COUNCIL AGENDA: 9-14-04
ITEM: 4.3

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Leslye Corsiglia

SUBJECT: **SUBSTANTIAL REHABILITATION LOAN REVISIONS**

DATE: August 25, 2004

Approved Kay Winer

Date 9/1/04

COUNCIL DISTRICT: Citywide

RECOMMENDATION

It is recommended that the affordability requirements for substantial rehabilitation loans made by the City of San Jose Housing Department be revised as follows:

1) It is recommended that, if agreed upon by the borrower, after five years of the loan term, the affordability requirements for substantial rehabilitation loans currently in the Housing Department's portfolio be revised as follows:
    a. Cap the amount of equity share borrowers pay to the City at 50% of the gain in equity in the property.
    b. For the term of the affordability restriction, annually reduce the share of the equity increase borrowers must pay the City proportional to the length of the affordability restriction.
    c. Upon the sale of a home to an income-ineligible buyer, borrowers, at a minimum, must pay the City the loan principal plus 3% simple interest.
    d. The revisions will not impact borrowers who sell their home to an income-eligible household.
    e. The revisions will not impact borrowers who sell their home before five years of the loan term.
2) It is recommended that, after five years of the loan term, the above revised affordability restrictions be applied to substantial rehabilitation loans the Housing Department makes in the future.

BACKGROUND

As required by State law, redevelopment agencies must set aside at least 20% of the funds received from tax increment in redevelopment project areas for affordable housing purposes. To ensure that the "20% Funds," as they are called, continue to be used for affordable housing, California law requires that affordability restrictions be placed on properties that receive funding for substantial rehabilitation activities for a specified number of years. The affordability restriction requires that a borrower that wishes to sell their property prior to the expiration of the restriction must sell the property to moderate- or lower-income residents at an "affordable" price. These requirements were put into effect to ensure that borrowers did not unfairly benefit from the government financing (i.e., did not receive a loan to rehabilitate their home, and then shortly thereafter sell the improved home and realize a large gain) and that a moderate- or lower-income family would benefit in the future.

California law provides that local agencies administering the 20% Funds may allow units subject to an affordability restriction to be sold at market value if the agency adopts a program to protect the funds for affordable housing. This is referred to as a "buy-out" provision because the borrower pays the agency a fee in addition to the regular loan repayment requirements, to remove the affordability restriction from the property. The additional fee the agency receives can be used to compensate the agency for the loss of the affordable unit and to help make another affordable unit available to another moderate- or low-income household.

Around the nation, as localities have created programs to assist lower- and moderate-income households with rehabilitation loans and homebuyer assistance, public lenders have established "equity share" provisions to help ensure that new buyers receive the economic benefits of homeownership without reaping disproportionate windfalls. Typically, these equity share provisions provide that any equity realized over time be shared proportionally between the buyer and the public lender.

In February 1993, the City of San Jose adopted an equity share mechanism that, for rehabilitation loans, provides the City a share of equity gain that is equal to the proportion of its loan to the after-rehabilitation value of the property. Under this mechanism, the borrower and the City share in the gain based on their contribution to the value of the property. If there is no increase, or in the case of a decrease in equity, the City does not receive an equity-share payment and there is no cost to buy-out of the affordability restriction.

In summary, due to State law requirements, the City requires that borrowers either (1) sell to an income-eligible household under the terms of the affordability restriction, or (2) sell at a market rate price with the restriction removed, but the City must share in the equity realized by the sale. These proceeds are then used to replace the restricted unit that was lost.

ANALYSIS

In its portfolio, the Housing Department has approximately forty substantial rehabilitation loans executed over the last fifteen years. Over the last decade, the City of San Jose has seen an unprecedented increase in property values that was unanticipated at the time that the original equity share policy was established. As a result, many of the borrowers of the substantial rehabilitation loans who buy-out of the affordability restriction under the equity share provision would be required to pay significant amounts to the City when compared to the amount they borrowed.

The Housing Department has reviewed the equity share program, and is recommending changes that ensure that the 20% Housing Funds are protected as required by State law, while providing a reasonable return to the borrower. The revisions will not impact borrowers who sell their homes to income-eligible borrowers. It is recommended that, if agreed upon by the borrower, the affordability requirements for substantial rehabilitation loans currently in the Housing Department's portfolio be revised as follows:

1) **Revisions come into effect after five years of the loan term:** In order to ensure neighborhood stability, and to provide incentives for owners to remain in their homes for a minimum period, it is recommended that the proposed revisions apply only to those loans older than five years. If the borrower sells their home before five years of the loan term, the original loan terms remain in effect.

2) **Cap the amount of equity share the borrower pays to the City at 50%:** In instances of severe degradation, some residents have had to borrow amounts from the City that consist of over 50% of the after-rehabilitated value of the home. As a result, in the City's portfolio there are a number of substantial rehabilitation loans that require the borrower to pay the City more than 50% of the increase in equity in their home. In its first-time homebuyers program, the City follows the Federal Housing Administration's guidelines to restrict a second mortgage lender's equity share to a maximum of 50%. To be consistent with the first-time homebuyers program, it is recommended that the City's equity share for substantial rehabilitation loans also be capped at 50%.

3) **For the term of the affordability restriction, annually reduce the proportion of the equity increase borrowers must pay the City:** Under the current substantial rehabilitation guidelines, for the length of the affordability restriction, borrowers must pay the City the same proportion of the increase in equity regardless of the amount of years they have stayed in the home. With property values increasing over time, this requirement results in borrowers paying the City larger amounts the longer they remain in the home.

   It is recommended that the proportion of the equity share a borrower must pay the City be annually reduced, proportional to the length of the affordability restriction. For example, if a loan has a thirty-year affordability restriction, every year the borrower stays in their home the equity share will be reduced by $1/30^{th}$. If the borrower sells their home to an income ineligible household after 10 years, the amount of equity share they must pay the City will be reduced by 1/3. If they stay in the home for the full period of the affordability restriction, the equity share requirement is removed. By annually reducing the proportion of the equity increase the borrower pays to the City, the new guidelines reward households who remain in their rehabilitated homes longer.

4) **At sale of the home to an income-ineligible buyer, borrowers, at a minimum, must pay the City the loan principal plus 3% simple interest:** If the required equity share payment is less than 3% simple interest on the loan principle, the borrower must provide the City a payment equal to the interest. The required 3% simple interest payment on top of the loan principal provides funding for future inflation and housing price increases to ensure that the 20% fund can continue to provide affordable housing.

Example:

The following example illustrates how the current and recommended affordability requirements impact the distribution of proceeds from the sale of homes that have been substantially rehabilitated using the City's 20% Housing Funds:

In 1994, a resident borrowed $124,488 to make substantial repairs to her home. The City's loan represented 64% of the after-rehabilitation value of the home. The loan was deferred for 30 years, carried a 3% simple interest rate and had a 30-year affordability restriction at the moderate- or low-income level.

1994 – Loan Conditions	
Loan Principal (City Loan)	$124,488
After-Rehabilitation Value	$195,000
City's Share of Equity (Loan Principal/After-Rehab Value)	64%
Interest Rate	3% simple interest

The borrower sold her home for $510,000 to a household with an income higher than was eligible under the affordability restriction. After all sales and transaction fees and the City loan were taken out, the net equity increase on the property was $280,262. The City was paid 64% of the equity, or $179,369. In addition, the City was repaid its loan amount plus 3% simple interest. In total, the City received $345,334 in repayment for the loan and the borrower received the remaining $129,929 to pay off any existing home loans and contribute to future housing costs.

2004 – Home Sold (Current Requirements)	
Sales Price (income-ineligible borrower)	$510,000
Net Equity Increase in Property (less city loan and sales and transaction costs)	$280,262
City's Share of Equity Increase (64%)	$179,369
3% Simple Interest (10 years)	$41,478
City Loan	$124,488
Total Amount Paid to City (principal)	$345,334
Borrower's Profit	$129,929

If the borrower had sold her home to a moderate-income family of four, after paying the City and all sales and transaction fees, the borrower would have received $114,298, $15,631 less than if she had sold her home at market rate.

Under the recommended new guidelines, in addition to the loan principal, the borrower in the example above would pay the City at least 3% simple interest, but no more than 50% of the increase in equity. The borrower's loan was ten years old and had a 30-year affordability restriction, resulting in a 1/3 reduction in the equity share paid to the City, or a payment of 42.7% of the equity increase. Therefore, the City would receive the reduced equity share plus the loan principal, for a total payment of $244,160. The borrower would receive the remaining $231,103, $101,175 more than under her original loan conditions.

2004 Home Sold – Proposed Requirements	
Sales Price (income-ineligible borrower)	$510,000
Net Equity Increase in Property (less city loan and sales and transaction costs)	$280,262
Reduced City Equity Share (10/30 * 64%)	42.7%
City's Share of Equity Increase (42.7%)	$119,672
Total Amount Paid to City (principal + Equity Share)	$244,103
Borrower's Profit	$231,103

Due to reductions in funding, in the near future it is unlikely that the Housing Department will make very many, if any, substantial rehabilitation loans. The substantial rehabilitation loans that the Housing Department does make will be for emergency health and safety repairs. For those substantial rehabilitation loans that are made in the future, it is recommended that after five years of the loan term, the revised affordability requirements be applied as follows:

- Cap the amount of equity share the borrower pays to the City at 50%.
- For the term of the affordability restriction, annually reduce the proportion of the equity increase borrowers must pay the City.
- For loans that have an equity share provision, require the borrower to pay the City at a minimum, the original loan amount plus 3% simple interest.

These revisions will not impact borrowers who sell their homes to income-eligible borrowers.

SUMMARY

Under the new guidelines, borrowers who have substantial rehabilitation loans for longer than five years will not be required to pay the City more than 50% of the increase in equity plus the actual loan amount (principal). Because upon the sale of their home to an income-ineligible buyer, borrowers must pay the City at least 3% simple interest on their loan in addition to repaying their principal, there will be a sufficient return on the 20% funds to make another unit affordable to a moderate- or low-income household. At the same time, the borrower or their heir will be able to enjoy the increase in value of their home, without reaping disproportionate rewards.

PUBLIC OUTREACH

Not applicable

COORDINATION

This memorandum has been coordinated with the Office of the City Attorney.

CEQA

Not a project.

FISCAL IMPACT

It is likely that the recommendations will result in a financial loss to the City from decreased interest and equity share payments as compared to the original conditions on the loan documents. However, the true fiscal impact of the recommendations is unclear due to the inability to predict future housing values and when the borrowers will actually sell their homes.

LESLYE CORSIGLIA for
Director of Housing