Good Neighbors
San Diego
Housing Commission

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REPORT

DATE: For the Agenda of October 12, 2001 **ITEM 108**

REPORT NO.: HCR01-106

SUBJECT: Determination of Housing Commission Priorities for the FY02 Rental Housing Loan Program (Citywide)

SUMMARY

Issue 1: Given that FY02 development funds have already been committed, what should the Housing Commission's lending strategy be for the balance of the fiscal year?

Recommendation No. 1: Maximize available resources by: 1) capitalizing on available "outside" funding sources such as tax credit allocation programs; 2) committing future fiscal year funds for permanent loans with a cap of one million dollars per project; 3) borrowing below market rate funds where feasible to take advantage of major opportunities.

Issue 2: What should priorities be for project selection?

Recommendation No. 2: Focus priorities for project selection as discussed in this Report.

Fiscal Impact: Making 75 percent of forecasted FY03 rental housing funds available for this NOFA could result in the commitment of approximately $3 million in HOME and HTF funding.

Affordable Housing Impact: Typically, proposals include a range of affordability levels with restricted rents affordable up to 60 percent of area median income (AMI). For some funding sources, the maximum affordability level is 50 percent of AMI.

Previous Related Action: At its meeting of February 5, 1999, the Commission approved a recommendation to open the then current Notice of Funding Availability (NOFA) for Rental Housing to all developers subject to availability of funds. On March 2, 2001, the Commission discussed the use of unrestricted funds in the FY02 budget and affirmed continuation of the NOFA process for solicitation of proposals for rental housing loans.

Future Related Actions: This Report will be docketed for discussion at the next available meetings of the Land Use and Housing Committee and the Housing Authority.

BACKGROUND

The Housing Commission solicits interest in loan funds for rental housing development through a Notice of Funding Availability (NOFA) process. This process was initiated to help affordable housing developers, who were finding that potential sellers would not hold properties off the market to wait for the Commission's twice yearly Request for Proposals. Under the NOFA process, a developer can approach the Commission for a funding commitment when a project is ready. The NOFA process has proven convenient and effective in providing funding opportunities for rental housing projects.

One of the major funding sources for affordable housing is the Low Income Housing Tax Credit (LIHTC) program, an indirect federal subsidy used to finance the construction and rehabilitation of affordable housing. LIHTC has two parts: the "Nine Percent" program, which provides equity in the form of a tax credit (allowed over 10 years) equivalent to approximately 70 percent of the development cost; and the "Four Percent" program which provides approximately 30 percent of cost but links with bond allocation to provide additional below market financing.

Historically, the Nine Percent program has been very popular and over-subscribed. Until this year, the most recent award of Nine Percent credits for a development project in the City of San Diego was in 1998 (Vista Verde, 43 units). However, this year five projects with Housing Commission loan commitments received allocations. Six additional projects received "Four Percent" allocations. Please see Attachment 1 for information regarding these developments.

DISCUSSION

Rental Housing NOFA funds are used to cover the difference (or "gap") between the debt that project rents can support and the cost of developing the project. Typically, the supportable debt is significantly less than the amount of funds needed to complete a project. The Commission's investment, usually in the form of a loan with a "soft" (residual receipts) debt service or repayment requirement, is commonly referred to as "gap funding."

In the past three years, the Commission has experienced an upsurge of rental housing finance activity and a shift to larger scale projects with opportunities for improved leverage through bond financing and tax credits. To capitalize on these opportunities, the Commission has committed almost $5.9 million to downtown housing and $15.6 million to housing in other areas for FY01-02.
The success of these projects has resulted in commitment of 100% of FY02 funds.

FY02 LENDING STRATEGY

To maximize available resources, San Diego Housing Commission staff proposes: support for projects utilizing Low Income Housing Tax Credits and tax-exempt multifamily revenue bonds; commitment of up to 75% of FY03 projected receipts for rental housing production; and pursuit of below-market funds available to the Housing Authority.

Two major sources of funding for affordable housing are Low Income Housing Tax Credits and tax-exempt multifamily revenue bonds. The application rounds for these two programs are typically in the spring and summer of each year. The inclusion of public subsidy as a funding source is critical to high scoring in these programs. Utilizing a forward commitment of approximately 75% of the FY03 projected receipts for rental housing production ($3 million) in a new Notice of Funding Availability would enable developers to demonstrate public subsidy and attract these (and other) funding sources.

Because these programs have extensive application and funding processes, permanent funding is commonly not needed for several months or even one year after the allocation is made. In addition, projects involving construction loans can take up to two years or more before permanent financing is needed. To avoid prematurely tying up Commission funds, staff recommends limiting NOFA funding to permanent financing.

To maximize the number of projects funded, staff recommends a temporary reduction in the maximum investment per project from $2 million to $1 million.

To increase resources, the Housing Commission can apply for funds under programs such as California's HELP program. Any application for funds would be presented to the Housing Commission for approval.

Potential Funding Sources

Three million dollars represents a small portion of funds available for projects in FY01 and FY02. There are several funding sources that, if dedicated, could provide additional funds, thereby making more funds available for the NOFA offering and subsequently produce additional affordable units. Examples of those sources include:

Documentary Transfer Tax. The documentary transfer tax is collected by the County of San Diego at a rate of $1.10 per $1000 of the property's value on every real estate transaction. The County returns 50% of the revenues to the City for transactions completed within the City. These funds go directly into the City's General Fund. The City's revenue from this source has been increasing due to increases in property values and in the number of transactions in recent years. A portion of the documentary transfer tax could be leveraged with other funds in the production of affordable housing.

CDBG funding of Affordable Housing. Council Policy 700-02 (CDBG Program) established a goal that 20 percent of the City's annual CDBG entitlement "be used for affordable housing purposes". This amount was intended to include operating funds for eligible Commission activities, programmatic allocations to the Commission, and allocations to nonprofits to carry out their housing activities. The percent of CDBG funds allocated for affordable housing activities for FY02 was 7.5%, in FY01, 11 % and in FY00, 14%. A higher allocation towards affordable housing activities, specifically, the allocation granted to the San Diego Housing Commission, would allow more resources to become available for the NOFA.

Redevelopment Area Set Aside Funds. State law dictates that twenty percent of redevelopment area funds be used for the funding of affordable housing. Any projects the Housing Commission is funding which are located within redevelopment areas within the City could instead be funded with the redevelopment area funds, where available, thereby freeing up the Housing Commission funds to serve other areas of the City. However, it should be noted that this action would result in no net gain in funds for housing.

PRIORITIES FOR PROJECT SELECTION

Under the current NOFA, project selection criteria include: the capacity of the proposed development team; the effectiveness of the financing plan; response to the City's housing priorities; timeline; costs; amenities and location.

In anticipation of increased competition for limited funds and higher costs per unit, staff recommends that these general criteria continue to be used. However, additional factors could include consideration of: 1) the nature of housing currently in development and relative need of various types of housing; 2) conditions and opportunities driven by federal, state, and local programs; 3) available funds and other resources; and 4) energy conservation.

1. Shortage of Family-Sized Units

At this time, the Commission's housing development pipeline includes over 1600 units, consisting of studios and one-bedroom units (44 percent), two-bedroom units (28 percent), and units with three or more bedrooms (28 percent). Staff recommends that the FY02 NOFA promote the development of family housing because there are more small units (studios and one-bedroom units) in the development pipeline and more of these units are also available in the City's existing housing inventory. This larger inventory of small units also avails itself to use as affordable housing through tenant-based rent subsidies that are currently available.

2(a). Preservation of Rental Restrictions

In the near future, several local properties currently under HUD-imposed rent restrictions will be eligible to opt out of HUD's programs and raise rents to market. These units are termed "at-risk." At this time, Housing Commission borrowers have 614 at-risk units in the acquisition/rehabilitation pipeline. Preservation of these units continues to be among the City's top housing priorities and thus should be reflected in project selection under the FY02 NOFA.

2(b). Inclusionary Housing Requirements

Housing developed in the northern sector of the City must comply with existing inclusionary housing requirements, whereby a minimum of fifteen percent of the units will be affordable at or below 65 percent of area median income. This requirement provides the Commission with a unique opportunity to purchase affordability below 65 percent AMI as a means of providing units at lower levels

of affordability in an area of the City were the scarcity of affordable housing is critical.

3(a). Leverage of Other Funding Resources

Given the level of funding for new projects, there are a number of factors to consider for achieving the best "leverage" of dollars to housing units produced.

The non-Commission funding in a project is referred to as "leverage" because it is considered return on the Commission's investment. High leverage minimizes the use of Commission funds, allowing the Commission to support a larger number of affordable housing projects.

Bond-financed projects achieve leverage through below market interest rates combined with "four percent" tax credit equity. Rent affordability is primarily at 60 percent AMI. The "nine percent" tax credit program, which does not involve bonds, provides a significantly greater equity contribution and better affordability (lower rents). However, the competition for "Nine Percent" allocations is greater.

3(b). Cost Factors

Cost per affordable unit is an additional factor for consideration. The Commission's cost per unit varies widely. New construction projects cost more than acquisition/rehabilitation projects, but they deliver additional housing inventory with a maximum useful life.

4. Energy Conservation

Energy conservation measures that surpass California Building Code energy efficiency standards ("Title 24 requirements") should be encouraged because supplies of resources (water, electricity, natural gas) are expected to be limited and costs are expected to rise. Efficient utilities systems can reduce operating costs substantially. A reduction in operating costs helps a project achieve economic stabilization.

<u>Summary and Plan of Action for FY02 NOFA</u>

At this time, approximately $3 million can be made available for future commitments for multifamily housing activities; no significant source of additional funding has been made available. Given the scarcity of resources, staff is recommending the following for the upcoming NOFA round: (1) that the maximum loan per project be established at $1.0 million; (2) that all financing

commitments be for permanent financing, to be disbursed in FY03 and beyond; and (3) that favorable ranking be awarded to "Nine Percent" tax credit projects because they provide the greatest leverage and affordability.

In addition, staff recommends that the following priorities be set for the FY02 Multifamily Housing NOFA:

A. Emphasize family-sized units;
B. Favor projects with inclusionary requirements or non-permanent affordability restrictions;
C. Require significant leverage of Commission funds with other funding sources; and
D. Encourage projects promoting energy conservation measures.

Staff would open the FY02 NOFA for projects applying under the first 2002 round of the Nine Percent Federal Low Income Housing Tax Credit program because that program provides the best leverage and affordability. Concurrently, projects with inclusionary requirements would be considered. Bond projects that do not have inclusionary requirements but need Commission financing would be considered after the Nine Percent tax credit program's first application round.

ALTERNATIVES

Commissioners could omit or change any of these recommendations.

Submitted by,

Signature on File
With Original Document

Pat Duplechan
Director, Housing Programs

Approved by,

Elizabeth C. Morris
Chief Executive Officer

Attachment: FY01-02 Multifamily Loan Commitment Report

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