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CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Leslye Krutko

SUBJECT: **IMPACT OF FINANCIAL MARKETS ON THE CITY'S AFFORDABLE HOUSING PROGRAM**

DATE: December 17, 2008

Approved

Date 12/18/08

INFORMATION

Over the past few months, the City Manager has provided informational updates to the City Council outlining the stress in the financial markets as well as direct impacts the market shifts have had to the City. This memorandum is a continuation of that discussion, focusing specifically on impacts to the Housing Department's affordable housing program.

The instability in the financial markets has caused two primary challenges for the City in the implementation of its Five Year Housing Investment Plan: (1) the ability of the Housing Department to secure short- and long-term debt; and (2) the ability of affordable housing developers to secure outside financing necessary for their projects to move forward. This memorandum describes these challenges in detail and outlines the actions the Housing Department is taking in response.

Securing Debt

In a similar fashion as the Redevelopment Agency, the City finances its affordable housing program by issuing debt, in the form of Tax Allocation Bonds (TABS), which is secured by the 20% Low and Moderate Income Housing Program tax increment. However, unlike the Redevelopment Agency, which funds capital projects that it can project over the course of several years, the City's housing program responds to applications from developers and cannot project what applications for funding it may receive over the course of time. As a result, the City uses a line of credit, which gives the City cash to provide to projects as they become known. Once completely drawn down, the line of credit is repaid by the TABs and then replenished.

Line of Credit – For the past nine years, the Housing Department has had a line of credit with the Bank of New York (BNY). BNY recently informed the City that it is no longer in the line of credit business, and thus the City's $50 million line of credit will not be renewed and will expire on April 1, 2009.

In response, the Housing Department, working together with the Finance Department and the City's Housing Financial Advisors, has developed a two-pronged strategy. First, the Housing Department will draw the entire $50 million prior to the April 1, 2009 deadline. This will provide the liquidity necessary to fund affordable housing projects previously committed to by the City Council as well as to fund critical pipeline projects. Pursuant to the terms of the agreement with the BNY, once the line of credit expires, the $50 million line will convert to a five-year loan with principal and interest payments due quarterly. Once a viable long-term source of debt is identified, this loan will be paid off. Second, we are working with our partners to identify a new short-term debt mechanism.

Letter of Credit – The Bank of New York also provides a letter of credit, which secures approximately $60 million for the Redevelopment Agency for City of San José Housing Set-Aside Tax Allocation Bonds Series 2005C and Series 2005D Bonds. The BNY has also notified the City that this letter of credit on the bonds will expire in April 2010. The City will seek to replace the letter of credit bank at that time with a new letter of credit provider.

Bond Issuance – Due to Federal tax guidelines, the Housing Department's TABs are issued on a taxable basis to raise capital for affordable housing projects. The size of the Housing Department's future affordable housing program is reliant on a continued ability to issue this type of debt at reasonably affordable interest rates. The recent instability in the financial markets has led to higher long-term interest rates in the municipal bond markets. The interest rates on tax-exempt TABs have sky-rocketed for those issuers fortunate enough to attract investors; there are virtually no investors for long-term taxable TABs at this time. Additionally, rating downgrades of all traditional bond insurers have effectively eliminated the availability of credit enhancement as a means of lowering the Housing Department's borrowing costs. If this interest rate market continues, the Housing Department's leveraging capacity will be adversely affected.

The Housing Department is working with the Finance Department to prepare for an $85 million bond issuance in early 2009. However, if the rates remain unfavorable for the Housing Department, the issuance may be postponed until such point that long-term interest rates are more attractive.

Affordable Housing Projects – The potential inability to issue long-term bonds at favorable rates has led the Housing Department to carefully consider the resources necessary to fund projects previously committed by the City Council as well as projects in the pipeline. At this time, the Housing Department is limiting all commitments those that can be funded by the $50 million line of credit and an additional $15 million from other sources available to the Department. In order to save several deals that have been underway for months and have received their planning approvals, the Department will be recommending that the City Council approve funding for only the land portion of those projects.

Existing Commitments: The following projects have previously received City Council approval and have partially drawn down their funding. The City has existing contractual relationships with these developers that commit the City to providing this funding.

Project Name	Developer	Funding Commitment	Disbursements Remaining
Belovida at Newbury Park	CORE	$17,925,000	$8,914,614
Fairgrounds Senior Apts	ROEM	$12,300,000	$4,889,490
McCreery Courtyards	Pacific West	$7,900,000	$1,150,000
North Fourth Street	First Community Housing	$10,375,000	$8,780,000
Round Table Drive	Unity Care	$2,125,000	$474,000
Cornerstone at Japantown	CORE	$6,300,000	$219,000
90 Archer	Charities	$4,580,000	$4,580,000
Total			**$29,007,104**

Pipeline Projects: The following projects have been underway for many months or, in some cases, years. These projects have received their planning approvals and are awaiting a financing commitment from the City. In order to save as many of these projects as possible, several of which have deadlines for land purchase, the Department is bringing forward recommendations to the City Council to immediately fund land acquisitions, and will return to Council with recommendations for construction and permanent financing in the future.

Project Name/ Developer	Funding Request	Funding Recommendation	Status
First and Rosemary Family/ ROEM	$26,470,000	$6,300,000	Land only commitment on 12/16 Council Agenda
First and Rosemary Seniors/ ROEM	$12,165,000	$3,700,000	Land only commitment on 12/16 Council Agenda
Orvieto Family/ ROEM	$10,575,400	$3,857,200	Land only commitment on 12/16 Council Agenda
Second St. Studios/ First Community Housing	$13,235,000	$13,235,000	Commitment to be heard by the Council in Spring 2009
Via San Antonio/ ROEM	$10,659,000	$5,350,800	Land only commitment to be heard by the Council in February 2009
Villas 184 South 11th Street/ InnVision	$625,000	$625,000	Refinance commitment on 12/16 Council Agenda
Markham Terrace/ Charities	$18,803,000	$3,625,000	Relocation costs and predevelopment loan on the 12/16 Council Agenda
Total		**$36,693,000**	

Projects Placed On Hold: The following list includes projects that are being recommended for land acquisition only at this time (see previous chart), but will need an additional commitment to cover construction financing. Additionally, this list includes projects that have an application on file, but have not yet received planning approvals. And, it includes projects that have made significant progress, including receipt of planning approvals, but which have not yet submitted an application to the City for a funding commitment.

Project Name	Developer	Funding Request	Notes
First and Rosemary Family	ROEM	$20,020,000	Construction Financing
First and Rosemary Seniors	ROEM	$8,172,000	Construction Financing
Orvieto Family	ROEM	$6,895,400	Construction Financing
Via San Antonio	ROEM	$5,308,200	Construction Financing
Markham Terrace	Charities	$15,178,000	Construction Financing
Willow Glen Woods	CORE and Satellite	$5,500,000	City Surplus Land/ Developer Selection Made
Ford & Monterey	Eden Housing	$11,000,000	City Surplus Land/ Developer Made
777 Park Avenue	ROEM / Housing Authority of Santa Clara County	$13,490,000	Application Received
Edenvale Avenue	Mid-Peninsula	$8,800,000	Entitlements Needed
Donner Lofts	Affirmed Housing	$15,430,000	Pre-application Received
Leigh and Southwest Expressway	First Community Housing	$6,500,000	PD Permit Approved by Council on 12/2/08
Baypointe	CORE and Charities	$45,000,000	Under Contract
Senter Road	Charities	$5,000,000	Needs Entitlements
Blossom Hill and Snell	Charities	$20,000,000	Under Contract
		$186,293,600	

In summary, the total amount of money needed to meet existing commitments and pay for pipeline projects that are ready to go is $65,700,104, which will be funded with the $50 million line of credit and funding from loan repayments. More than $186 million in current deals are on hold pending a return of normalcy to the financial markets. The Housing Department is consulting with its financial advisors to determine bonding capacity based on projected tax increment revenue. Preliminary reports indicate that the entire bonding capacity may be absorbed by these projects placed on hold.

Affordable Housing Project Financing

City financing is leveraged with a number of other sources, including multi-family housing revenue bonds, Low Income Housing Tax Credits, State funding such as the Multi-Family Housing Program, and conventional bank financing. The two most significant sources, which enable projects to provide significantly reduced rents, are bond financing (debt) and tax credits (equity). Both of these sources have been impacted by the current credit markets.

Multifamily Housing Revenue Bonds – Developers use two types of multifamily housing bonds to finance affordable housing projects: publically-offered bonds and privately-placed bonds. The publically-offered multifamily housing revenue bonds are typically issued as tax-exempt, variable rat, demand bonds in which the interest rate is reset weekly. The rates on these bonds continue to remain low and are favorable at this time; however, indentifying investors is more difficult than in the past.

For nonprofit affordable housing developers, the private placement market remains the financing arena of choice. US Bank, Bank of America, Wells Fargo, Union Bank of California, and the California Community Reinvestment Corporation are the major lenders/bond purchasers operating in the San José markets. Banks, however, have become increasingly selective in the affordable housing projects they will fund. They have become relationship-driven and, to qualify for Community Reinvestment Act credits, prefer new construction infill projects in urban areas.

An additional primary partner in financing affordable housing developments is the California Housing Finance Agency (CalHFA). This quasi-public agency has not been able to issue housing revenue bonds due to a lack of investors at this time. CalHFA is a critical partner in the Housing Department's affordable housing projects and this challenge is impacting the ability of our own projects to move forward.

Tax Credits – Low Income Housing Tax Credits have typically funded approximately 25% of the cost of the typical affordable housing project. Until relatively recently, Low Income Housing Tax Credit pricing was extremely attractive to borrowers. Tax Credits were being sold for up to $1 per credit a year ago, but pricing has now declined to between $0.75 and $0.85 for desirable, well located projects. The decline in pricing has adversely impacted project feasibility and will result in an additional source of funding needed to fund the "gap." The reason for the decline in Tax Credit pricing is that Tax Credits appeal to large and profitable corporations who owe taxes, but many of these corporations are now facing financial losses and have no need for Tax Credits. Historically, Fannie Mae and Freddie Mac have been the dominant providers, but they are now in conservatorship. The amount of equity available nationally to purchase Tax Credits is approximately one-half of the amount that was available three years ago. With fewer investors, higher returns are required, resulting in lower pricing for the projects.

Based on the reality of the current financing and Tax Credit markets, the Housing Department expects project financing to be more complex and challenging than in the past. Like the lenders and Tax Credit investors, the Department, too, must become more selective in the projects it chooses to fund. Such projects not only must be strategically aligned with our mission, they also must have a realistic chance of obtaining the full array of financing sources needed for project implementation.

State Funding

Over the past few years, affordable housing developers in San José have been successful in obtaining State funds from programs including the Multifamily Housing Program (MHP) and the Infill Infrastructure Grant funded through the Proposition 1C statewide bond measure. These finite resources are almost depleted and no replacement source has been identified. The potential sunset of these programs, even for one or two years, eliminates a critical and substantial layer of funds for our affordable housing developers.

Conclusion

The instability in the financial markets has created a challenge for the City in the implementation of its housing program, and has provided significant challenges for our developer partners. The Housing Department has been financially prudent and has not over-leveraged nor overextended its credit capacity and, as a result, is well positioned to weather the current instability and changes in the financial markets. Over the coming months, the Housing Department, in partnership with the Finance Department and the City's Housing Financial Advisors, will monitor its financial situation and the financial markets on a monthly basis with the goal of making proactive decisions resulting in solvency in all of its funds while being ready to issue bonds as soon as possible.

As new information is available, I will continue keeping you informed. Please contact me if you have any questions or concerns.

LESLYE KRUTKO
Director of Housing