



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Leslye Krutko

SUBJECT: SEE BELOW

DATE: February 11, 2008

Approved

Christine J. Shippie

Date

2-21-08

COUNCIL DISTRICT: City-Wide

SNI AREA: N/A

**SUBJECT: INCREASE IN THE PERCENTAGE OF LAND ACQUISITION COSTS
THAT CAN BE FUNDED BY CITY LOANS**

RECOMMENDATION

It is recommended that the City Council adopt a resolution approving an increase from 50% to 100% of land price that can be funded under the City's property acquisition loan program for affordable housing projects that receive a funding commitment from the City Council.

OUTCOME

Approval of the recommended action will make it easier and less costly for affordable housing developers to do business in San José, thereby contributing to meeting the City's affordable housing production goals.

BACKGROUND

On December 12, 2006, the City Council approved a new property acquisition loan program for affordable rental housing projects that receive a funding commitment from the City Council. Prior to that time, City funding for land acquisition or any other purpose was withheld until all other financing for a project had been secured, which could easily be 12 months or more after the City's funding commitment. Under the new program, the City's funding for land acquisition could be released prior to the project sponsor securing all other construction financing.

The Housing Department recommended in its 2006 report to the City Council that the City should fund only 50% of the land acquisition price to reduce the City's risk exposure in such transactions. For reasons spelled out in the Analysis section below, the Department now believes that other factors should take precedence and that the City should fund up to 100% of the land acquisition price.

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ANALYSIS

Since adoption of the property acquisition loan program in late 2006, the City Council has approved funding commitments for four affordable housing projects. For each of these projects, the sponsor asked for and received approval for a loan for 50% of the land acquisition price.

The record to date clearly indicates that the land acquisition loan product is a popular one. What is not reflected is the fact that the City's funding of only a part of the acquisition cost entails hidden costs and problems which are enumerated below.

First, whenever multiple sources are financing an affordable housing transaction, each of those sources reviews the draft loan documents prepared by all the other lenders and, in many cases, wants alterations to satisfy its own legal counsel. In the case of a 50% land acquisition loan, this means that staff from the Housing Department and City Attorney's Office are involved in the document review and alteration process as well as the other lender's underwriting staff and legal counsel and the sponsor and its legal counsel. This kind of back-and-forth negotiation is time-consuming, both because closing on the land acquisition transaction can be delayed and because finite staff resources are consumed. If the City is the sole lender in the land acquisition transaction, the City's standard-form documents can be made available much sooner and any issues resolved much earlier in the process, and less time spent by the developer's attorney on multiple sets of legal documents will contribute to lower project costs.

Secondly, City loans are always in a subordinate position to loans from commercial lenders. Subordinate lenders are constrained in their ability to enforce their terms in the event that there is a potential or real default situation, and in many cases may enforce only if the senior lender(s) is paid off. If the City is the sole lender in the land acquisition transaction, its ability to enforce loan terms and conditions in a timely fashion is greatly strengthened. In the case of foreclosure, the City would take back the property, which would facilitate the production of affordable housing on that site.

Third, loans made under the City's affordable housing program typically carry simple (as opposed to compounding) interest, and are at lower interest rates than available from other sources. The extent to which the City's land acquisition loan program effectively requires project sponsors to use commercial borrowing rates during the predevelopment phase makes carrying costs and, in the end, overall project costs higher.

Thus, the proposal to fund 100% of land acquisition costs will reduce time and administrative costs for both City staff and project sponsors, will give the City improved loan management control, and will reduce developers' carrying costs. For these reasons, the Housing Department recommends that the maximum amount of land acquisition loans be increased to 100% of land cost. Additionally, there is also some urgency in dealing with this issue since developers are facing a tighter credit market in the aftermath of the subprime mortgage crisis.

In this context, it should be noted that the City's total funding for affordable rental housing typically exceeds land cost alone. Therefore, the increase in the size of acquisition loans from 50% to 100% of land cost simply involves an earlier expenditure of a portion of the City's funding commitment, not an increase in amount of the ultimate City subsidy for a project.

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Other than the proposed increase in the amount of the loan, the Land Acquisition Loan Program's requirements that land values be validated by appraisal and that there be no relocation issues involved will stay in place.

In the interests of equity, the Department also recommends that this increase be made available to sponsors for whom 50% acquisition loans have been approved over the past 14 months.

EVALUATION AND FOLLOW-UP

The City Council approves each individual land acquisition loan under the recommended policy change.

POLICY ALTERNATIVES

Alternative # 1: Do not increase the current limitation on land acquisition loans from 50% to 100% of land cost.

Pros: Delaying the funding for the other 50% of a project's land acquisition cost will marginally improve the Housing Department's short-term cash flow position and will put less City funds at risk.

Cons: Requiring developers to finance 50% of land acquisition costs will increase their carrying costs and, ultimately, the cost of delivering affordable housing units.

Reason for not recommending: Increasing the amount of land acquisition loans to 100% of land cost will facilitate affordable housing production and is responsive to stakeholder needs.

PUBLIC OUTREACH/INTEREST

- Criterion 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

On February 6, 2008, the Housing Department sent an electronic mail notification to Department's list affordable housing developers and other interested parties of the Department's intent to recommend an increase in the amount of land acquisition loans to 100% of land cost.

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The response has been largely favorable. At an off-site meeting between the Housing Department and four developers on February 8, 2008, the developers endorsed the Department's proposal. Additionally, this report will be posted on the City Council agenda website for the March 4, 2008 meeting.

COORDINATION

Preparation of this report was coordinated with the City Attorney's Office.

FISCAL/POLICY ALIGNMENT

Approval of the recommended increase in land acquisition loans is intended to spur the production of affordable housing to meet the production goals set forth in the *2007-2012 Five-Year Housing Investment Plan*.

CEQA

CEQA: Not a Project. Each affordable housing development for which a land acquisition loan is made will have received environmental review in the land use entitlement process prior to funding commitment and approval of a land acquisition loan.



LESLYE KRUTKO
Director of Housing

For questions please contact Jacky Morales-Ferrand, Assistant Director of Housing,
at 408-535-3855