



# Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Leslye Krutko

**SUBJECT:** SEE BELOW

**DATE:** November 20, 2006

Approved

*Kay Wener*

Date

*11/25/06*

**COUNCIL DISTRICT:** Citywide  
**SNI AREA:** All

**SUBJECT: LAND ACQUISITION LOANS FOR AFFORDABLE HOUSING PROJECTS**

## RECOMMENDATION

It is recommended that the City Council adopt a resolution:

1. Approving a property acquisition loan program for affordable housing projects that have received a funding commitment from the City Council; and
2. Authorizing the Director of Housing to establish specific terms for such loans and implement the program.

## OUTCOME

The recommended land acquisition loan program will assist affordable housing developers secure options to purchase property and reduce project costs by lowering carrying costs.

## BACKGROUND

In February 2004, the City Council approved a project-selection system – including threshold criteria and weighted scoring – upon which to base funding-commitment recommendations for affordable housing development projects. Since then, the City Council has made certain adjustments to the project-selection system, primarily regarding what types of projects are eligible for funding.

The project-selection system – more commonly known as the Notice of Funding Availability (NOFA) process – provides that a commitment of City construction/permanent funding can be approved by the City Council as soon as a PD rezoning has been approved. However, disbursement of City funds is withheld until the project sponsor has secured commitments for all the other sources of funding necessary to construct the project, a process that can take up to 12 months or more.

Affordable housing developers have requested that the City consider making available funding to assist them to purchase property prior to securing commitments from all project funding sources in order to make affordable housing developers more competitive with developers of market-rate projects in securing option agreements and therefore reduce project costs.

### ANALYSIS

The expenditure of funding for an affordable housing project requires that an affordability restriction be recorded on title of the development site. State law makes it extremely difficult to remove such a restriction, so that, for all practical purposes, once the restriction is recorded, the City is committed to the project.

Prior to 2004, acquisition/predevelopment loans for projects were funded shortly after the City Council had approved the funding commitment, prior to other sources of construction/permanent financing being committed. In a number of situations, the developer was subsequently unable to obtain the level of outside funding originally contemplated, and the City was forced to increase the level of its funding commitment to fill the gap or the project was delayed by months or years. Another possible outcome of a failed project is that the City would have to take the property back, which would then entail long delays in finding a substitute developer through a Request for Proposals process. The current policy of withholding the disbursement of the City's funding commitment until all funding sources for a project are committed was intended to avoid such situations.

However, this policy has had unintended consequences. Because developers are currently unable to access City funds for land acquisition until they have secured their land-use entitlement (approximately 12 months to secure PD rezoning approval) and commitments from all funding sources (another 12± months), they must obtain option agreements from the seller of the land for periods of at least two years. In San Jose's competitive land market, developers have found it difficult to negotiate such a long option period and, if they can, the land price is more costly because of the long option period. As a result, developers have been bringing forward fewer development proposals to the City, reducing the production of affordable housing.

For this reason, providing acquisition funding earlier in the predevelopment phase of a project would make affordable housing developers more competitive in securing site control of land for future projects.

The recommended land acquisition loan program will comply with established City lending policies, namely:

- The acquisition price must be supported by an independent appraisal that concludes that the value of the property is equal to or greater than the contracted purchase price, ensuring that the City is not overpaying for land. If the contracted land cost is less than appraised value, the City will not pay the higher appraised value because the difference is an unnecessary project cost.

- The purchase price must be established by a written contract or agreement between unrelated buyer and seller and must be an “arms-length” transaction. Any transactions contemplated between parties related to the buyer that increase the price stated in the underlying contract or agreement between unrelated buyer and seller is not considered a valid contract or agreement for the purpose of establishing the purchase price of the land, nor the amount of City funding available for such purpose.
- Brokers’ fees or “finders’ fees” over and above the contract sales price are not allowed expenses to be financed by a City loan. Such fees are the responsibility of the seller, to be paid for out of sales proceeds.

To limit the City’s financial risk in making such loans, the Housing Department recommends that:

- Land acquisition loans made prior to the developers’ securing all funding commitments be limited to 50% of the acquisition price; the other 50% of the acquisition price would need to come from another source, most likely a commercial lending institution.
- The relocation of any pre-existing residential or commercial tenants must have been accomplished in accordance with applicable State or federal law prior to the City’s disbursement of acquisition loan proceeds.

### POLICY ALTERNATIVES

In reaching the recommendation spelled out above, the following alternatives were also considered:

***Alternative #1: Continue to require that developers secure all funding commitments before disbursing City funds.***

**Pros:** Eliminates all risk that the City will disburse funds for a project that turns out to be not viable or can be made viable only with an increased City loan.

**Cons:** Affordable housing developers will continue to operate at a competitive disadvantage against market-rate developers in securing building sites. As a result: (a) fewer projects will be proposed to City, thereby impeding affordable housing production; and/or (b) project costs will be higher due to more expensive carrying costs.

**Reason for not recommending:** Affordable housing production will be negatively impacted if sponsors cannot secure development sites.

***Alternative #2: Fund 100% of land purchase price once a funding commitment has been approved by the City Council.***

**Pros:** Reduces the affordable housing developers’ carrying costs while seeking funding from other sources, which contributes to lower overall project costs.

**Cons:** Failing to require that developers leverage City funds will reduce the City’s ability

to simultaneously assist other prospective developments; funding 100% of land acquisition costs increases the risk to the City's loan; and funding the entire land acquisition cost at the City's favorable interest rates is a disincentive for developers to aggressively solve problems and obtain outside financing.

**Reason for not recommending:** This alternative does not adequately leverage City funds and increases the risk to the City.

***Alternative #3: Make land acquisition loans available prior to PD rezoning (or similar land use entitlement).***

**Pros:** This alternative would significantly shorten the term of the option that developers would need to negotiate with the seller, making land acquisition easier and possibly less expensive. It would also minimize the developers' carrying costs, which contributes to lower overall project costs.

**Cons:** City Council approval of funding for a project prior to the PD rezoning (or similar land-use entitlement) would have the appearance of making a land-use decision prior to the noticed public-hearing process required in connection with land use entitlements.

**Reason for not recommending:** This alternative would compromise the integrity of the noticed public hearing process for rezoning (or other required land use entitlement) for a development project.

It is the Housing Department's conclusion that the recommended action is superior to these three alternatives.

**PUBLIC OUTREACH**

- Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criteria 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)**
- Criteria 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)**

Terms of a proposed land acquisition loan program were reviewed with affordable housing developers at a Developers Roundtable on September 28, 2006. The approved version of this report will be e-mailed the Housing Department's list of developers and realtors when it becomes public on December 1, 2006.

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### **COORDINATION**

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

### **FISCAL/POLICY ALIGNMENT**

Removal of barriers that developers encounter promotes the production of affordable housing which, in turn, supports the City's economic development strategy.

### **CEQA**

Not a project. Projects qualifying for land acquisition loans will have received environmental clearance as a part of the Planned Development Zoning process.

  
LESEYE KRUTKO  
Director of Housing

For questions, please contact Leslye Krutko, Director of Housing, at 408-535-3851.