Ordinance 120-H effective June 9, 1979. All services to be performed are set forth in the "Scope of Services" section of the Economic Development Corporation (EDC)/City of Detroit personal service contract and is coordinated and performed by the DEGC. The DEGC is a private non-profit 501c.4 organization and is an agent of the EDC that acts as a liaison between the EDC and the City.

National Regional Retail Restaurant Chain Loan Program

In an effort to further the City's ability to assist the small Detroit-based, women-owned, and minority-owned businesses throughout the City, the EDC received Casino Development Funds to administer various programs per their funding agreement including the National Regional Retail Restaurant Chain Loan Program. The goal of this program is to foster investment in recognized retail/restaurant ventures along the East Riverfront, along the Woodward Corridor (from Jefferson Ave. to Warren Avenue) and within the Central Business District area.

Program Budget & Expenditures

According to the EDC Casino Development Funds Budget and Expenditure report dated March 31, 2019, the program had a budget of \$5,000,000. The EDC revised the budget to \$3,985,808 on May 24, 2016. The EDC stated that seven loan applicants were approved for \$2,350,000 in loans. EDC disbursed a total of \$2,689,632.55 including \$339,632.55 for EDC administrative fees. There is \$1,296,175.45 available for loans for this project.

Five out of the seven businesses or 71% are still in existence as of June 2019. Two businesses are no longer operating. As of June 2019, the EDC lost a total of \$470,848.75 in loan repayments due to business failures.

Non-Affiliated Retail/Restaurant Loan Program

The goal of this program is to foster investment in "in-fill" ground floor retail/restaurant ventures along the East Riverfront, along the Woodward Corridor (from Jefferson

Avenue to Warren Ave.) and within the Central Business District area. Preferences are given to full service restaurants and retail outlets providing services not otherwise available in the general neighborhood.

Project Budget & Expenditures

According to the EDC Casino Development Funds Budget and Expenditure report dated December 31, 2017, the program had been 100% funded. The program received a budget of \$2,000,000 per the Funding Agreement. Nine recipients were approved and received a total of \$1,725,000 in loans to support 10 business ventures as of March 31, 2019. There is \$275,000 currently available for loans for this project.

Five out of the ten businesses or 50% are still in existence as of June 2019. The other five business are no longer operating. As of June 2019, the EDC has lost a total of \$567,677 in loans repayments due to business failures.

AUDIT FINDINGS AND RECOMMENDATIONS

1. Economic Development Corporation (EDC) Did Not Have an Application Process for the National Regional Retail Restaurant Chain Loan and Non Affiliated Retail/Restaurant Loan Projects

We reviewed the application process for the National Regional Retail Restaurant Chain Loan and Non Affiliated Retail/Restaurant Loan projects. Our review included the EDC process for applying for a loan, required document submission, loan document review, loan approval, loan closing and finally funding of the loan. Based on our review, we determined that:

Applying for a Loan

- There was no loan application on the EDC website for the two loan projects.
- EDC did not have a written process for perspective applicants on how to apply for the two loan projects.
- Applicants were able to email or call EDC to initiate a loan application.
- The loan files for five of the six recipients of the National Regional Retail Restaurant Chain Loan project did not have a loan application. The remaining recipient had an application in their file from the Brownfield Development Authority.
- The loan files for six of the nine recipients of the Non-Affiliated Loan project did not have a loan application. The remaining three recipients had applications in their files from the Downtown Development Authority.

Loan Approval

- The documentation deficiencies in borrowers' files provided no assurance that agency staff insured that all required information had been submitted to perform an adequate application analysis or verification before submission to the EDC Board.
- National Regional Retail Restaurant Chain Loan project
 - One recipient received more funding than the maximum allowed per the Funding Agreement.
 - Two projects were outside of the geographical area specified in the Funding Agreement.
- Non-Affiliated Retail/Restaurant Loan project
 - One recipient received more funding than the maximum allowed per the Funding Agreement.
 - One project was outside of the geographical area specified in Attachment 1 of the Funding Agreement.

Best business practices for loans management include a standard applications process and required documentation, a loan review and approval process. The Small Business Administration program, an industry leader in assisting businesses requires the following steps in the life of a loan:

- A loan application.
- Loan application review.
- The lender makes a decision on whether to approve the loan.
- Upon satisfaction of all items and conditions of the loan authorization, the loan is closed.

In addition, the Federal Deposit Insurance Corporation recommends, at a minimum for installment lending policies, a process that addresses the loan application.

The EDC Loan Credit Policy states that staff shall ensure that all loans are properly documented in accordance with the loan approval and the requirements of the particular loan program. The loan approval authority resides solely with the EDC Board of Directors.

Due to a lack of standard required application and loan documents, we cannot determine if proper documentation was submitted and reviewed for the loans approved. Failure to require and maintain proper documentation can result in fraud and other losses of funds by approving ineligible applicants.

We determined that EDC's lack of a comprehensive standard operating procedures allowed for inconsistencies in the management of the project.

Recommendations

We recommend that the EDC Board:

- Review and revise the EDC credit policy manual, ensuring that it is consistent with the relevant provisions of the Funding Agreement.
- Implement a transparent application process.
- Ensure that the EDC provides oversight consistent with the sections of the Funding Agreement and approved guidelines governing loan program management.
- Require that EDC retain documents that ensures that eligibility requirements are met and included on all required documents for EDC Board review and verification.

2. EDC Failed to Enforce Loan Agreements

We reviewed a sample of loans from both loan projects, as of April 30, 2019 with the following results:

- Late payments for the National Regional Retail Restaurant Chain project borrowers ranged from 5 to 21 payments with the average late payments for the borrowers totaling 17%.
 - Currently the National Regional Retail Restaurant Chain has one unpaid loan. Forty-seven percent of the borrower's payments were late.
- Late payments for the Non-Affiliated Retail/Restaurant borrowers ranged from 13 to 47 payments with the average late payments for the borrowers totaling 53%.
 - Currently the Non-Affiliated Retail/Restaurant project has one unpaid loan. Ninety percent of the borrower's payments were made late.

In addition, EDC:

- Sent collection notices to the borrowers but there was no indication that late fees were charged at any time during the period of the delinquencies.
- Did not report the payment histories of borrowers to any credit reporting agency.

According to the Payments section in the loan agreements for both projects, if any payment is not received by the 10th day of the month, it shall be deemed late, and a daily late charge equal to five cents (\$.05) for each dollar of any monthly installment not timely paid shall be due and payable.

EDC failed to collect penalties and interest on current loans from the National Regional Retail Restaurant Chain Loan and from the Non-Affiliated Retail/Restaurant Loan projects creating lost revenue to the loan portfolios. In addition, EDC did not receive consistent payments to be used for additional loans to other borrows.

We determined that EDC did not:

- Enforce the loan repayment agreements.
- Charge late fees which contributed to the borrower's late payment patterns.
- Report the payment histories of borrowers to credit reporting agencies; a practice that could have encouraged prompt monthly payments.


Recommendations

We recommend that the EDC:

- Enforce the loan agreements approved by the EDC Board.
- Assess and collect required late charges per the loan agreements.
- Report loan recipients' payment history to credit reporting agencies.



TO: Mark W. Lockridge, Auditor General

FROM: Glen W. Long, Jr, Authorized Agent 

DATE: October 21, 2019

RE: THE CASINO DEVELOPMENT FUND AUDIT
National Retail and Non-Affiliated Retail Loan Projects

We are in receipt of your Final Draft report dated October 14, 2019 concerning the National Retail and Non-Affiliated Retail Loan projects. We recognize all of the hard work that your staff has done in their auditing of the fund. We acknowledge their findings, and appreciate their suggested improvements; but feel that their conclusions require further clarification. Our response is as follows:

CONCLUSIONS:

Your staff concluded that EDC did not have all of the proper documentation in its files and did not charge late fees on delinquent payments. These two conclusions became findings and our responses are detailed in the next section.

The third conclusion of the report notes that the EDC reprogrammed project funds for administrative costs; however, the report also notes that this reprogramming is expressly permitted under the terms of the funding agreement where interest income is insufficient to cover the administrative cost. We note that this reprogramming became necessary because the City's contribution to the program was \$10,250,000 less than contemplated when the program was approved and payments from the City were not made on the agreed upon schedule.

FINDINGS AND RECOMMENDATIONS:

EDC Did Not Have an Application Process . . .

1. Applying for a Loan

The auditors are correct when they say that there was no loan application on the website and that the loan files did not have a loan application. Staff

has initiated corrective measures. An application process has been put in place for other EDC loan programs and will be applied to this program as well. These applications appear on the website. This will ensure a transparent application process.

EDC does have a written checklist for its Loan Officer to follow when working with a borrower. It was followed, but in an attempt to correct this perceived weakness, EDC will make the checklist available to prospective borrowers going forward.

Applicants have always been able to email or call EDC to initiate a loan application. The loan programs have been marketed by the Business Development staff of the DEGC as well as by Program Partners such as Invest Detroit and Detroit Development Fund. These loan programs have specific geographical and usage restrictions, and as such it has been our experience that a narrowly tailored and targeted marketing strategy has led to the most successful applications.

All of the loan files may not have had an application on file. That said, it is not as if the information necessary to review and underwrite a loan request was not all gathered and meticulously vetted. This is clear from the Board memos and resolutions. It is important to remember that this audit has gone back to 2007 when there were different staff members in place over the program. Current staff has agreed to utilize an application on every loan, and we will incorporate that into our next Credit Policy Manual revision.

2. Loan Approval

The auditors cite that deficiencies in borrowers' files provided no assurance that agency staff ensured that all required information had been submitted. Again, these deficiencies are found in the older files that were maintained by staff no longer with us. Furthermore, it is worth noting that the underwriting, vetting, and Board document preparation could not have been completed had staff not gathered all pertinent information. We can testify that current staff ensures that all files are complete. Unfortunately, completeness of the files can be a problem with an audit spanning a 12 year period, where staff turnover has happened and retention deadlines have been passed.

The auditors cite projects where loans had been issued in exception to the geographical and maximum amount limitations spelled out in the funding agreement. Staff does not dispute these findings, but does note that the EDC Board has the authority to waive these restrictions under extraordinary circumstances.

Previous City Administrations and EDC Staff felt that the projects were so important, and the need for a local match for State Funds (in the case of the Gateway Meijer project) couldn't be found elsewhere so these exceptions were taken to the EDC Board who knowingly approved them.

3. Recommendations

The auditors recommend a review and revision of the EDC's Credit Policy Manual. The EDC Staff and Board currently review the Credit Policy Manual every few years and a review was already scheduled for 2020.

The auditors recommend implementation of a transparent application process. We recognize the weaknesses of the previous process and have already implemented changes including the posting of the applications, guidelines, and checklists on to our website.

The auditors recommend that the EDC provides oversight consistent with the Funding Agreement. While the EDC feels that it already does this, we will be making improvements to our application process as well as updating the Credit Policy Manual. Again, some of these weaknesses have already been improved, but an audit over a 12 year period can uncover some old weaknesses that have already been addressed.

Lastly in this section, the auditors recommend that EDC ensure eligibility requirements are met and included on all required documents for EDC Board review. This is already being done, however the EDC Board does have the right to approve exceptions to the eligibility requirements. Again, existing improvements in current staff record keeping must be considered.

I. EDC Failed to Enforce Loan Agreements

1. Late Fees

The auditors noted several loan payments that were late and cite delinquency rates and the lack of late charges and credit reports being made. EDC staff doesn't deny any of these facts, but does wish to provide the reasoning.

This finding highlights a fundamental difference between a bank and an economic development agency. These Loan Programs were meant to provide "but for" financing and many of the loans are high risk. At the beginning of the program EDC Staff and Finance Committee made a conscious decision to be extremely judicious when levying any late fees on borrowers. While the auditors feel that late fees would encourage the borrowers to pay on time, it has been staff's finding that additional charges

only serve to put the borrowers further behind. Staff has a dedicated employee who works with the borrowers and who is responsible for collections. She has a remarkable record for collecting the principal and interest on the loans, but adding late fees only serves to poison that relationship.

Further, staff insists that the reporting of payment histories on these borrowers to credit reporting agencies would damage these small local businesses, which would be in clear contradiction to purpose of the program and the very mission statement of the EDC and DEGC. Staff feels that damaging the credit rating of the local businesses and damaging the relationship of the Loan Officer with the borrower by charging late fees that are difficult to collect is not good practice.

Having said all of that, we will be reviewing this audit and our responses with the current version of the EDC Finance Committee at an upcoming meeting and if the current committee feels differently than the previous versions then staff will adjust accordingly.

2. Recommendations

The auditors recommend that the EDC enforce the loan agreements approved by the Board, assess and collect late fees, and report borrower payment history to credit reporting agencies.

As stated previously, staff feels that this would disadvantage our high risk borrowers and would cause damage to the very local businesses we are trying to assist, however we will revisit this topic with the EDC Finance Committee and Board and will enforce whatever directive they give us.