ESTADO LIBRE ASOCIADO DE PUERTO RICO
COMISIONADO DE INSTITUCIONES FINANCIERAS

ALFREDO PADILLA
Comisionado

A.F.V.P.R.
DIV. DE SERV. GEN.
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24 de agosto de 2010

Sr. George Joyner
Director Ejecutivo
Puerto Rico Housing Finance Authority
PO Box 71361
San Juan, PR 00936-8461

Estimado señor Joyner:

Le acompaño el informe final de examen realizado a la "Puerto Rico Housing Finance Authority".

Tomando en cuenta el compromiso demostrado por la Gerencia y Junta de Directores de atender nuestros señalamientos, el poco tiempo transcurrido del cambio de administración a la fecha de examen, y el gran esfuerzo dedicado a implementar la política pública en el área de la vivienda, modificamos positivamente ciertas partes del examen previamente distribuido.

Agradeceré que este informe se presente y discuta con la Junta de Directores y que nos envíe una certificación a tales efectos con la firma de los Directores presentes.

Además, necesitamos una contestación formal siguiendo el borrador de contestación que nos proveyó recientemente.

Estamos a sus órdenes.

Alfredo Padilla

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Commissioner of Financial Institutions
Commonwealth of Puerto Rico

REPORT OF EXAMINATION

PUERTO RICO HOUSING FINANCE AUTHORITY

Examiner-In-Charge: Néstor J. Rodríguez
Examination Start Date: February 22, 2010
Examination As Of Date: December 31, 2009

This Report of Examination is Strictly Confidential

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All dollar amounts are reported in thousands, unless otherwise indicated.

	Current Exam	Prior Exam	Prior Exam
Ratings by Examination Function	12/31/2009	N/A	N/A
Risk Management Composite	2		
Risk Management Component:			
Capital	2		
Asset Quality	2		
Management	2		
Earnings	2		
Liquidity	1		
Sensitivity to Market Risk	1		

ORGANIZATION

In 2001, the Commonwealth of Puerto Rico (the Commonwealth) prioritized the need to merge under a single operation the financing services for low-income housing. Effective February 8, 2002, the former Housing Finance Corporation became the Puerto Rico Housing Finance Authority (the Authority or PRHFA) and the former Housing Bank and Finance Agency was dissolved and its powers were transferred to the Authority (Act 103 of August 11, 2001). The PRHFA is a subsidiary of Government Development Bank for Puerto Rico (GDB), a component unit of the Commonwealth subject to examination and supervision of the Office of the Commissioner of Financial Institutions (the Commissioner or OCFI). The Authority provides mortgage loans to public and private housing developers for the construction, improvement, operation and maintenance of rental housing for low to moderate-income families. Also, it grants mortgage loans to low and moderate income citizens and manages the Mortgage Loan Insurance Program (Act 87 of June 25, 1965), among other services. The accounting and reporting policies of the Authority conform to accounting principles generally accepted in the United States of America (U.S. GAAP), as applicable to governmental entities.

The Authority is headed by an Executive Director who responds to the President of GDB, who in turn responds the Board of Directors of the PRHFA (the Board). The Executive Director supervises the daily operations of the Authority and complies with the administrative responsibilities in his charge.

GENERAL INFORMATION

By Resolution CE-2009-21 adopted in November 2009 by the Board of Directors of GDB, the Commissioner was called upon to perform the first examination of the Authority. The examination is based on safety and soundness practices and guidelines, and it covered the 2009 calendar year as well as subsequent events, if any. In evaluating the PRHFA, examiners considered that it operates under a unique set of conditions that places it apart from other financial institutions of the Puerto Rico banking industry. Also, the Authority was evaluated as a whole instead of based on major and non-major funds. Therefore, government-wide financial statements were examined as they report information via accounting methods similar to those used by private sector companies.

An examination generally includes reviewing, on a test basis, compliance with applicable laws, regulations and other legal statements. Examiners have applied limited procedures on compliance, which consisted principally of inquiries of the Authority's management. Therefore, we did not realize a full scope review on compliance as might be the recommendation for future examinations.

SUMMARY OF CONDITION

The financial condition and overall performance of the Authority is satisfactory. Management performance is satisfactory. The financial condition of the Authority is fundamentally sound. Asset quality is satisfactory, earnings are satisfactory to support operations, and capital (i.e., net assets) is deemed satisfactory in relation to the present risk profile. Liquidity reflects a strong level while the Authority's sensitivity to market risk is well controlled.

CAPITAL – 2

Capital is satisfactory in relation to the Authority's risk profile. As of examination date, capital balance amounted to $612 million represents an 11% increase when compared to the fiscal year end 2009. Of the aforesaid amount, $307 million or 50% is unrestricted and accordingly, such resources are available for general purposes. Capital represents 34% of average assets, a growth of almost 2% when compared to the preceding period. This indicator is favorable in comparison with the 7% average for all commercial banks in the island. The Adversely Classified Items Coverage Ratio is satisfactory at 16%.

In addition, despite the needed provision to replenish the allowance for both, loan losses and ORE the Authority is profitable and is expected to remain profitable in the foreseeable future. Although it experienced an improvement in earnings but suffered erosion on assets at the examination date, the unrestricted capital portion is sufficient to absorb future losses.

Dividend payments do not erodes capital as the Authority is not required to realize this type of disbursement. The current nonexistence concentrations of credit add no capital concerns. In addition, the risk exposure coming from several lawsuits against the Authority is minimal. Legal counsel stated that the ultimate liability, if any, resulting from these pending proceedings will not have a material effect on the financial position or results of operations of the Authority.

ASSET QUALITY – 2

Asset quality is satisfactory but credit administration practices need improvement. At present, the level and severity of classifications and other weaknesses do not require supervisory attention. As reflected on the Examination Data and Ratios page, the volume of adversely classified assets represents 6.03% of total assets which is deemed acceptable given the risk nature of the PRHFA's activities. The bulk of adverse classification is: (1) centered in loans that represent only 12% of total assets at examination date and, (2) the less severe category (Substandard) that represents 82% of total classifications. Most of the assets adversely classified Substandard are loans that are totally or partially covered by real estate collateral.

Loans

The adverse classification of loans is slightly concentrated in the residential mortgage portfolio (i.e., single-family loans). However, loans adversely classified Loss (two loans and portions of two loans totaling $6.4MM) are mostly multi-family loans. Most troubled credits result from the depressed economy, particularly the local real estate industry. Management is taking affirmative steps to strengthen credit administration by tightening overall underwriting standards, increasing the equity provided by borrowers, and avoiding more than one financing to a same real estate developer. Although these actions have longer-term positive implications, present credit quality remains complicated by a high delinquency ratio at 42.4%, non-accrual mostly. This percentage is proportional to the level of adversely classified loans which represents 34.5% of total loans. Additional details on loans adversely classified refer to the Items Subject to Adverse Classification pages.

Loan Review and Internal Grading System

The defined scope of the internal loan review and grading system is satisfactory. However, assigned credit grades for several larger credits were inaccurate, as exemplified by the partial Loss classification of the Los Claveles I and Los Claveles II credit facilities. In both cases, the credits were internally rated Substandard or Doubtful. In addition, several credits adversely classified Substandard were internally rated Special Mention as exemplified by the loans to Altos del Río and Jardín del Atlántico. To address this issue, management should define more tightly all credit grades and ensure that they are accurately applied. Also, loans are internally reviewed and graded by project instead of by borrower. This issue should be addressed by joining all credits corresponding to one borrower to assign an overall credit grade.

Allowance for Loan Losses (ALL)

As of examination date, the ALL for single-family loans at $11.8 million is adequate. However, the $9.2 million ALL for multi-family loans is inadequate by at least $2.6 million, primarily due to moderate internal credit grading. Additionally, the Authority does not allocate any ALL for non-classified nor uninsured loans. In getting the ALL computation, examiners applied the same loss percentage for the Substandard, Doubtful and Loss categories as the Authority does.

Lending Policies and Credit Administration

Credit administration requires further attention. In particular, the following significant credit weaknesses should be addressed:

- *Methodology to determine the ALL for single-family loans* – The overall methodology to determine the adequacy of the ALL for single-family loans appears to be adequate. However, the computation is done twice a year and is based on an average loss factor of the last two years. Management is recommended to perform a quarterly computation on the adequacy of the ALL to tie with the future filing of the quarterly report to OCFI. Reference is made to the *Uniform Retail Credit Classification and Account Management Policy* that states standards for the classification and treatment of retail credit in financial institutions. For purposes of this policy, retail credit includes loans to individuals secured by residential real estate.

- *Methodology to determine the ALL for multi-family loans* – The internally classified multi-family loans are assigned a specific reserve as of June 30 of each year. This procedure should be changed to compute the ALL for this kind of loans at least quarterly. Also, no reserve is allocated for loans that are internally classified as Excellent or Good. Due to the inherent risk of loss, this matter should be addressed by assigning them a loss percentage to be determined by the Authority. Such procedure would conform to the standard practice of the banking industry.

- *Multi-family credit policy* – Multi-family loans represent 53.5% of gross loans and 7.2% of total assets with a high potential of growing this portfolio in the near future. This lending activity includes participated loans either as the lead or participant institution. However, the Authority lacked a multi-family credit policy addressing all the matters that encompass such activity, including the loan review and internal grading system.

Management's response: On April 6, 2010, a policy and guideline for multi-family loans is drafted and pending to be reviewed and approved by the Board.

- *Timely recognition of loan losses* – Several loans or portion of loans classified Loss in this examination are considered uncollectible. However, they are kept in the Authority's books as bankable assets. It is not practical or desirable for management to defer writing off these basically worthless assets even though partial recovery may be effected in the future (e.g., Quintas de Santa Elena and Los Claveles).

- *Maximum lending limit* – The Authority has not a limit on the outstanding amount granted to a same borrower as exemplified by all the multi-family loans granted to Juan C. Albors. Management should state a maximum lending limit to protect the security and financial soundness of the Authority upon preventing excessive loans to a same person, or people related that are financially interdependent.

Other Real Estate

As of December 31, 2009, the expanding portfolio of Other Real Estate (ORE) consists of 430 properties that are managed and controlled by personnel in the Real Estate Division. Only 53 out of the 430 properties have book value of $9.3 million and almost this entire sum is extended a Substandard and Loss classification. The remaining 377 properties have no book value. There is a general allowance for losses in ORE that amounts $6.5 million as of examination date. The overall process needs to improve in both, the timeliness of obtaining appraisals and efforts of disposing properties. Specifically, management should obtain and maintain current valuations for all ORE properties or document why individual properties retain their value in a declining real estate market. Also, management should increase disposition efforts to avoid a greater accumulation of ORE as such portfolio encompasses maintenance and disposition expenses. Reference is made to the Risk Management Assessment pages for additional comments regarding the handling of ORE.

Other adverse classifications

Adverse classifications also include two sub-investment quality Securities and Other Assets that are detailed in the Items Subject to Adverse Classification.

Disposition of Assets Classified Loss

All assets classified Loss in this examination should be charged-off by receipt of this Report, unless the asset is paid in full or the status of the credit is substantially improved.

MANAGEMENT - 2

For purposes of this component, management includes both the Board members, which are designated by the Governor of Puerto Rico and confirmed by the Senate, and executive officers, who are appointed to their positions by the Board. In aggregate, management performance and risk management practices are satisfactory given the nature of the Authority's activities. However, below are some steps that management should take to make their performance more effective.

Policies

Directors must provide a clear framework of sound and clear written policies within which executive officers operate and administer the Authority's significant activities. They should contain procedures, including a system of internal controls, designed to promote sound practices and to protect the Authority against external crimes and internal fraud. Specific policies should cover at a **minimum**:

- Multi-family loans, including internal loan review procedures for all type of loans.
- Investments
- Liquidity
- Asset-liability/funds management
- Other real estate

All policies should be monitored to ensure that they conform to changes in laws and regulations, economic conditions, and the Authority's circumstances. Policies should be approved and reviewed periodically (i.e., at least annually) by the Board to determine that they remain applicable. The depth and detail of such written policies depend on the nature, scope and complexity of the Authority's operations.

Management's response: In the near future, a multi-family loans policy will be presented to the board's review and approval. Also, the Authority is planning to adopt selected sections of GDB's investment policy as it applies to the PRHFA's activities.

Board Supervision

The Board members need to become more actively involved in the Authority's affairs and business. The absence of formal written policies may difficult the directors in fully discharging their supervisory responsibilities. In most cases, mechanisms to monitor the institution's operations include management reports to the board. These reports should be carefully framed to present information in a form meaningful to the board. The appropriate level of detail and frequency of individual reports should tie with the circumstances of the Authority. Reports generally will include information such as the following:

- Monthly financial statements
- Production of loans and investments
- Delinquency of loans and investments
- Problem loans and their current status
- Allowance for loan losses (at least quarterly)
- Concentrations of credit
- Losses and recoveries, including disposition of other real estate
- Funding activities
- Insider transactions (i.e., loans to employees)
- Performance in all of the above areas compared to past performance
- Audit reports

Reports should be provided far enough in advance of board meetings to allow for meaningful review.

Regarding the review of minutes of the Board's meetings for the calendar year 2009 was observed the following:

- The Board did not meet regularly as it only held five ordinary and two special meetings; the last board meeting during the aforesaid period was held on September 16, 2009.
- All the minutes were in draft.
- Financial statements are just received from time to time (e.g., the most recent are dated June 30, 2009 which were received by the Executive Committee of the Board in a meeting held on November 3, 2009).
- The minutes lacked the effective date of the appointment and resignation of various directors.

The Bylaws of the PRHFA establishes that *"The minutes of each meeting of the Board shall be read at the following meeting and presented for approval by the Secretary. This requirement is not being met.*
There is an Executive Committee (EC) of the Board that is vested with the same attributions and powers as the Board. The Bylaws of the PRHFA establishes that the EC *"shall keep regular minutes of its meetings and shall report its activities to the Board of Directors at each of such Board's meetings."* These requirements are not being met as: (1) there are not minutes nor draft for six out of seven meetings held during the calendar year 2009, and (2) its activities are not reported to the Board. Only a summary of all resolutions adopted by the EC was available for examination. Review of the minutes of the EC' meetings should be a standard part of the Board meeting agenda.

The contents of minutes of both the Board and the EC should be improved based on the items listed above. The Board is encouraged to become actively involved in the Authority's affairs and to meet more frequently. Both, the Board and the EC should implement a mechanism to prepare, review and approve its minutes regularly.

Management's response: Periodic financial statements and other detailed reports are presented to the Board but the minutes failed in reflect it. In the near future, the Board will hold a special meeting to review and approve all the minutes that are still in draft.

Strategic Planning

A vital part of the responsibilities of directors is to set the future direction of the institution. In order to be effective, planning must be:

- carefully attended - projections must be revised periodically as new risk factors arise and current market conditions change; and
- well supported.

Although PRHFA has a strategic plan, a formal planning process is not in place. The minutes of the Board's meetings should reflect that it is actively involved in the planning process and periodically reviewing the strategic plan. Also, goals appear to be realistic but they lacked financial objectives. The Board should revise the current plan to include financial factors.

Apparent Violation

Management appears to be cognizant of applicable laws and regulations. Board members cannot be expected to be personally knowledgeable of all laws and regulations, but they should make certain that violations are not knowingly committed by themselves. As of examination date the board was incomplete. Although it is not your responsibility to fill the vacancies is recommended that members should take the necessary steps to be filled in the shortest possible time vacancies.

Audit and Internal Control

Various internal control deficiencies are detailed under the Internal Routine and Controls page of this Report. . Directors and senior management should ensure that the following key characteristics are reflected in the internal audit function.

- *Structure* – Create an audit committee of the Board despite the risk profile, size and complexity of activities of the PRHFA. Also, internal audit reports should be reviewed and monitored by the Board. According to management, they are reviewed by GDB's audit committee. This procedure is due to the fact that PRHFA's internal audit function is performed by GDB under a dual Services Contract.

  The board or an audit committee of the board of PRHFA should oversee the internal audit function, evaluate performance, and assign responsibility for the internal audit function to the internal audit manager. An effective directors' audit committee, made up of or including outside directors, is desirable to accomplish that responsibility. It should also annually analyze the extent of external auditing coverage needed by the Authority.

- *Scope* – The audit's control risk assessment and the audit plan scope should be review and approved by the Board.

  At least annually, the Board or the audit committee should review and approve internal audit's control risk assessment and the audit plan scope. The audit committee should also periodically review the internal audit's adherence to the audit plan and should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the Authority's environment, structure, activities, risk exposures, or systems.

Reports of Condition and Income

The Authority is required to submit a quarterly Report of Condition and Income to the Commissioner beginning in the quarter ended on *September 30, 2010*. Records and work-papers reconciling with reported figures should be kept for each quarter ending. Refer to Circular Letter CIF CC-09-2 issued by the OCFI on August 25, 2009.

Although there are a large number of reference tools available in the banking industry, management is referred to *selected provisions* of the following sources of information. The implementation of selected provisions will help management to improve the administration of the Authority's affairs and business.

- *Interagency Guidelines Establishing Standards for Safety and Soundness set forth in Part 364, Appendix A, of the FDIC Rules and Regulations*. The standards, which should be viewed as minimum recommendations, establish the objectives of proper operations and management, but leave specific methods of achieving these objectives to each institution.

- *Sarbanes-Oxley Act of 2002*. The provisions of the Sarbanes-Oxley are primarily directed toward those companies, that have a class of securities registered with the Securities and Exchange Commission (SEC) or the appropriate Federal banking agency under the Securities Exchange Act of 1934, i.e., public companies. It regards issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure.

- *The Committee of Sponsoring Organizations of the Treadway Commission (COSO) report entitled "Internal Control-Integrated Framework".* It regards a continued internal audit function that is conducted in accordance with professional standards. Institutions are encouraged to evaluate their internal control against the COSO internal control framework if they are not already doing so.

EARNINGS – 2

Earnings are satisfactory and sufficient to support operations and maintain adequate capital and allowance levels. As of examination date, the Authority shows a net income (i.e., change in net assets) of $6.6 million for the first six months of fiscal year 2010. This result explains the increase to $612 million in capital as of examination date. Profits are overstated due to inadequate provisions for losses on both, loans and other real estate owned. Once the additional recommended provision of $3.4 million (i.e., $2.6 million for loans and $807 thousand for ORE) is made to corresponding allowances, the Authority will still show a net income of $3.2 million for the first six months of fiscal year 2010.

The return on assets (ROA) reflects an improvement to .37% as of December 31, 2009 from -1.22% as of June 30, 2009. In spite of this, net interest margin (NIM) weakened between such time periods given that it dropped from 1.27% to .70%. The satisfactory earnings performance is a direct result of a satisfactory asset quality, despite the high level of ORE. The NIM has been reduced, in part, due to the high level of nonperforming assets which will require additional loan loss provisions. Although nonaccruals and other nonearning assets are high, the unfavorable outcome over the NIM is slight as most of the assets structure comprises high quality investment securities and interest-bearing balances.

Total Noninterest Expense as a percentage of Average Assets has steadily decreased over the last year and has diminished to 5.67% as of December 31, 2009. However, present overhead level is still more than 300 basis points above the Puerto Rico financial industry average, but results largely from expenses associated with housing assistance programs instead of overhead. Salaries and employees benefits reflect a decreasing trend based on operational changes and cost-cutting measures. However, overhead expenses are expected to increase as additional lending staff will be necessary to handle the projected raise in the construction loans portfolio. Also, effective July 1, 2010 the Authority will be charged with the responsibility to administer the HOME Program.

Budget

The fiscal year 2010 budgeting process appears to be satisfactory. Based on annualized figures accrued up to December 31, 2009, total income should be under estimated by $6.4 million but total expenses should be over estimated by $29.4 million for a probable $35.8 million positive variance in the net income. Management identified the following main assumptions to explain the aforesaid positive discrepancy: $6 million un-incurred interest expense in "Banco Fase II" as $164 million principal were redeemed in October 2009; $5 million provision for loan losses; $2 million Key for Your Home Program Subsidy; and $8 million New Secure Home Program Subsidy.

LIQUIDITY - 1

Liquidity levels and funds management practices are adequate as the Authority has access to sufficient sources of funds to meet present and anticipated liquidity needs, including off-balance sheet items. As of December 31, 2009, the PRHFA has access to two difference sources of funds: non restricted and restricted. For examination purposes, non restricted funds are considered to maintain in equal manner with PRHFA's liquidity computation. Restricted liquid assets are not considered in evaluating the liquidity component as the funds are linked to determined commitments and specific purposes.

Total non restricted funds amount to $128 million which consist mainly in deposits placed with banks. The principal source of funds consist of lines of credits from the GDB which amount to $53 million plus other short term debts for $9 million. Total liabilities reach to $62 million of its liquidity position or an excess of 206% as of examination date. However, this percentage would be higher if examiners add investment securities for $18 million and operational cash for $3 million (not restricted) that the Authority does not deem as liquid assets. This change would enlarge the liquidity position by $22 million for an improved excess to 241%.

The PRHFA does not have a formal liquidity policy and parameters to allow an adequate liquidity monitoring process. However, it monitors the liquid funds to establish minimum liquidity procedures in accordance with its operation.

SENSITIVITY TO MARKET RISK - 1

The Authority's sensitivity to market risk is minimal as it relates primarily to interest rate risk. The balance sheet composition and characteristics demonstrates a low volume of volatile assets, and funding sources match the Authority's asset re-pricing structure. PRHFA does not engage in off-balance sheet derivative activity. The Authority's management has decided not to adopt a formal policy for interest rate risk in view that current earnings and capital are impacted to a minimum in the event of interest rate changes. The loan portfolio represents twelve percent of total assets comprised of adjustable-rate construction loans and fixed-rate single and multi family mortgage loans.

MEETING WITH MANAGEMENT

The results of this examination were discussed on a meeting held on May 13, 2010. Representing the Authority were Executive Director George R. Joyner, Deputy Executive Director Carmen Y. Cordero, Assistants to Executive Director Luis Burdiel, Luis O. Berrios and José A. Lebrón, Accounting Director Mayra I. Guadalupe, Information Systems Director José De Jesús, and Audit Office Manager Juan M. Vázquez. Representing the OCFI were Commissioner Alfredo Padilla, Deputy Commissioner Antonio Salvá, Supervisor of Examiners Carmen Velasco, Examiner Christian Cancel and the undersigned. Most of the discussion was devoted to the CAMELS risk management components and the risk management composite.

DIRECTORATE RESPONSIBILITY

Each member of the Board of Directors is responsible for thoroughly reviewing this Report of Examination. Each director must sign the Signatures of Directors page, which affirms that he or she has reviewed the Report of Examination in its entirety. Findings and recommendations should be reviewed carefully. Progress in addressing problems should be tracked.

Néstor J. Rodríguez Examiner in Charge (Signature)	Alfredo Padilla Commissioner (Signature)

1. **Are risk management processes adequate in relation to economic conditions and asset concentrations?**

Generally, yes. However, a formal strategic planning is not in place. Refer to comments under Management on the ECC page. As of examination date, no asset concentrations are addressed in this Report. However, there is concern on the projected increase in the loans portfolio to finance the real estate industry, which is projected to remain depressed for the foreseeable future.

The Commissioner is aware that financing the real estate industry of Puerto Rico is commensurate with the Authority's public mission. However, there is a large concern about the Authority's current and future financing activity for the construction of medium price homes. Puerto Rico has been facing a depressed economy since 2006 while local economists foresee a negative economic outlook beyond 2011. The Puerto Rico real estate market is oversupplied as there is an inventory of more than 11,000 units that remain unsold. In fact, the banking industry of Puerto Rico has practically stopped to finance all kind of construction real estate loans and has restricted the granting of new mortgage loans. Another of the serious consequences of the real estate industry crisis is the housing depreciation which fell 6% between years 2008 and 2009.

2. **Are risk management policies and practices for the credit function adequate?**

No. A formal credit policy for the multi-family loans portfolio is not in place. Also, it is unclear if the credit policy for single-family loans detailed latter in this Report is approved by the Board. If was approved, it was not reviewed by the Board during the calendar year 2009. Also, the internal credit review needs improvement, and various credit administration practices are deficient. Refer to the comments under Asset Quality on the ECC page.

Although the single-family loan policy dated October 31, 2008 is generally adequate, it fails to address the following matters:

- *Appraisals* – The Authority accepted an old appraisal (i.e., almost two years and a half old) in the residential mortgage loan granted to loan 83122-09 on March 31, 2008. The policy lacks specific guidelines pertaining to the maximum issuance time to accept appraisals.

- *Flood certificate issued for more than one year* – The Authority granted various residential mortgage loans with a flood certificate that was issued for more than one year. This matter is not specifically covered in the single-family loan policy. Management is recommended to verify the Federal Emergency Management Agency (FEMA) map before the loan closing or to update the loan documents if changes have occurred.

Other Real Estate

As noted in the ECC pages, the ORE portfolio consists of 53 properties with a book value of $9.3 million. Of the 53 ORE properties owned, 12 were acquired during the calendar year 2009. Of the new properties acquired, 11 have recent appraisals (i.e., 18 months or less prior to the examination date). However, management failed to obtain a current appraisal or update of value on 25 of the existing properties. In addition, there are four properties without appraisal or value. For example, the $5.9 million book value of the ORE 04-00002 is classified Loss in this examination as it was acquired in February 1996 but no appraisal or value is available for this property. In summary, of 53 properties owned, 29 or 55%, have non-current appraisals or value. Without current appraisals or valuations, the validity of the balances reported in the general ledger is questionable. In the current declining real estate market, additional losses in ORE valuation may be required. In fact, it is the examiner's estimate that an additional $807 thousand is needed to take the general allowance for losses on ORE to an adequate level. Management should obtain and maintain current valuations for all ORE properties or document why individual properties retain their value in a declining real estate market.

Also, a formal ORE policy approved by the Board is not in place. Instead, informal policy and procedures are used to manage the ORE properties and compute the related allowance. Also, there is a regulation 7397 dated September 24, 2007, that governs the acquisition, maintenance and disposition of ORE but it lacks risk factors as the aforementioned. Management is recommended to adopt an ORE policy and to clarify some terms included in Regulation 7397 which are deemed general (i.e., Maximum Period Agreement, Reasonable Deposit, and Reasonable Profit Margin).

3. **Are risk management policies and practices for asset/liability management and the investment function adequate?**

Generally, yes. The Authority follows GDB's investment policies, which provide that investment transactions shall be entered into only with counterparties that are rated BBB+/A-1 or better by Standard & Poor's or equivalent rating by Fitch Ratings or Moody's Investors Service, depending on the type and maturity of the investment and the counterparty to the transaction. Any exceptions must be approved by the Board. These investment policies also provide that purchases and sales of investment securities shall be made using the delivery vs. payment method. However, the aforesaid guidance is the one used by GDB but the policy is not extensive to PRHFA. Also, the Authority does not have a formal policy for interest rate risk management.

4. **Are risk management processes adequate in relation to and consistent with, the institution's business plan, competitive conditions, and proposed new activities or products?**

Yes.

5. **Are internal controls, audit procedures, and compliance with laws and regulations adequate (includes compliance with the Bank Secrecy Act [BSA] and related regulations)?**

No. The system of internal controls needs improvement as several deficiencies are addressed in the Internal Routine and Controls pages. As indicated under Management on the ECC page, the audit and internal control function need improvement. Also, a violation of Act 103 regarding the composition of the Board is cited during this examination. Full details of this citation can be found under Violations of Laws and Regulations page.

<u>BSA</u>

The Authority's Legal Counsel has concluded that PRHFA is exempted from establishing an Anti-Money Laundering Program as it is a governmental entity that provides mortgage loans to low and moderate income citizens. The Commissioner agrees with such determination as set by 31 U.S.C.A. §5312. However, management is reminded that PRHFA might be subject to certain BSA requirements (e.g., customer identification program) in the near future as the federal authorities are moving toward such direction.

6. **Is Board supervision adequate, and are controls over insider transactions, conflicts of interest, and parent/affiliate relationships acceptable?**

Generally, yes. However there are some areas that need improvement. (Refer to comments under the Management heading on the ECC page.)

Parent/subsidiary relationship

GDB charges the Authority a $10 thousand monthly management fee for human resources, payroll, information systems, legal counsel and internal audit, among other services. This relationship is evidenced by a Services Contract in place since July 2002 that is renewed annually. Such management fee has remained unchanged since the inception date of the contract. Also, it forces the Authority to refund GDB any expense and disbursement it incurs for any claim arising during the contract validity.

Management and other fees paid by subsidiary institutions should have a direct relationship to the value of actual goods or services rendered based on reasonable costs consistent with current market values for such services. Following are some recommendations about this parent/subsidiary relationship:

- The agreement needs to be independently reviewed by the Board to ensure that it is fair and in the best interest of the Authority.
- Sanctions for noncompliance should be contained in the agreement in both directions instead of against the PRHFA only.

Board of Directors

Article 4 of the Act 103, as amended, that created the PRHFA establishes that the Board of Directors of the PRHFA shall be comprised of seven members all of whom shall be appointed by the Governor of Puerto Rico. The Board shall be constituted by the following members: the Secretary of the Department of Housing, the Chairperson of the Board of Directors of GDB, three additional members of the Board of Directors of GDB, and two members from the private sector.

The Authority is in apparent violation to Article 4 of the Act 103 as the Board was comprised by not more than six members during the whole calendar year 2009. As of examination date, the Board has only four members so there are three vacant.

It is especially important that the Authority have the benefit of the advice and direction of people appointed to fill such vacant.

Management's response: At the close of the examination process, the Board is duly composed.

ASSET QUALITY		ADVERSELY CLASSIFIED			
		Substandard	Doubtful	Loss	Total
Loans		65,972	1,253	9,571	76,796
Securities		13,582			13,582
Other Real Estate Owned		2,162		7,027	9,189
Other Assets		58		511	569
Other Transfer Risk					
Subtotal		81,774	1,253	17,109	100,136
Contingent Liabilities					
Totals at Exam Date	12/31/2009	81,774	1,253	17,109	100,136
Totals at Prior Exam	N/A				
Totals at Prior Exam	N/A				

	Exam Date 12/31/2009	Prior Exam N/A	Prior Exam N/A
Total Special Mention			
Adversely Classified Items Coverage Ratio	15.81		
Total Adversely Classified Assets/Total Assets	6.03		
Past Due and Nonaccrual Loans/Gross Loans	42.40		
Adversely Classified Loans/Total Loans	34.54		
ALLL/Total Loans	9.45		

CAPITAL	Period Ended 12/31/2009	PR Average 12/31/2009	Period Ended 6/30/2009	Period Ended 6/30/2008
Total Equity/Average Assets	33.93	7.34	32.28	32.50
Retained Earnings/Average Total Equity	49.96	(11.07)	44.50	45.76
Asset Growth Rate	(10.15)	(4.21)	(10.48)	6.94
Cash Dividends/Net Income	N/A	(1.49)	N/A	N/A

EARNINGS	Period Ended 12/31/2009	PR Average 12/31/2009	Period Ended 6/30/2009	Period Ended 6/30/2008
Net Income/Average Assets	.37	(.77)	(1.22)	.52
Net Interest Income/Average Earning Assets	.70	2.64	1.27	2.00
Total Noninterest Expense/Average Assets	5.67	2.38	10.61	8.73

LIQUIDITY	Period Ended 12/31/2009	PR Average 12/31/2009	Period Ended 6/30/2009	Period Ended 6/30/2008
Liquidity Ratio	206.10	47.77		
Net Loans/Assets	12.12	64.97	11.08	10.09

Footnotes:
In the future, the Authority might adopt the computation of risk-based key ratios to measure its capital adequacy level. Reference is made from the Prompt Corrective Action (PCA) provisions of Part 325 of the FDIC Rules and Regulations even though they do not apply to the Authority.

	12/31/2009	6/30/2009
ASSETS		
Total Loans	222,340	225,765
Less: Allowance for Loan Losses	21,012	21,012
Loans (net)	201,328	204,753
Interest-Bearing Balances	538,446	545,053
Securities: Held-to-Maturity (at Amortized Cost)	878,096	1,053,359
Available-for-Sale (at Fair Value)		
Total Earning Assets	**1,617,870**	**1,803,165**
Premises and Fixed Assets	12,757	13,039
Other Real Estate Owned	2,757	4,247
Other Assets	27,323	27,918
TOTAL ASSETS	**1,660,707**	**1,848,369**
LIABILITIES		
Other Liabilities	134,244	143,942
Subordinated Notes and Debentures	914,036	1,098,592
Total Liabilities	**1,048,280**	**1,242,534**
NET ASSETS		
Invested in Capital Assets	3,877	4,159
Restricted for:		
Debt Service		31,311
Affordable Housing Program	241,333	235,256
Mortgage Loan Insurance	60,620	58,852
Unrestricted	306,597	276,257
Total Net Assets	**612,427**	**605,835**
TOTAL LIABILITIES AND NET ASSETS	**1,660,707**	**1,848,369**
OFF-BALANCE SHEET ITEMS		
Unused Commitments	22,239	33,125
Letters of Credit		
Other Off-Balance Sheet Items	3,030	
Other Derivative Contracts		
Appreciation (Depreciation) in Held-to-Maturity Securities	374,955	

Footnotes:

Date: 12/31/2009

Category	Amount	Percent
Single-family Loans	97,772	43.97
Multi-family Loans	119,060	53.55
All Other Loans	5,508	2.48
Gross Loans	222,340	100.00

PAST DUE AND NONACCRUAL LOANS

Category	Past Due 30 through 89 Days and Accruing	Past Due 90 Days or More and Accruing	Total Past Due and Accruing	Percent of Category	Nonaccrual	Nonaccrual Percent of Category
Single-family Loans	22,676		22,676	23.19	33,565	34.33
Multi-family Loans	8,177		8,177	6.87	29,853	25.07
All Other Loans						
Totals	30,853		30,853	13.88	63,418	28.52
Memorandum						
Restructured Loans Included in the Above Totals	1,256		1,256	4.07	2,966	4.68

Footnotes:
Restructured single-family loans that are not past due and accruing amounted $386M.

Recapitulation of Securities

Description	RESTRICTED		UNRESTRICTED	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. Treasury Securities				
U.S. Government Agency Obligations	44,755	44,755		
Issued by States & Political Subdivisions				
Mortgage-backed Securities (MBS) Pass-through Securities: Guaranteed by GNMA Issued by FNMA and FHLMC Other pass-through securities Other MBS (include CMOs & REMICs): Issued or Gtd. by FNMA, FHLMC, or GNMA Collateralized by MBS Issued or Gtd. by FNMA, FHLMC, or GNMA All Other Mortgage-Backed Securities	528,584	524,236	812	775
Asset-backed Securities (ABS) Credit Card Receivables Home Equity Lines Automobile Loans Other Consumer Loans Commercial and Industrial Loans Other				
Other Debt Securities Other Domestic Debt Securities Foreign Debt Securities	286,316	665,656	17,629	17,629
Equity Securities Investments in Mutual Funds and Other Equity Securities with Readily Determinable Fair Values				
Totals	859,655	1,234,647	18,441	18,404

SECURITIES APPRECIATION (DEPRECIATION)

Description	Restricted	Unrestricted	Total
Securities Appreciation (Depreciation)	374,992	(37)	374,955
As a Percent of Amortized Cost	43.62%	(.20%)	43.42%

Footnotes:

Items Subject to Adverse Classification	PRHFA

Includes assets and off-balance sheet items which are detailed in the following categories:
Substandard Assets - A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
Doubtful Assets - An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
Loss Assets - An asset classified Loss is considered uncollectible and of such little value that continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY		
	Substandard	Doubtful	Loss
LOANS			
732 SOCIAL HOUSING CORP. (Project: Quintas de Santa Elena)			732
6,027 LOS CLAVELES I	5,492		535
3,863 5,631 9,494 LOS CLAVELES II	5,319		4,175
8,651 ARMANDO TROCHE & ASSOC., INC. (Project: Palomino Hills)	8,651		
2,297 MUNICIPIO DE JAYUYA (Project: Altos de Río)	2,297		
1,000 PERLA DEL SUR PARTNERSHIP (Project: Ponce Darlington)			1,000
1,253 JARDINES DE CIALES		1,253	
7,690 JUAN C. ALBORS LAHONGRAIS (Project: Lomas de Santa Marta, Jardín del Atlántico, and Parque de San Juan)	7,690		
39,652 RESIDENTIAL MORTGAGE LOANS (Serviced by Banco Popular de Puerto Rico and Doral Bank)	36,523		3,129
Total Adversely Classified Loans	65,972	1,253	9,571

AMOUNT, DESCRIPTION AND COMMENTS	CATEGORY		
	Substandard	Doubtful	Loss
SECURITIES			
8,000 POPULAR, INC. Guaranteed Investment Contract (Acct. 750001026)	8,000		
5,582 POPULAR, INC. Guaranteed Investment Contract (Acct. 750002024)	5,582		
Total Adversely Classified Securities	13,582		
OTHER REAL ESTATE OWNED			
9,189 51 Foreclosed Properties	2,162		7,027
Total Adversely Classified Other Real Estate Owned	2,162		7,027
OTHER ASSETS			
569 Accounts Receivable	58		511
Total Adversely Classified Other Assets	58		511

Comparative Statements of Income and Changes in Equity Capital Accounts

PRHFA

	12/31/2009	6/30/2009	6/30/2008
INTEREST INCOME:			
Interest and fee income on loans	6,339	13,336	12,130
Income from lease financing			
Interest on balances with depository institutions	13,074	27,239	33,180
Income on Federal funds sold and repos			
Interest from assets held in trading accounts			
Interest and dividends on securities	25,551	53,643	63,223
Other Interest Income			
TOTAL INTEREST INCOME	44,964	94,218	108,533
INTEREST EXPENSE:			
Interest on deposits			
Expense on Federal funds purchased and repos			
Interest on demand notes, other borrowed money, mortgages, and capitalized leases			
Interest on subordinated notes and debentures	32,746	71,146	71,027
TOTAL INTEREST EXPENSE	32,746	71,146	71,027
NET INTEREST INCOME	12,218	23,072	37,506
NONINTEREST INCOME:			
Services charges on deposit accounts			
All other noninterest income	91,221	138,802	143,917
TOTAL NONINTEREST INCOME	91,221	138,802	143,917
NONINTEREST EXPENSE:			
Salaries and employee benefits	5,403	10,668	12,919
Premises and fixed assets expense (net of rental income)	661	1,031	689
Amortization expense of intangible assets (including goodwill)			
Other noninterest expense	96,296	187,358	155,251
TOTAL NONINTEREST EXPENSE	102,360	199,057	168,859
Provision (credit) for loan and lease losses		(540)	1,770
Securities gains (losses)	5,512	13,719	(695)
NET OPERATING INCOME (PRETAX)	6,591	(22,924)	10,099
Applicable income taxes			
NET OPERATING INCOME (AFTER TAX)	6,591	(22,924)	10,099
Extraordinary credits (charges) net of income tax			
NET INCOME (LOSS)	6,591	(22,924)	10,099
Early Retirement Program			8,837
Other increases in equity capital accounts	68,698	61,277	105,489
Other decreases in equity capital accounts	68,698	61,277	105,489
Cash dividends declared on common stock			
Net change in equity capital accounts for the period	6,591	(22,924)	1,262
Equity capital accounts at beginning of the period	605,835	628,759	627,497
Equity capital accounts at end of the period	612,426	605,835	628,759

Footnotes:

Residential Mortgage Loans

Private financial institutions in Puerto Rico licensed by OCFI to carry out mortgage business are subject to the legal requirements set forth in Act 97, known as Mortgage Institutions Act, as amended. In view that the Authority is a governmental unit not subject to Act 97, the following deficiencies are treated as internal routine and controls instead of violations of laws and regulations. Therefore, the Authority should deem them as standard procedures of the Puerto Rico mortgage industry. The detail of the cases subject to criticism was left with management on a meeting held on April 22, 2010.

A. Amounts withheld unduly during the closing of the loan

Article 7a.(5) of Act 97 states that no dealer may unduly withhold any sum of money and/or document related with a transaction or not informing the client's right or about any sum of money and/or documents part of a transaction.

A review of 15 residential mortgage loans sampled reflected that in three cases or 20% the Authority billed excessive charges amounting $103 for mortgage stamps, title insurance, and financial intermediary costs, among other. The Authority is expected to return the corresponding amount to borrowers in a reasonable period of time.

B. Unavailable documents for examination

Article 8.(a) of the aforementioned Act 97 states that concessioners of mortgage loans to finance or refinance the acquisition of real estate property shall make available to the Commissioner the accounting books, records, documents and any other data necessary for inspection.

A review of 15 residential mortgage loans sampled reflected the lack of the following documents in 11 cases: hazard insurance, title insurance, paid-off letter, and minute's presentation of mortgage cancellation, among other.

C. Supplementary documents not delivered to the borrower

Article 10.D.7 of the Regulation 5337, known as Mortgage Institutions Regulation, states that if the payment is to settle a mortgage whose creditor or servicer is a person different from that receiving it, the receipt should include a confirmation as to the pertinent procedures to cancel the mortgage promptly. Article 10.D.8 of said Regulation states that the receipt should be accompany by a notice to the borrower or to the person that performed or to who was retained the payment, notifying his\her right to obtain the receipt of the mortgage pay-off balance from the creditor or servicer in a 30 days' deadline.

A sample of files reviewed reflected that three cases where money was retained to settle the mortgage, the Authority did not deliver the client a confirmation on the procedures to cancel the mortgage. It did not deliver also a notice to the mortgagor notifying him\her the right to obtain the mortgage balance receipt from the administrator in a 30 days' deadline from the date in which the payment was received.

Residential Mortgage Loans Policy

Part III of the residential mortgage loans policy states that cases to be considered by the Authority should have a credit scoring not smaller than 650. It was found that loan 83752-07 out of 15 cases sampled have a credit scoring of 562. Management is strongly encouraged to enforce its policy while the real estate market remains depressed.

Vacation Policy

The Authority's vacation policy requires employees to be absent from their normal duties for an uninterrupted period of two weeks each calendar year. During calendar year 2009, 17 employees did not remain absent during two-week vacation which included various employees dealing with sensitive transactions. Management is strongly encouraged to enforce its policy, particularly for employees who are responsible for sensitive transactions.

Reconcilement of Correspondent Bank Accounts

Due from bank reconcilements for December 2009 were examined to ensure statement balances reconcile with general ledger, are performed at least monthly and approved by supervisory personnel. The review reflected that 82 checks were outstanding and has not been canceled even though expired over six months. The identified checks range from $1 to $1,500 with an aggregate amount of $7,144 for which a copy was provided and signed-off by the Accounting Manager. It should be pointed out that all checks include a warning that the same won't be valid after six months of issuance.

Management's response: The Accounting and Pre-Audit Supervisor accepted the above deficiency and proceeded to cancel the aforementioned checks during the examination process.

Administration of Other Real Estate

A. Properties with old appraisals

Although not approved by the Board, the written Methodology to Value Foreclosed Assets from Single–Family Loans requires recent appraisals (i.e., 18 months or less) to value said assets. As of examination date, there are 25 properties with appraisals that are older than 18 months. As stated before, this situation raises uncertainty on the validity of the balances reported in the general ledger.

B. Old properties retained as bankable assets

The aforementioned Methodology states also that *"Upon passing from 5 years, the assets executed should be charged-off in their totality"*. As of examination date, the Authority owns nine properties with a book value of $6.8 million that are older than 5 years. A Loss classification is extended to this full amount.

The Board is encouraged to approve an ORE Policy that addresses the above deficiencies and enforces compliance with it.

We the undersigned directors of Puerto Rico Housing Finance Authority, San Juan, Puerto Rico, have personally reviewed the contents of the Report of Examination dated December 31, 2009.

Signatures of Directors	Date
Ana C. Alemañy	
Carlos M. García	
Manuel H. Dubón	
Yesef Y. Cordero	
Vacant	
Vacant	
Vacant	

NOTE: This form should remain attached to the Report of Examination and be retained in the institution's file for review during subsequent examinations.