CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Office of the City Auditor

Report to the City Council
City of San José

HOUSING LOAN PORTFOLIO: APPROVAL AND MONITORING PROCESSES SHOULD BE IMPROVED

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May 2014

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Office of the City Auditor
Sharon W. Erickson, City Auditor

May 8, 2014

Honorable Mayor and Members
Of the City Council
200 East Santa Clara Street
San José, CA 95113

Housing Loan Portfolio: Approval and Monitoring Processes Should Be Improved

San José consistently ranks as one of the least affordable cities in the country. Affordable housing is seen as a critical issue by City Council, staff and the public. The Housing Department has worked for over two decades to increase the supply of affordable housing in the City but sits at a difficult time without the major funding source it previously relied on, redevelopment funds.

Finding 1: The City's Homebuyer Loan Process Should be Improved. The City of San José administers a number of homebuyer programs to help low and moderate income residents purchase their first homes. A number of different programs have been utilized, each with its own funding source and specific goals and requirements. Altogether, there are approximately 1,900 active single-family loans with an outstanding principal balance of over $98 million. The main sources of funding have been federal and state funds as well as local redevelopment funds and inclusionary housing fees. These funding sources and City policy require that loan applications be scrutinized to ensure that only qualifying applicants receive loans.

Overall, we found inadequate documentation of income eligibility for all adult household members, such that we were not confident that some of the applications should have been approved. Specifically, almost a quarter of the 29 single family loan application files we reviewed did not contain sufficient documentation of income from other household members. We also found that the Department's policy of allowing new household members to count in determining income eligibility for homebuyer loans exposes the City to the risk of abuse. In 5 of the 29 homebuyer loans we reviewed, we found that new unemployed or low income earning household members were added to households which otherwise would not have qualified for the loans. These applications were all submitted to the City by one loan agent for home loans in one particular condo development. At our request, the Department and the City Attorney's Office reviewed these loans and found that there is not sufficient evidence to indicate that the applicants wouldn't have qualified for these loans.

Finally, we note that the homebuyer program has wound down dramatically since its peak in the late 2000s. With the demise of redevelopment and federal sequestration, funding for all low and moderate income housing programs have decreased and the City has decided to focus the limited funds available in San José on lower income groups who benefit more from rental programs. Our recommendations are mainly focused on increasing the stringency of homebuyer policies and procedures and modifying the program to better target long term low and moderate income residents should the City begin to increase the funding for these programs in the future.

Finding 2: Housing Should More Aggressively Monitor the Multifamily Rental Portfolio for Loan Repayments, Tenant Income Verifications, and Physical Building Inspections. The Housing Department works with developers to provide rent restricted apartments to low income families in multifamily developments around San José. These developments are built, in part, with Housing funds that are typically structured as developer loans. At the end of FY 2012-13, there were 136 permanent multifamily loans with an original principal balance of approximately $590 million. Most of the loans come with a requirement that the buildings maintain affordability restrictions for 55 years. San José's Housing Department is responsible for monitoring each development over the span of the affordability restriction to ensure that they stay affordable for the entire term. The Housing Department must also monitor financial information and building conditions for each project with outstanding loans from the Department to ensure repayment in a timely manner and physical building quality.

We found that Housing should more aggressively monitor financial information to ensure compliance with loan repayment requirements. We reviewed loan repayments for 12 of the 136 multifamily development loans and found that none had been recently reviewed, and that one project was underpaying their City loans. Based on the audited financial statements, it appears that this project owes the City about $260,000 for 2011 and 2012. This type of monitoring is important, not only to ensure timely loan repayments, but also to allow the Department to maintain predictable cash flows for budgeting purposes.

We also found that Housing could improve its tenant monitoring and building inspections. We found some errors in the annual tenant income and rent reviews that Housing staff use to determine if tenants are charged the correct amount of rent and to monitor occupancy and current income mix for tenants. In addition, building inspections are supposed to occur at least once every two years depending on a variety of factors, such as funding source, age of building, and resident mix. Due in part to staff turnover in this work area, we found that inspections were not occurring with the stated frequency or sampling minimum of units and common areas the Housing Department requires. We also found that inspections were not always reported in the Department's shared data application which made it difficult for supervisors to monitor work. Finally, as noted in our office's recent Code Enforcement Audit, there is insufficient coordination with Code Enforcement inspections.

This report includes 10 recommendations. We will present this report at the May 15, 2014 meeting of the Public Safety, Finance, and Strategic Support Committee. We would like to thank the Housing Department and the City Attorney's Office for their time and insight during the audit process. The Administration has reviewed the information in this report and their response is shown on the yellow pages.

Respectfully submitted,

Sharon W. Erickson

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City Auditor

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This report is also available online at www.sanjoseca.gov/audits/

Table of Contents

Table of Exhibits

Introduction

The mission of the City Auditor's Office is to independently assess and report on City operations and services. The audit function is an essential element of San José's public accountability and our audits provide the City Council, City management, and the general public with independent and objective information regarding the economy, efficiency, and effectiveness of City operations and services.

In accordance with the City Auditor's fiscal year (FY) 2013-14 Audit Work Plan, we have completed an audit of the Housing Department's multifamily development and single family homebuyer loan portfolios. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finds and conclusions based on our audit objectives. We limited our work to those areas specified in the "Audit Objective, Scope, and Methodology" section of this report.

The City Auditor's Office thanks the management and staff of the Housing Department and City Attorney's Office for their time, information, insight, and cooperation during the audit process.

Background

San José consistently ranks as one of the least affordable cities in the country with regard to renting and buying homes. In 2013, 78 percent of San José residents rated the availability of affordable quality housing in the City as only fair or poor.[1] An October 2013 report reviewed affordability for the 100 largest metropolitan areas in the U.S. and found that San José ranked sixth worst on the list with only about 31 percent of for-sale homes in San José affordable to a household earning the area's median income.[2] San José's median single family home price in 2013 was $720,000, while its median household income was about $80,000.[3]

About 46 percent of renters and homeowners in San José do not have "affordable" monthly gross rents or homeowner costs, using a standard

[1] Survey data taken from the 2013 National Citizen Survey conducted in September 2013.

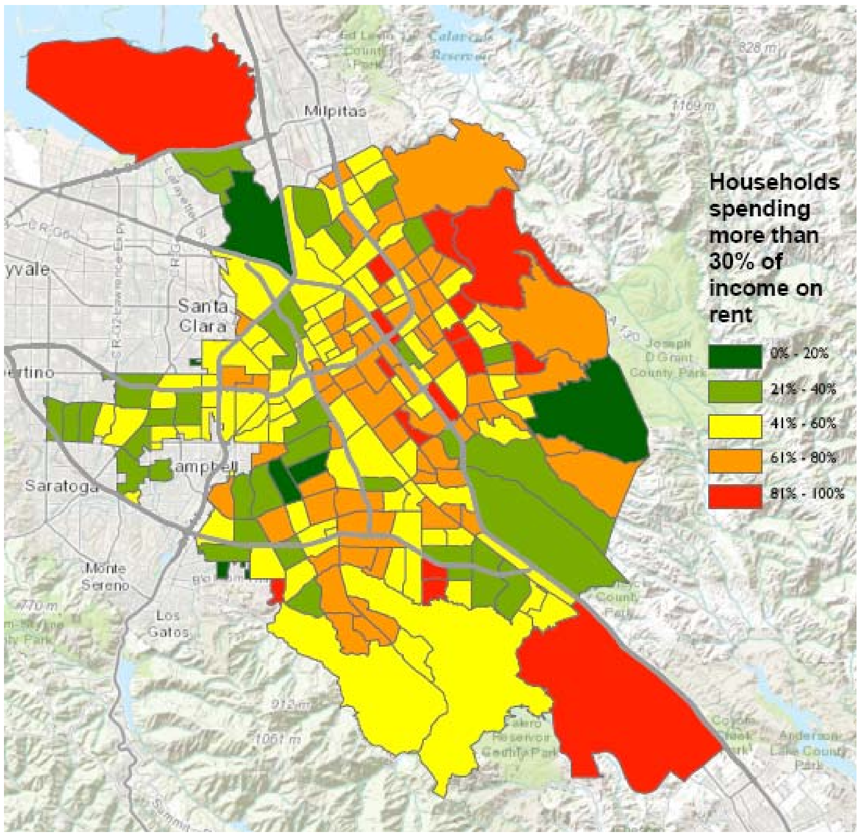
[2] Trulia.com research on all for sale homes on October 2, 2013.

[3] Median household income data taken from the Census Bureau's American Community Survey 2012 One-year Estimate. This figure differs from the median income figures issued by the U.S. Department of Housing and Urban Development, which the Housing Department uses for income eligibility for its programs.

definition of affordability meaning that they pay no more than 30 percent of their household incomes towards housing.[4] Further, about 25 percent of San José's renting households were severely housing cost-burdened in 2011, paying more than 50 percent of their income for housing costs.

The map below shows the percent of households burdened with unaffordable rent citywide.

Exhibit 1: Percent of Households with Unaffordable Rental Costs In San José



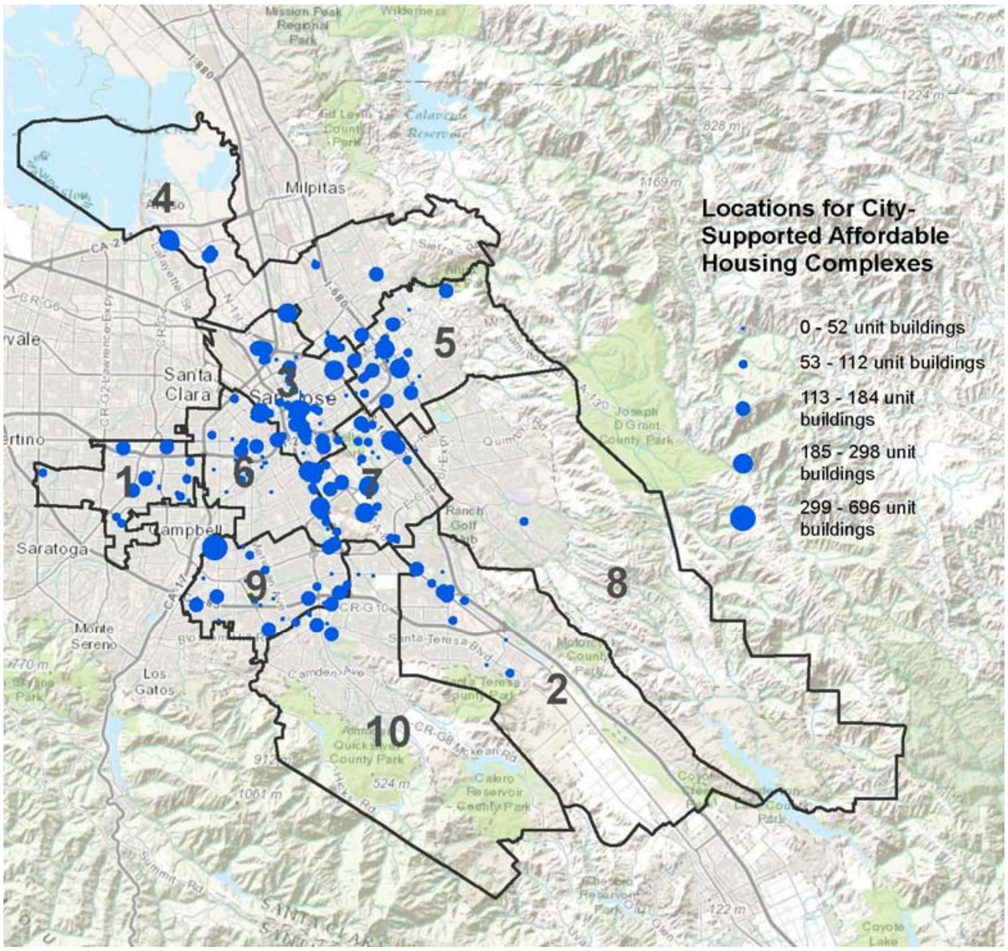
Source: U.S. Census Bureau; 2010 American Community Survey 5-Year Estimates, Table B25070

The City Council and City staff have long recognized that having a variety of housing options in the City and affordability for a wide range of residents is important in maintaining a strong economy and vibrant city. Since 1988, they have financed more than 17,500 units of affordable rental housing, the majority of which have been multifamily units (there are a total of about 119,000 rental units within the City limits). In spite of these efforts, affordable housing remains in short supply in San José.

[4] Data taken from the Census Bureau's American Community Survey 2011 Five- year.

Exhibit 2 shows the location of City- and HUD-supported affordable multifamily developments built throughout San José.

Exhibit 2: Map of City and HUD Supported Affordable Multifamily Developments



Source: San José Housing Department's cloud-based housing asset management database

San José's Housing Goals

San José sets detailed housing goals for funding of affordable housing projects in its *Housing Element*. San José's most recent *Housing Element*, 2007-2014 (updated in 2009) had the following goals for Housing Department assisted rental unit development:

Exhibit 3: Housing Element Goals for Rental Unit Development

Targeting for 2009 - 2014	Regional Housing Needs[5]	New Construction Assistance Target	Acquisition and Rehab Target	5-Year Target	Unit Type (Percent of Target)
Extremely Low Income (ELI, 0 - 30% of AMI)[6]	3,876	563	125	688	25%
Very Low Income (VLI, 31 - 50% of AMI)	3,875	1,462	325	1,787	65%
Low Income (LI, 51-80% of AMI)	5,322	225	50	275	10%
Moderate (81 - 120% of AMI)	6,198	0	0	0	0%
Market (Above 120% of AMI)	15,450	0	0	0	0%
Total	34,271	2,250	500	2,750	100%

Source: 2009 update to the 2007-14 San José Housing Element Update

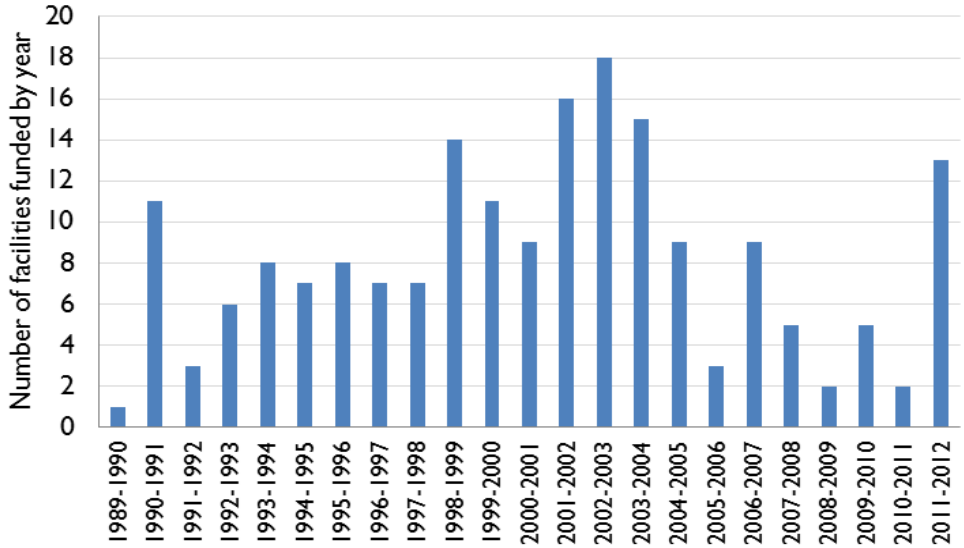
As shown in Exhibit 3, San José's recent 5-year targets fall short of its regional housing needs. The 2009-14 targets focused limited resources on developing rental housing for the neediest residents of the City. However, the City has only been able to build or rehabilitate about 1,600 units of affordable housing during that 5 year period, which is about 60 percent of its 2009-2014 *Housing Element* targets.

The City's Housing Department has been funding multifamily developments since the Department's inception. The chart below shows the number of projects by year.

[5] The City has regional housing needs goals which are quite large. This chart shows both the goal for total new development by target group (Regional Housing Needs Goal) as well as the Housing Department's goals for units it can fund.

[6] AMI is an acronym for Area Median Income. More details on these income groups can be found in Finding Two.

Exhibit 4: Housing Department Multifamily Development Projects by Year



Source: San José Housing Department's housing asset management database as of August 2013

The Housing Department

San José's Housing Department was created in 1988 to consolidate various housing programs—including administration of the San José Redevelopment Agency's affordable housing set-aside and the administration of the City's homeless and housing rehabilitation programs—into one organization.

Since 1976, California Community Redevelopment Law required that 20 percent of tax increments be set aside to create, preserve, and improve housing for low and moderate income persons. Since then the Housing Department has been responsible for the City's comprehensive affordable housing programs and, until 2012, its core revenue stream had always been property tax increments from redevelopment areas.

To organize its service delivery, Housing develops and maintains numerous strategic plans tied to its various funding streams and goals. Housing prepared a comprehensive homeless plan in 2003, created a Five-Year Housing Investment Plan in 2007, and updated its Five-Year Consolidated Plan for the Federal Department of Housing and Urban Development (HUD) in 2010. It has also provided many informational memos to City Council recently to try to determine how to prioritize and potentially increase revenues since losing property tax increment funding. Additionally, it creates annual action plans describing its planned use of federal and other funds, consolidated annual performance evaluation reports (CAPERs) describing its results, and participates in the development of the Housing Element of the City's General Plan.

Department Mission

To meet the needs and challenges of San José's changing community, the Department has broadened its focus, as well as its funding sources, to its current mission: "To strengthen and revitalize our community through housing and neighborhood investment."

In support of this mission, the Department has the following core services:

- **Housing Development and Preservation** – Main efforts: provide funding and technical assistance for the construction of new affordable housing, first time homebuyer assistance, provide rehabilitation loans and grants and construction oversight to extend the useful life of affordable housing, including single-family homes, mobile homes and multifamily buildings, provide inclusionary and market rate housing assistance to the housing development community
- **Neighborhood Development and Stabilization** – Main efforts: provide investment and support to neighborhoods through funding infrastructure improvements and provide Rental Rights and Referrals services to community residents
- **Community Development and Investment** – Main efforts: coordination of services aimed to end chronic homelessness, Community Development Block Grant Program, information and referral services for homeless and those at-risk of homelessness

Department Staffing

The Department's authorized staffing has fallen by about 25 percent over the last five years. There were a total of 57 full-time equivalent (FTE) employees budgeted for the Housing Department in FY 2013-14.

The Department has organized itself into the following teams:[7]

- 8.5 FTEs: Neighborhood Stabilization programs and rehabilitation
- 8.25 FTE: Multifamily and single family asset management team
- 8 FTE: Grants administration
- 6 FTE: Fiscal management
- 5.75 FTE: Multifamily and single family loan origination team
- 5.5 FTE: Administrative support staff
- 4 FTE: Executive management

[7] It should be noted that this presentation differs from the Department's budgeted staffing by core service.

- 4 FTE: Homelessness programs
- 3.5 FTE: Rental rights program
- 3.5 FTE: Policy development

Housing Revenues and the End of Redevelopment

In the last few years of redevelopment in San José, the Housing Department received as much as $40 million per year in tax increments that the Department used towards the creation of affordable housing, as shown in Exhibit 5. In 2011, the Governor and State Legislator dissolved redevelopment agencies statewide, which became effective February 1, 2012. Although the State abolished the redevelopment agency and ceased the flow of new housing revenue, cities do retain control over housing assets and continue to enforce the housing covenants, restrictions, and all other rights, powers, duties and obligations of the former redevelopment agency.

The elimination of tax increment revenue shown in Exhibit 5 has far-reaching implications for the Housing Department and local affordable housing development. For many years, tax increment financing made possible most of the multifamily affordable projects that the Department helped develop.

Exhibit 5: Housing Department Tax Increment Revenue Over Time

Source: Housing Department Tax Increment data

* No tax increments were received in 2012-13 due to the dissolution of redevelopment

Since its creation in 1988, the Department has worked to expand its reach and has received funding from federal programs including CDBG and HOME, as well as other state and local grant programs. It has also created some fee programs within San José, such as the loan origination and loan servicing fees for newly assisted multifamily developments. The table below shows the breakdown of program funds received in FY 2012-13 for **all** Housing programs.[8]

Exhibit 6: 2012-13 Housing Program Funds Received

2012-13 Housing Program Funds Received	
Loan Repayments and Interest Earnings	$22,902,085
Community Development Block Grant (Federal)	9,469,576
Neighborhood Stabilization Program (Federal)	8,863,044
Negotiated Development Agreement Fee Payments	6,885,000
County Childrens Shelter Settlement Agreement	5,126,000
San Carlos Senior Apartments Project Grant Bond Repayment	4,775,000
Miscellaneous Fees, Rent, Bond Revenue, Property Sales, and Revenues	3,031,132
HOME Investment Partnership Program (Federal)	2,736,336
Housing Opportunities for People With AIDS (Federal)	1,254,330
Building Equity and Growth in Neighborhoods Program (State)	1,182,755
Emergency Shelter Grant (Federal)	845,083
Mobilehome Seismic Retrofit Program (Federal)	760,199
Other	575,937
Rental Rights and Referrals Fee Program	516,153
Total	$68,922,630

Source: FMS transaction detail

Inclusionary Housing Requirements

State law requires that 15 percent of residential development occurring in Redevelopment Project Areas adopted after January 1, 1976 be subject to long term affordability restrictions. To satisfy this requirement, the City Council and Redevelopment Agency Board jointly adopted an Inclusionary Housing Policy. While the State dissolved redevelopment agencies and the ability to collect tax increments, it did not dissolve redevelopment areas and so the inclusionary requirements for redevelopment areas are still active. The City has also adopted a citywide Inclusionary Ordinance for both rental and for-sale development that has been on hold indefinitely as it is the subject of pending litigation.

[8] As described above, the Housing Department helps build and finance housing but it also provides other services such as homelessness programming, and grants to non-profits. The funding in this chart shows fund used for all types of Housing programming.

The redevelopment area inclusionary policy requires that developers building projects offering more than ten units of housing must complete an Inclusionary Compliance Plan. There are a lot of details to the requirements but at their essence they require developers of for-sale projects to offer 15 to 20 percent of their for-sale units to low or moderate income home buyers, pay an in-lieu fee, or build a stand-alone rental project targeted to low income residents, and require developers of rental projects to offer 20 percent of their units to low income renters, pay and in-lieu fee, or build a stand-alone rental project targeted to low income residents. Due to a recent court decision, the citywide inclusionary policy is not currently applied to newly entitled rental projects.

Housing Loan Portfolio

The City uses funds generated from repayment of tax increment funded loans as well as other state and federal grant sources to offer financial assistance to qualified multifamily project developers and individual homebuyers and homeowners by providing loans at "below market" interest rates. Typical loans and related terms are summarized in Exhibit 7.

Exhibit 7: Housing Loan Types

Loan Type	**Interest Rates**	**Due**
Multifamily development rental projects	Up to 4%	Up to 55 years
Multi-unit rental rehabilitation	Up to 3%	Up to 55 years
First time home buyer	Up to 3%	Up to 45 years
Home repair	Up to 3%	Up to 30 years

Source: Housing Department

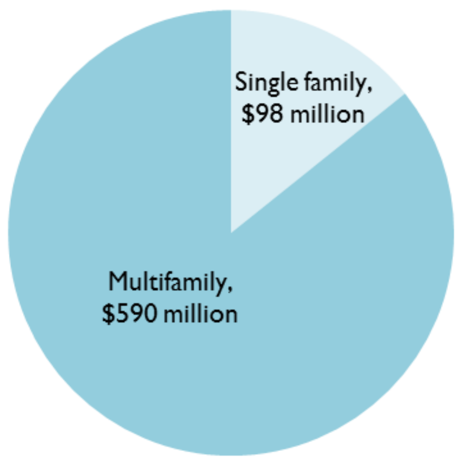
In accordance with City policy, loans are funded at below market rates of interest and include amortized net cash flow or deferred repayment terms. This policy exists to enhance the well-being of the recipients or beneficiaries of the financial assistance who are extremely low, very low, low, or moderate-income individuals or families.

The City has heavily invested in multifamily rental housing projects serving low income individuals through subordinate loans with terms of up to 55 years. Typically, these loans are repaid through net cash flow payments from project operations and the term and potential risk of each loan varies (the repayment process for these loans is explained in greater detail in Finding 2). Because of the net cash flow feature of these subordinate loans, there is greater risk of variability in the timing of payments and, potentially, a lower probability of eventual repayment on these subordinate loans than on traditional loans made by commercial lenders. The Department's form of subsidized lending is very common for affordable housing programs.[9]

Size of the Loan Portfolio

Altogether, at the end of fiscal year 2012-13, there were approximately 1,900 active single-family loans with an outstanding principal balance of over $98 million. In addition there were 136 multifamily permanent loans with an original principal balance of approximately $590 million, as of August 2013.[10]

Exhibit 8: Housing Loan Portfolio



Source: San José Housing Department's housing asset management database and Amerinational database of the single family loan portfolio.

[9] For financial statement purposes as of June 30, 2013, the City had established a $326 million allowance against the loans receivable balance to provide for potential risk associated with the portfolio. This loan loss reserve is what the City expects it could lose in loan repayments from the Housing loan portfolio. The Department has established general loss rates for each of the types of loans it carries from as low as 10 percent on loans made to multifamily developments making scheduled payments, to as high as 100 percent on loans made to homeless shelters. The City's overall loan loss reserve is approximately 52 percent of the portfolio. The purpose of the reserve is to ensure that the City takes seriously the possibility that some portion of the loan portfolio will not be fully repaid. The loan loss reserve methodology the City uses is not as rigorous as is required for commercial lenders as the purpose of the portfolio is different. We compared the loan loss reserve in San José with that of five other local jurisdictions and found that San José is in the middle of the group. Loss reserves for housing assets were as low as 6.5 percent in Santa Cruz and as high as 93 percent in San Francisco. We did not find any issue with San José's reserves during our review.

[10] As of August 2013, there were at least 12 other projects with City affordability restrictions that had either fully repaid their loans or had not yet been completed and occupied with renters.

Objective, Scope, and Methodology

The purpose of this audit was to evaluate the housing loan portfolio, including the efficiency and effectiveness of loan repayment, compliance monitoring, and administration. The specific objectives of this audit were: 1) to determine if the multifamily housing asset management program in the Housing Department is functioning well, which means that: the loans are closely monitored to ensure timely and sufficient repayments to cover administrative costs and allow for funding of more projects; and compliance with unit quality and tenant income levels is met and monitored in an efficient manner; and 2) to ensure that the small first-time homebuyer program complies with all legal authorities and is set up in such a way that it will best meet the Department's stated goal of assisting as many low and moderate income homebuyers as possible with limited homebuyer funds in attaining homeownership when they otherwise would not be able to purchase a home. We focused on the Department's multifamily housing asset management and homeownership programs and did not review other programs such as homelessness services, affordable housing revenue bond administration, or multifamily loan structuring or construction monitoring.

In order to achieve our objectives we:

1. Interviewed staff from the Housing Department and City Attorney's Office to get their perspective on issues and to better understand Housing processes.
2. Interviewed staff and reviewed policies from other jurisdictions including Palo Alto, Menlo Park, San Francisco and Santa Cruz.
3. Reviewed the Municipal Code, IRS Codes, State Laws for legal requirements and direction on affordable housing development, funding restrictions for the types of funds used by the Housing Department and affordability requirements.
4. Reviewed legal and other guidance on tax exempt housing bonds, tax credits for affordable housing, redevelopment, inclusionary housing, and affordable housing mechanics in California.
5. Reviewed prior audits by grantor agencies of City programs.[11]
6. Reviewed City contracts and covenants for affordable housing developments that we sampled.
7. Reviewed Census data on household income.
8. Reviewed Housing Department reports and the current Regional Housing Need Plan for the San Francisco Bay Area to understand the

[11] The City's Housing Department programs are subject to audit by a number of outside funding agencies including the United States Department of Housing and Urban Development (HUD), the State of California and others.

current environment of housing development in San José and the region as a whole.

9. Reviewed budget information for the Housing Department to better understand administrative expenditures.
10. Reviewed Redevelopment Agency reports, Successor Agency reports, and Housing Department databases to ensure that affordable housing developed through the Redevelopment Agency is being monitored by the Housing Department and if any housing-related assets are currently being disputed.
11. Reviewed and compared the current Housing Department multifamily asset database with older repositories to ensure that all assets have transferred to the new database.
12. Analyzed assets in the housing multifamily database to determine a variety of statistics on repayment rates, unit mix, affordability restriction terminations, and size of the portfolio.
13. Reviewed a sample of twelve multifamily projects to ensure completeness and availability of legal documents and other documents relating to loan repayments and annual building monitoring; cash flow projections if available, annual financial reports, and repayment of loans to the City.
14. Reviewed a sample of eight multifamily projects for annual tenant monitoring of income and rents charged for accuracy.
15. Reviewed the buildings inspections database for completeness and adherence to the Housing Department's inspections procedures.
16. Reviewed the Amerinational single family loan portfolio maintenance and monitoring contract and reviewed expenditures and revenues for fiscal year 2012-13 to see if they matched the contracted prices and seemed reasonable.
17. Reviewed a sample of 29 single family home loans to ensure that the loan origination files matched the information in the Amerinational database and if the loan originations met the City's policies and procedures as well as State laws for use of funds. There are a number of single family home loan programs that the City has employed including first time homebuyer programs and housing rehabilitation loans. Our sample of 29 loan recipients was made up entirely of individuals in the first-time homebuyer programs.

Finding I The City's Homebuyer Loan Approval Process Should Be Improved

Summary

The City of San José administers a number of homebuyer programs to help low and moderate income residents purchase their first homes. A number of different programs have been utilized, each with its own funding source and specific goals and requirements. The main sources of funding have been federal and state funds as well as local redevelopment funds and inclusionary housing in-lieu fees. These funding sources and City policy require that loan applications be scrutinized to ensure that only qualifying applicants receive loans.

Overall, we found inadequate documentation of income eligibility for all adult household members, such that we were not confident that some of the applications should have been approved. Specifically, almost a quarter of the 29 single family loan application files we reviewed did not contain sufficient documentation of income from other household members.

We also found that the Department's policy of allowing new household members to count in determining income eligibility for homebuyer loans exposes the City to the risk of abuse. In 5 of the 29 homebuyer loans we reviewed, we found that new unemployed or low income earning household members were added to households which otherwise would not have qualified for the loans. The majority of these problem loan files were submitted to the City for approval from one loan agent. At our request, the Department and the City Attorney's Office reviewed these loans and found that there is not sufficient evidence to indicate that the applicants wouldn't have qualified for these loans.

Finally, we note that the homebuyer program has wound down dramatically since its peak in the late 2000s. With the demise of redevelopment and federal sequestration, funding for all low and moderate income housing programs have decreased and the City has decided to focus the limited funds available in San José on lower income groups who benefit more from rental programs. Our recommendations are mainly focused on increasing the stringency of homebuyer policies and procedures should the City begin to increase the funding for these programs in the future.

The Homebuyer Programs in the City of San José Are Intended to Help Low and Moderate Income Residents Purchase Their First Homes

The mission of the City of San José Homebuyer Program is to assist low and moderate-income households attain homeownership in San José's neighborhoods through down payment assistance loans provided by the City. The City's homeownership funds are intended to target applicants that would not be able to purchase a home without City financing.

In the last five years, more than 600 households have received down payment assistance and more than 950 households have received rehabilitation assistance through the single family loan programs. Altogether, there are approximately 1,900 active single-family loans with an outstanding principal balance of over $98 million.

The main programs within the Homebuyer Programs have been funded through redevelopment, State and federal funds and included:

- Loans to education professionals (the Teacher Homebuyer Program)
- Project-based down payment assistance and inclusionary project assistance for specific new construction for-sale developments.
- The WelcomeHOME program for low income first time homebuyers

The program is currently limited to:

- BEGIN funds from the State which are available for a small number of targeted new construction developments
- The San José Dream Home program which has funds remaining from the American Recovery and Reinvestment Act ("The Recovery Act")[12]
- Inclusionary Projects[13]

Mechanics of the City's Single Family Loan Programs

The single family loan programs can be divided into two groups – down payment assistance programs and financial assistance for rehabilitation projects to current homeowners. Loans have low-interest rates and are often deferred with no payments due until the loan term ends. Loan terms vary depending on the funding source but generally have 30 or 45 year terms. In order to qualify for any of the loan programs, applicants must be income-eligible and must occupy the residence. In order to qualify for *homebuyer* loans, homebuyers must be first-time homebuyers.

In the case of homebuyer loans, the City's loans are second loans which are subordinate to a traditional primary mortgage. They are "silent", meaning that the homebuyer does not have to make monthly payments on their loans until the loans mature or the homeowner moves. For example, one of the units we

[12] Funding through the Recovery Act is winding down. The Department estimates that is has enough funding to assist one more household through this program.

[13] As described in the Background of this report, the City's Inclusionary Policy is currently limited to requiring an Inclusionary plan for for-sale developments in Redevelopment Areas.

reviewed was a condo unit that sold for a little over $400,000. The borrower received about $105,000 in silent loans from the City that allowed the borrower to obtain a more affordable traditional mortgage of about $285,000. As long as this borrower stays in their unit, they will not have to make payments to the City for 30 years. The City's loans provide that if a restricted homebuyer unit is sold or transferred to a market rate buyer, the City's loans become due and payable along with a pro rata percentage of any equity received in the sale to the new buyer.

Loan Monitoring

Once single-family home rehabilitation and down payment assistance loans are approved by Housing, compliance and basic monitoring tasks are outsourced to Amerinational, a private sector loan servicer. City staff assists borrowers in hardship situations, requests for exemptions to certain loan requirements, refinancing and other out-of-routine tasks (sometimes this assistance can be extremely time consuming).

Amerinational's main duties for the portfolio include distributing funds for single family rehabilitation loans and loan servicing functions including: establishment of impound accounts, as requested; loan collections; follow-up on delinquent accounts; supplying borrowers and the IRS with annual interest-paid notices; ensuring that property insurance and property tax requirements are current; and providing the Housing Department with a variety of monthly reports documenting the status of each and all loans in the portfolio.

Amerinational charged the City about $82,000 in FY 2012-13 to service a loan portfolio of 1,900 accounts with outstanding principal balance of over $98 million. We reviewed a sample of monthly statements from Amerinational and tested the Amerinational database for accuracy against the City's paper files and did not find any discrepancies between Amerinational and City records.

The contract with Amerinational has ended and the Housing Department is currently in the process of posting a new Request for Proposal (RFP) for the services that Amerinational provides.

The City's Loan Origination Procedures Are Not Adequate and Were Not Adhered to Regarding Verification of Household Income

Descriptions of the City's homeownership programs and loan application requirements are outlined in the City's homeownership guidelines.[14] These guidelines require that loan applications include a variety of documents including

[14] The City's *Homeownership Loan Programs General Underwriting Guidelines (Updated 7/30/2011)* are online at http://www.sanjoseca.gov/documentcenter/view/1169,

verification (third party verification where possible) of income for ALL adult household members.

Verification of Income and Assets

The income eligibility for homeownership programs is generally higher than the rental programs that the City offers because the homeownership programs target both low and moderate income residents (the rental programs target low to extremely low income households). Most of the homebuyer programs have been available to both low and moderate income residents but some have been available only to low income residents. In 2013, the maximum incomes for all homebuyer programs were:

Exhibit 8: 2013 Income Limits for Homebuyers

	Household Size					
	1	2	3	4	5	6
Low Income Limit[15]	$52,550	$60,050	$67,550	$75,050	$81,100	$87,100
Moderate Income Limit	$85,100	$97,250	$109,400	$121,550	$131,300	$136,000

Source: Housing Department's website

Verification of Household Size and the Problem of Household Formation

In our review of loan applications, a number of applicants were forming new households with other adults that had not lived together before. In these loans, the primary loan applicant would not have qualified for City loans at their current household size but by adding some number of unemployed or marginally employed people to their households, they were able to qualify for the loans. We found new household formation was particularly endemic in the project that we focused our sampling on, The Cannery.

It should be noted that the City's policy does allow for new households to be formed. Furthermore, the State and Federal rules for each program we reviewed do not specify how household size should be confirmed. However, other jurisdictions have requirements that discourage adding household members for purposes of income qualifying. In the case of San Diego, Palo Alto and Menlo Park, they require that households can only apply for their homebuyer programs as an established household, meaning that the applicant must qualify under whatever circumstances they are already in, whether living alone or with multiple dependents but that they cannot add household members who have never previously lived together. In San Francisco, all adult household members must appear as owner or co-owner of the unit, which would discourage casual, short-term household formations.

[15] Low income *homebuyers* are defined as households earning less than 80 percent of the AMI. This is different than the definition of low income *renter* households, which are discussed more in Finding Two and limited to 60 percent of AMI.

Identification and Follow-up of "Red Flag" Issues

In conducting our review of loan files we found loan issuance guidelines issued by the State of California Department of Housing and Community Development for use by some other jurisdictions around the State. San José is not subject to this guidance but it contains valuable best practices that we would recommend for the homebuyer loan programs such as its discussion of household size.

> *The income limits are adjusted by household size; therefore, one of the first steps in determining eligibility is to determine and verify the size of the applicant household. Should the Grantee have inconsistencies in documents as to the true household size, no assistance should be given without clearing the red flags issue(s).*

Almost one quarter of the loan files we reviewed, 7 out of 29, had what we would call "red flag issues". Each of the seven applications we flagged as containing red flags were for purchases in just one condo development (The Cannery), for condos purchased between March and December 2009. Six of these seven applications were submitted to the City by one particular loan agent at the development. Five of the seven applications were submitted as newly formed households. In our opinion, it is likely that this loan agent understood and took advantage of the City's loophole for new household formation.

Exhibit 9: Outside View of the Cannery, a Building with Many City-Assisted First-Time Homebuyers

Source: Trulia.com

Other Inconsistencies

We found a number of inconsistencies in the loans we sampled and have identified some "red flag" issues that should be incorporated into the City's single family loan procedures, as described below.

Red Flag: Applicant may be understating income from other household members in order to qualify for a loan

Larger households can earn greater income and still qualify for loans. A household is determined by the number of people living together, not the size of the structure they live in.

The City's Homeownership Program Guidelines state that household income may not exceed the income limit in effect at the time of application to the homebuyer program and that income is defined as income earned from all household members age 18 years and above. It further states that income includes earnings from employment, government benefits, investments, interest income, and other cash-generating activities. The guidelines then state that City staff will calculate household income.[16]

We found incomplete reviews of income in all seven of the problematic loan applications we reviewed. In one case we noted a single adult marketing professional whose annual income was approximately $400 too high to qualify for a loan on his own. This applicant was applying to purchase a one-bedroom condo and had listed a young adult sister as another household member. It was not stated that the two siblings had been living together prior to this home purchase. Nevertheless, the homebuyer's young adult sister wrote a three-sentence "To Whom it May Concern" letter stating her intention to move in with her older brother while she continued to attend a local university. The City's own guidelines require such statements to be signed under penalty of perjury; this letter was not.

The City should have verified all income of adult household members[17] but the only information the City gathered for the sister were a few pay stubs showing her year-to-date income from that source was less than $7,000. The City also did not gather any information on whether or not she was actually enrolled in the university and if she was, what other income was used to cover her school expenses. If she relied on other family members, such as parents, to pay for schooling expenses and living expenses those assets should have been counted towards the limit for qualifying as a two-person household. The potential that

[16] These requirements have been written into the City's Guidelines since at least 2008 (before any of the problem loan applications we found were approved) and are stated on page 10 of the City's current guidelines, page 9 of the 2009 guidelines and page 2 of the 2008 guidelines.

[17] In this case, the loan applicant was required to provide three years of income tax forms, pay stubs, and bank records to verify his assets and income.

she received income from other sources such as other jobs or interest earnings was also not considered.

Best practices recommend that:

> *Any inconsistencies should be resolved and noted in the file. Assume at all times that the file will be monitored and must stand on its own without any additional explanation. Assume the staff person who income qualified the household for assistance will not be there to defend their determinations…. It may be necessary to request additional verifications to further analyze the red flag item or inconsistency before approving assistance.*[18]

We found other cases of red flag issues stemming from the same leniencies in the City's household formation allowance and laxity in income and asset review of all adult household members. In the same month that the household mentioned above moved into The Cannery, at least two other households received City loans on condos in The Cannery with new household sizes. Condo A was being purchased by a married adult couple and Condo B was being purchased by their single adult relative. In both cases, the parties gave no indication that they had been living with anyone else prior to moving in to the Cannery and in both cases, their income was too high to qualify for all the City loans they received under their original household size.

The applicant for Condo B originally applied for a loan listing another family member as a new household member (Family Member X), but then crossed out this application and wrote in a different new household member (Family Member Y). When reviewing the application for Condo A, we noted that Family Member X showed up again as a household member in their new household. Essentially, it appeared as though the three borrowers were divvying up potential low or no income family members to create households that would qualify for the loans.

As with the case previous cited, the City did not scrutinize income including income derived from financial assets of these additional, new household members like they did for the named borrowers. We also note that these last two loan applications were received and reviewed by City staff at approximately the same time, their loans closed on the same date, and these red flags were readily apparent in the loan application files.

Red Flag: Applicant May be Understating Self-employment Income

We also found inconsistencies in household income even when household size was not in question. Two of the seven red flag applications covered applicants that were not changing the size of their household. In one case a single woman submitted pay stubs which indicated that her salary was approximately $2,000

[18] California Department of Housing and Community Development, CDBG Program - Income Calculation and Determination Guide for Federal Programs

under the annual income limit but this applicant also operated a small business. She stated in a personal note that her business was operating at a loss but the most recent business revenue or expense information she submitted was 15 months old. The City did not ask for additional business documentation when approving this loan.

Another household was comprised of a married couple whose income was projected at $99,400, $1,900 less than the maximum allowed as a two-person household. In addition, this applicant's spouse also had a small business. The applicants included an undated, handwritten note that the business was not earning any profits at the time and the City did not request any further verification of that.

Red Flag: Insufficient Documentation

We also note that a full picture of loan worthiness should be thoroughly examined. Small business balance sheets, profit loss/income statements prepared by Certified Public Accountant and salary documentation have all been listed in the City's single family program guidelines as types of evidence to consider when determining self-employment income yet none of these documents were included in the red flag applications we reviewed.

Follow-up on Potentially Problematic Loan Approvals

We provided information on each of the seven red flag applications we identified as potentially problematic to the Housing Department and the City Attorney's Office. The Housing Department has re-reviewed the applications and has concluded that there is not sufficient evidence to indicate that the applicants wouldn't have qualified for the loans.

Nonetheless, it was problematic to have approved these loans without including additional documentation and explanations for the red flags within them. The Department agrees that going forward, it will put more emphasis on a stringent process for loan approvals.

Additional Training

The red flag applications we highlighted above demonstrate the need for additional training on the City's policies and procedures. We note that each red flag application, like all homebuyer loan applications, was reviewed and signed by three separate Housing Department staff members before final approvals. The City's policies and procedures at the time required more income and asset information to be included in the files than we saw and these inconsistencies should have been caught at the time of loan approvals.

The Department has stated that the single family loan program is not expected to be a big program in the future nevertheless, there will continue to be some homebuyer assistance programming and as such we have the following recommendations.

Recommendation #1: We recommend the Housing Department update its single family loan procedures to ensure:

a) More stringent reviews of all assets and income of ALL adult household members,

b) That new household formation not be allowed as a way to income qualify for loans unless all adult household members appear as co-applicants on the loans and title to the property, and

c) That any inconsistencies be thoroughly investigated and the results of the investigation be thoroughly documented in the application file to ensure that problematic files are not uncovered in the future.

Recommendation #2: We recommend that City loan officers receive periodic training on how to conduct loan origination file reviews and the risks that could occur if the City were to approve ineligible applicants.

Recommendation #3: To ensure that loan agents do not recommend ineligible households, we recommend that the City provide mandatory training, as the Department has done in the past, on the City's eligibility and loan application requirements to loan agents working in the condo facilities that the City has targeted for down payment assistance.

Policy Changes to the Home Buyer Programs

As described in the Introduction, many San José residents face housing affordability challenges. The problem of deciding who should have access to limited funding is profound. The City's home buyer loans averaged $75,000 per unit in FY 2012-13. [19] The households covered by this program can earn up to 120 percent of AMI – in other words, they can be doing better than at least half of their neighbors.

[19] It should be noted that the rental program subsidy averaged about $118,000 per unit in FY 2012-13, but targeted a lower income population and covered longer time period.

The household also doesn't need to be likely to remain low or moderate income. As required for use of federal and State funds, the City bases applicant qualification for its programs on a snapshot of income and assets for homebuyers. This means that income is determined by looking at gross year to date pay for the homebuyer and projecting that forward. We found that many of the loan applicants in our sample were not in positions that were likely to remain low or moderate for long.

For example, one applicant applied for City funding for his purchase of a condo at The Cannery as a single borrower despite being married at the time. Up until a few weeks prior to applying for City funds, the spouse of the applicant had worked in a large international technology company; the couple's previous year's income tax returns listed their adjusted gross income as over $160,000 for the year. Despite this, they were reviewed based on a "snapshot" of income and assets, and in month this couple received their loans, their income was projected, including the spouse's unemployment insurance, at approximately $99,400 – $1,900 less than the maximum allowed as a two-person household.

In our review of 23 loan applications for The Cannery, we found that the median age at the time of application was 30, and many applicants were highly educated white collar employees who, from the documents in their applications, appeared to be in the first year or two of their careers, including:

- A mid-twenties marketing professional at an international design firm
- A late-twenties IT professional at a Fortune-100 company
- A late-twenties engineer, and
- An early-forties family therapist
- An early-thirties intellectual property attorney

While each of these loan applicants may qualify at the point in time at which they applied for City homebuyer assistance, they may or may not be low or moderate income in the long term.[20]

[20] We also noted that the homebuyer loan amounts and number of loans "layered" into individual loan packages could be quite high in the development we reviewed. The Housing Department states that it strives to assist as many homebuyers as possible by limiting the subsidy levels to the amount needed by the applicant to purchase a modest home that is appropriately sized for the household. However, we found seven applicants assisted in The Cannery received loan packages of over $180,000 each. One borrower received $248,000 from five different City loan sources. This was 58 percent of the total purchase price for the condo. At the time these loans were made, there was no restriction on the total amount or number of loans any individual homebuyer could receive. The Housing Department has since incorporated limits on both into the Homebuyer Loan Policies and Procedures. Homebuyers are now limited to down payment assistance not to exceed $100,000 with an exception for loan packages including Inclusionary or BEGIN loans.

Targeting Programs to Those Most in Need

The City's mission in its homebuyer programs is to assist residents "that would not be able to purchase a home without City financing." Our understanding from the Housing Department is that, when projects receive project-based funding for homebuyer assistance, the bulk of the advertising and promotion of those buildings is done by the buildings developers.

The City does not store interested residents' information in a citywide repository like some other cities, including Morgan Hill, Brentwood, Palo Alto and Menlo Park. Those cities encourage interested parties to proactively seek out homeownership programs for which they may qualify. Interest lists create perceived equity in the homebuyer programs.

Recommendation #4: To increase perceived equity in the City's Homebuyer Program, we recommend that the City increase its public outreach for homebuyer programs and maintain a homebuyer interest list.

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Finding 2 Housing Should More Aggressively Monitor Multifamily Rental Projects for Loan Repayments, Tenant Income Verifications, and Physical Building Inspections

Summary

The Housing Department works with developers to provide rent restricted apartments to low income families in multifamily developments around San José. These developments are built, in part, with Housing funds that are typically structured as a loans. The loans come with a requirement that the buildings maintain affordability restrictions for 55 years. San José's Housing Department is responsible for monitoring each development over the span of the affordability restriction to ensure that they stay affordable for the entire term. The Housing Department must also monitor financial information and building conditions for each project with outstanding loans from the Department to ensure repayment in a timely manner.

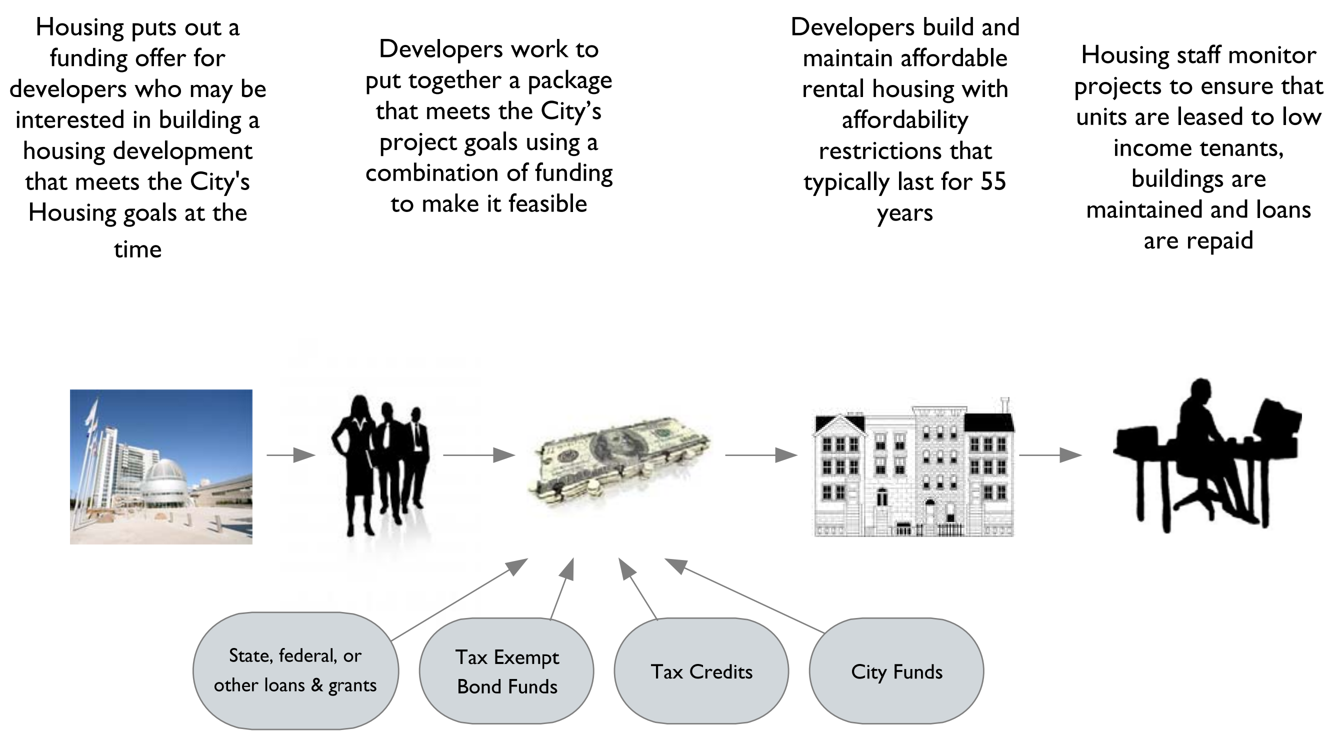
We found that Housing should more aggressively monitor financial information to ensure loan repayments. We reviewed loan repayments for 12 of the 136 multifamily development loans and found that none had been recently reviewed, and that one project was not making timely loan repayments. Based on the audited financial statements, it appears that this project owes the City about $260,000 for 2011 and 2012. This type of monitoring is important, not only to ensure loan repayment, but also to allow the Department to maintain predictive cash flows for budgeting purposes.

We also found that Housing could improve its tenant monitoring and building inspections. We found errors in all of the annual tenant income and rent reviews that we sampled, which Housing staff use to determine if tenants are charged the correct amount of rent and to monitor occupancy and current income mix for tenants. In addition, building inspections are supposed to occur at least once every two years depending on a variety of factors, such as funding source, age of building, and resident mix. Due in part to staff turnover in this work area, we found that inspections were not occurring with the stated frequency required or sampling minimum of units and common areas. We also found that inspections were not always reported in the Department's shared data application which made it difficult for supervisors to monitor work. Finally, as noted in our office's recent Code Enforcement Audit, there is insufficient coordination with Code Enforcement inspections.

Financing Affordable Multifamily Rental Development Projects

Exhibit 10 shows the process by which most of the Housing Department's affordable multifamily rental housing developments have been built and are maintained. The infographic visualizes the creation of a Housing Department assisted development. As the graphic shows, the initial push for a particular type of project (e.g. a homeless shelter, a one- and two- bedroom development for seniors, a development focused on families with children) come from the Housing Department after they have identified the priority for their next projects. These funding offers (NOFAS, or Notices of Funding Availability) spell out the particular goals for the project along with the amount of funding available.

Exhibit 10: Multifamily Development Financing Process



Source: Auditor analysis

Gap Financing

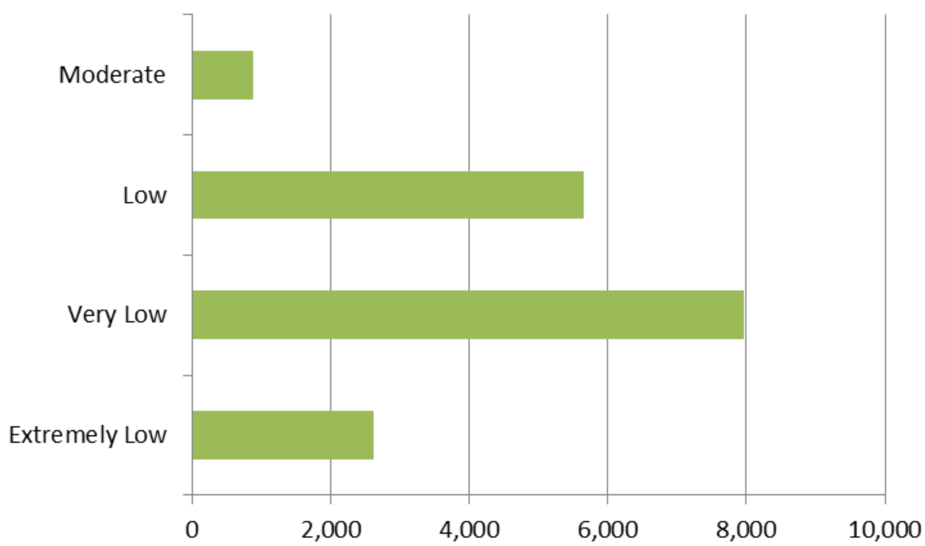
A common strategy, and one that San José typically employs is to offer for-profit and non-profit developers "gap financing" – the idea being to offer just enough financing (through a long-term low interest loan) to make an affordable housing project financially attractive to a developer. Developers will typically put together a package that combines their own funds, a City gap financing loan, cash from the sale of tax credits,[21] and also frequently includes tax-exempt bonds, and other state or federal grants and loans. Affordable housing developments typically have affordability restrictions of at least 55 years.

The City also issues multifamily housing revenue bonds to provide funds for loans to developers of multifamily housing projects. As of June 30, 2013, $483 million in multifamily housing revenue bonds ("conduit debt") were outstanding. These bonds are payable solely from payments made on related secured loans, and are not payable from any revenues or assets of the City. The City charges annual monitoring fees, which totaled $890,000 in FY 2012-13.

Targeted Population

With limited resources available, the City now has a policy to focus the majority of its resources on extremely low income and very low income units (units available to residents earning 0 to 50 percent of the Area Median Income) The chart below shows the number of units available by type.

Exhibit 11: City-Assisted Rental Development Units Available by Unit Type as of FY 2012-13



Source: San José Housing Department's housing asset management database

[21] In 1986, Congress created the federal Low Income Housing Tax Credit Program. The tax credit program allows housing developers to raise project funding through the sale of tax benefits to investors (typically large institutions such as banks and other large businesses). There are two types of tax credits: four percent and nine percent credits. These refer to the approximate percentage of a project's "qualified basis" that a taxpayer may deduct from their annual federal tax liability. The tax credit lasts for ten years, so the taxpayer using the tax credit may deduct the tax credit every year for ten years. The "qualified basis" refers to the portion of costs that will be used for low income housing. In addition to the federal tax credit program, the State of California created its own tax credit program in 1987. The State's program supplements the federal program, in that it is only available to projects that are eligible for federal credits. The State program provides tax credits for four years and is applied against companies' taxable liabilities with the State of California. There is a limit to how many projects may receive tax credits in each year, developers have to apply to receive them. Receiving nine percent credits is particularly competitive.

San José's affordable rental housing programs segment the population into four groups: Extremely Low Income (ELI), Very Low Income (VLI), Low Income (LI), and Above Low Income (Market).[22] These groups are defined based on household income using the county's Area Median Income (AMI) as a basis.[23] AMI is adjusted depending on household size, thus a one-person household needs to earn less than a two or three person household to reach the AMI. For example, the 2013 AMI for a one-person household in Santa Clara County was $73,850 and the AMI for a four-person household was $105,500. Therefore, using 2013 Santa Clara County AMI information, and *assuming a household size of four people*, San José's renter[24] population can be grouped in the following segments:

- ELI - below 30 percent of AMI (earning less than $31,850)
- VLI – between 30 and 50 percent of AMI (earning up to $53,050)
- LI – between 51 and 60 percent of AMI (earning up to $63,300)
- Above LI – above 60 percent of AMI (earning more than $63,300)

Affordable housing developments in San José's loan portfolio stipulate target populations for each building and generally use federal rent limits[25] for determining the rental rates for each type of unit in the facility (e.g. rates for ELI one- and two- bedrooms as well as VLI one- and two-bedroom units.) In 2013 the rent limits, including estimated utility costs for a one-bedroom apartment in a City funded project were:

- ELI one-bedroom rent: $598 per month
- VLI one-bedroom rent: $995 per month
- LI one- bedroom rent: $1,187 per month

To provide some context for these rents, San José's average rent for a one-bedroom apartment in June 2013 was $1,780.

Targeted Populations Can Have a Big Impact on Project Revenues and Therefore, Loan Repayments

Depending on the targeted population and, therefore, the rents charged in each facility, there can be a lot of variance in net cash flow across City-financed projects. For example, some City-funded buildings are restricted to be occupied by only ELI tenants. This can significantly limit the rental revenue for the building and may mean that the building is unlikely to be able to repay its City loan quickly.

[22] These groups have changed over time so some projects have slightly different definitions of population groups.

[23] AMI is calculated annually by the State of California's Housing and Community Development Department.

[24] LI is defined differently for the City's for-sale programs.

[25] Federal rent limits are set through each state's Tax Credit Allocation Committee, which is the group that determines which affordable housing developments are eligible to sell tax-credits in exchange for affordable housing units.

However, there is one major qualifier to this rule and that is that many rent-restricted units are occupied by tenants with Section 8 rental vouchers.[26] When Section 8 voucher holders inhabit a rent restricted unit within the City's loan portfolio, the property managers are allowed to collect a much higher total rent per month on each Section 8 occupied unit.

The rent limits outlined above only apply to the *tenant* portion of rent paid – it does not include any other type of payment such as Section 8 voucher. Section 8 will pay the difference between a "fair market rent" and the amount a tenant can afford. For example, in 2013 in one City funded facility, ELI one-bedroom units were rented for a total of $1,284 per month (about twice the maximum rent restriction of $638) when they were rented to Section 8 voucher holders.

In buildings with many Section 8 voucher holders there may be significant rental revenues despite having deep affordability restrictions. For example, one City funded development is comprised of 160 one- two- and three- bedroom units and they are all required to be occupied by ELI, VLI and LI tenants. In 2013, the tenant rent analysis reviewed by the Housing Department showed that 48 percent of the units were occupied by Section 8 voucher holders. This increases the rental revenue forecast for the building by about $143,000 annually.

Some Buildings Are Considered "Service" Oriented and Are Not Expected to Repay Their City Loans

Not every project that the City funds is expected to fully repay the City loan it receives. Most City funded projects are built with a tenant demographic mix that allows for repayment of City loans, e.g. some ELI units but also some higher rent VLI and LI units. However, some are focused so heavily on extremely low income and/or special needs populations that they expect no positive cash flow during the entire affordability restriction. The majority of these buildings are homeless shelters and transitional facilities for people at risk of homelessness, such as extremely low income foster children who are aging out of the system.

In some cases, the loan promissory notes are written such that the loans will be forgiven at the end of the affordability restriction or, according to the Department, if they are written with standard repayment terms, they may be renegotiated at the request of the building owner for reasons such as refinancing of senior debt. When a renegotiation occurs, the City receives something in return, such as an increased affordability period. The Housing Department has identified about 20 of the 136 outstanding loans as being "service" developments

[26] "Section 8" is a common name for the Housing Choice Voucher Program, funded by the U.S. Department of Housing and Urban Development (HUD). It is a program that allows private landlords to rent apartments and homes at fair market rates to qualified low income tenants, with a rental subsidy administered by the local housing authority. In San José, the program is administered through the County of Santa Clara. Fair market rates are determined by HUD and based on Census rental trends.

that are unlikely to repay or fully repay their loans. These 20 properties received approximately $20.6 million in City loans out of the total $590 million lent to multifamily rental projects with active City loans.

The Housing Department Manages the Loan Portfolio

The Housing Department is responsible for the management of the City's housing loan portfolio. This involves ongoing monitoring of City-financed housing developments to ensure that the requirements of the City's loan and grant terms are met.

Since the Housing Department's creation in 1988, it has helped build over 17,500 affordable housing units. There are currently nearly 136 developments with active City loans. As of June 30, 2013, the original principal of those loans was approximately $590 million. There is a mix of small and large developments in the group with the median building offering 61 units of affordable housing. See Appendix A for a list of the outstanding developer loans. The table below lists the City's top ten developers in terms of dollars lent.

Exhibit 12: Top Ten Developers by Principal Amount on Permanent Loans

Developer	Principal Amount of Permanent Loans	FY 2012-13 Loan Repayments	Total Affordable Units
ROEM Development Corporation	$103,637,355	$1,326,135	1,943
CORE Affordable Housing	$87,935,935	$158,130	1,765
JSM Enterprises	$83,893,748	$2,362,864	1,723
First Community Housing	$53,627,685	$538,106	1,118
Housing Authority of the County of Santa Clara	$36,519,326	$373,573	1,503
Community Housing Developers	$33,359,610	$382,883	581
BRIDGE Housing Corp.	$29,969,260	$429,860	593
Seven Hills Properties	$27,022,423	$0	243
Eden Housing	$21,001,428	$718,992	656
Charities Housing Development Corporation of Santa Clara County	$18,774,932	$18,598	374

Source: San José Housing Department's cloud-based housing asset management database as of August 2013

The top three developers in San José (in terms of dollars lent) were for-profit developers that specialize in affordable housing developments, but also build market rate projects. These developers were ROEM Development Corporation, CORE Affordable Housing, and JSM Enterprises, respectively. Forty-six of the City's 136 projects with active loans were developed by these three developers and their loan principal amounts total about 47 percent of the entire loan portfolio. Repayment rates for those three developers ranged from as high as $297,000 in 2012-13 on a loan of $14 million made in 2009-10, to as low as $0 on 10 of the projects.

Housing Needs to Monitor Residual Receipt Payments and Financial Statements Closely in Order to Create a Comprehensive Cash Flow for Portfolio Administration

Loan repayments also depend on the negotiated structure of the deal. The City's developer loans are not typically structured like traditional mortgages with fixed payment terms. Instead, most of the loans are structured to have payments due only in years when the projects report earning positive cash flow and, if a large sum is still owed in the final loan year, as a balloon payment.

This structure is called a "residual receipt" loan structure and is very common in affordable housing lending. The portion of net annual cash flow each project must pay to the City is negotiated up front and typically falls between 30 to 40 percent of net annual cash flow until the loan is fully repaid. It is intended to ensure that developers have sufficient funds to maintain the buildings and the building's affordability as well as to ensure that any positive cash flows the building may generate are used, in part, to pay down debt. The downside to this structure is that it is more complicated to monitor than a fixed term repayment structure.

A number of different documents are necessary to determine net cash flow for each development because each development has slightly different restrictions on what counts as revenues and expenses for determining net cash flow and because each loan has a unique percentage of net cash flow that must be repaid in each year. Additionally, because the City's loan is subordinate to other financing in the deal, there can be agreements between other parties that come before City repayment.

In our review of the Housing Department database for active loans, some documents, particularly agreements made between other parties (where the City was not a party to the agreement), were not easily accessible to Housing Department staff which made it difficult to determine net cash flow for at least one project we reviewed.

Recommendation #5: We recommend that the Department ensure that it has easy access to all relevant legal documents, including deals between other parties that can create repayment obligations "ahead" of City loans in priority.

Housing Department Has Not Collected all Loan Payments Owed in 2011 and 2012

In order to ensure that the City is repaid in accordance with negotiated loan agreements, it is critically important to review the annual financial statements for each project as provided by developers. In particular, these need to be reviewed to ensure that net cash flow or residual receipt calculations are accurate.

We reviewed 12 City projects for residual receipt payments in calendar years 2011 and 2012. We found that none of these projects had been recently reviewed for repayment by City staff. We found that at least one project did not pay the City when it appears that it should have. Based on the promissory notes for this loan, and the information contained in their audited financial statements, it appears that this project may have underpaid the City approximately $155,000 in loan repayments and $105,000 in lease payments for 2011 and 2012, including late payment interest.[27]

Of the remaining eleven financial statement reviews we conducted, three other projects did not make payments to the City during the review period (one project was a service project and the others reported no positive cash flows), and eight made payments to the City totaling $2.54 million in 2011 and 2012.

According to the Housing Department, they have not had the capacity to conduct in-depth reviews of each project in the loan portfolio in the last few years; instead they have focused attention on conducting a few each year.

Given the significant potential revenue from this portfolio and the potential for insufficient payments as we found in our sample, we recommend that Housing dedicate more staff time to annual financial reviews to ensure that the City receives loan repayments on time. The additional staff cost of doing this should be offset by repayment revenue.

[27] In response to our audit finding, the developer told the Housing Department that it actually paid more in deferred developer fees in 2011 and 2012 than was reflected in the project's audited financial statements, which would reduce its liability to the City in those years to approximately $50,000 in unpaid residual receipts. To date, the developer has not provided the City with updated audited financial statements reflecting these changes; nor has the developer paid any residual receipts for these years. Total developer fees to be paid are determined at the start of the project and are limited by the tax credit program, the City, and other funding sources.

A New Worksheet Should Facilitate the Reviews

The Housing Department has recently created a worksheet that includes some automatic calculations for determining net cash flow. The Department has begun to ask developers and their financial auditors to populate these worksheets and submit them at the same time as project financial statements. This should allow the Department to simply check the worksheets for accuracy rather than create them which should cut staff analysis time significantly.

The picture below shows a snapshot of the worksheet described above. The information used in this determination comes from audited financial statements for each development as well as the City loan's promissory note and other fee and loan agreements that may be paid ahead of the City loan such as developer notes, bond payments and deferred developer fees.

Exhibit 13: Net Cash Flow Calculation Sheet Used by the Housing Department

City of San Jose - Net Cash Flow Analysis

[Items in red and highlighted in yellow are to be completed;Items in black are formula]

Project Name:		**Auditor:**	
Developer(s):		**Period:**	CY 2011
Property Manager:		**# of Units:**	133

Budget Item	**Audited Amount**	**Per Unit**	**Borrower Notes:**
Gross Potential Rent	1,519,188	11,422	
Other Income	30,077	226	
Vacancy, Collection, Concessions Losses	33,152	249	
Operating Income:	1,516,113	11,399	
Operating Expenses:	627,397	4,717	Admin, ins, taxes, mgt fees,personnel, R&M, utilities
Debt Service:	631,632	4,749	debt service
Purchase of Fixed assets:	-	-	Increase in prepaid expenses and other assets
Net deposits into restricted cash:	27,378	206	Net cash used by investment activities
Other Adjustments:	-	-	
Other Permitted Expenses (as permitted in promissory note):			
Deferred Developer Fee	-	-	
Ground Lease:	-	-	
Other:	-	-	
Other:	-	-	
Partnership Admin Fees:	25,000	188	Maximum allowed as permitted expense
Total Permitted Expenses	1,311,407		
Net Cash Flow	204,706	1,539	
City's Percent of Net Cash Flow	70.0%	70.0%	As revised 9/30/2002
City's Share of Net Cash Flow	143,294	1,077	
Residual Receipts Paid When Due	144,000		Per actual receipts
Residual Receipts Not Paid When Due	(706)		
Late Fee (5% of late payment)	-	-	
Total Due to the City	**143,294**	1,077	
Replacement Reserve Activity:			
Replacement Reserve Beginning Balance	133,359	1,003	
Deposits to Replacement Reserve	31,794	239	
Withdrawals from Replacement Reserves	24,241	182	
Net Replacement Reserve Activity	7,553		
Ending Replacement Reserve Balance	140,912	1,059	
Capital Expenditures Total	-	-	
Deferred Developer Fee Activity:			
Initial Closing Deferred Fee Amount	-	-	
Amount Previously Paid to this Period	-	-	
Beginning Deferred Developer Fee Balance	-	-	
Deferred Developer Fee Payments	-	-	
Ending Developer Fee Balance	-	-	

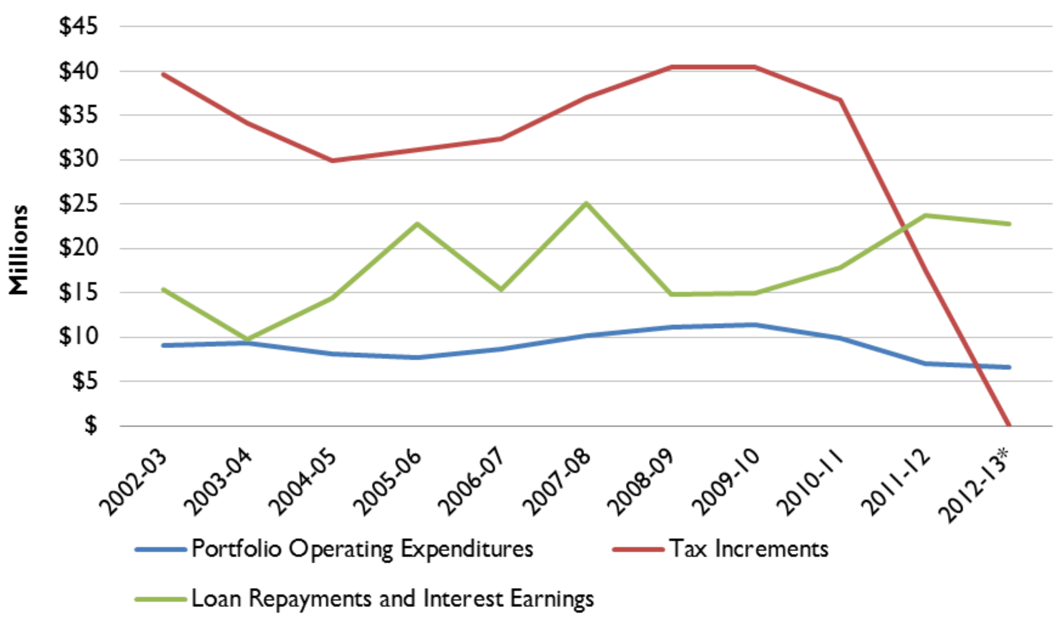
Source: Housing Department Asset Management Team

Recommendation #6: Conduct annual residual receipt analyses for all relevant projects.

Portfolio Cash Flow Analysis Is Needed

As discussed previously, the elimination of Redevelopment housing funds is having a dramatic impact on the City's Housing Department. In part, this means that revenue from the Housing loan portfolio has become an important source of funding. Exhibit 14 shows these changes. The green line shows what revenues have come in as annual loan payments, early payments, and balloon payment payoffs. Loan repayments spike the green line in the graph below because projects are sometimes repaid in somewhat unpredictable early pay-downs of loans to the City.

Exhibit 14: Loan Portfolio Revenues Over Time



Source: City of San José Operating Budgets 2004-05 through 2013-14 and Housing Department tax increment data

*No tax increments were received in 2012-13 due to the dissolution of redevelopment.

The Cash Flow From the Portfolio Is Uneven

The loan portfolio requires active management by staff in Housing, the Attorney's Office, and Finance. According to the Department, loans tend to pay unevenly throughout the loan term. They expect that loans generally will not begin to make payments to the City for the first few years after money is lent because, as part of the loan structure, the City makes its loans subordinate to the developer fees on the projects. Many loans are paid off or refinanced and significantly paid down around the 15th year of the project. This is due to the fact that most City financed projects receive tax credits (as discussed earlier in this finding) and the *federal* restrictions for the tax credits lift at the 15 year mark. After 15 years, the developers can apply for new tax credits, which can create the capital needed to rehabilitate the building and pay down debt to the City.

Project Level Cash Flow Analysis Is Needed

Each portfolio project has initial Cash Flow analyses created during the construction period of the project. These initial analyses are created for the project funders including commercial lenders. The City does not create updated cash flows during the repayment term.

Updated, accurate cash flow projections for each project are now quite important as the portfolio's revenue is the main funding source for Housing administrative costs. The Department has indicated that it would like to begin creating updated, relevant cash flow projections for each project in the coming year. Up until this point, the Department had not prepared formal projections because, with annual tax increment revenues, the revenues from the portfolio were not relied upon for budgeting purposes. The federal Office of the Comptroller of the Currency (OCC) provides guidance to banks and other lenders on assessing risk and reviewing loans for portfolio modeling and it also recommends frequent, comprehensive oversight of loans for predicting repayment streams. The City is not a regulated lender, and not required to follow OCC guidance, but the guidance is helpful for establishing basic systems of review.

We agree with the Department that cash flow analyses should be created for each project, and recommend that an in-house staff member focus time on an annual basis to obtain or create up to date cash flow analyses for each project.

Covering Departmental Administration Costs

The Department receives an average of just over $6 million per year in annual loan repayments. The Department believes that it is likely to continue to receive about $6 million per year in annual repayments for some time into the future. As Exhibit 14 indicates, this appears reasonable and, if our recommendation to review residual receipts more thoroughly is implemented, revenue could increase.

Portfolio revenues have become a concern for Housing because they are currently used to fund personnel costs for nearly half of the Department's staff. Revenues associated with projects originally funded through tax increments are accounted for in one of the City's special revenue funds, fund 346.

Housing Department staff expenditures charged to this fund have decreased by about a third since 2010-11, which was the last full fiscal year with tax increment revenues and cover a wide range of tasks including: Department administration, fiscal management, loan repayment monitoring, tenant and property manager monitoring, physical building inspections, refinancing and restructuring, single family loan approvals, and project planning and development.

Staffing

There are approximately 8.25 FTEs assigned to the single and multifamily asset management teams. Only one of these FTEs is in a classification requiring the ability to plan and coordinate the tabulation and analysis of data and ability to interpret and evaluate research and statistical data. The staff members working for this employee are only required to have knowledge of basic research and analysis methodology and techniques and knowledge of basic statistical methods. The cash flow analyses described above, as well as the tenant reviews described in the following section require a strong understanding of data analysis, mathematical skill, and real estate financial reporting. As such, the Housing Department may benefit from restructuring this team with different classifications than are currently in place.

Recommendation #7: Work with project owners to obtain up to date annual cash flows for all relevant projects. Use those cash flows to help create and inform a Housing loan portfolio cash flow.

Recommendation #8: Review job classification requirements for staff working in the Asset Management team and make changes as necessary to ensure that the team has the appropriate skill level necessary to complete the complex work required.

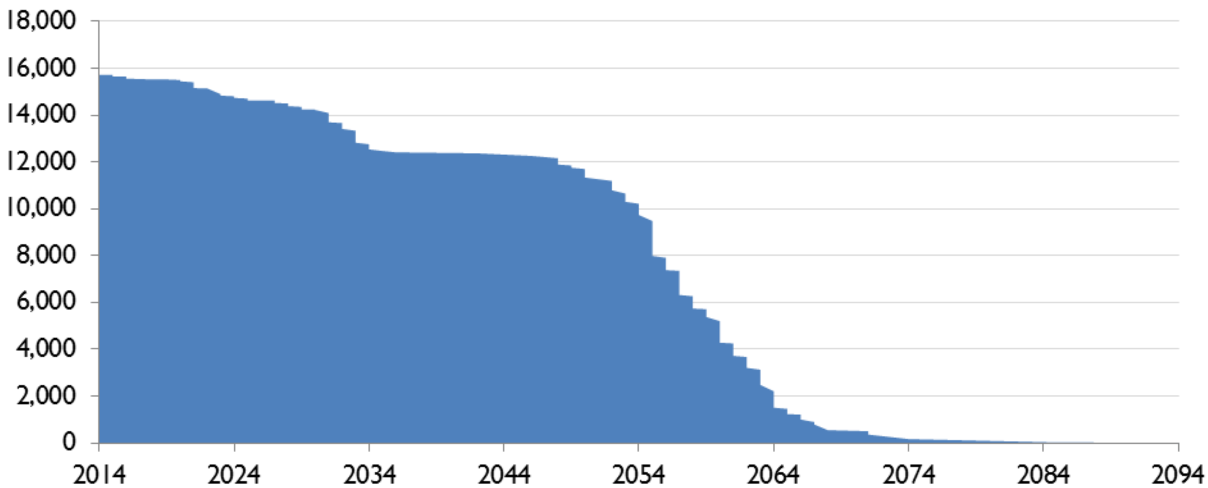
Housing Department Is Not Adequately Reviewing Annual Tenant Information

In addition to reviewing financial information for each project as described above, Housing monitors each building for compliance with other loan terms including ensuring that affordability restrictions are met by renting units to qualifying residents and that rents charged do not exceed affordability limits.

Affordability Restrictions Last for 55 Years

Once developments are built and operational, the Housing Department is required to monitor developments over the term of the affordability restriction to ensure that the terms are adhered to. Despite the fact that the Department cannot fund nearly as many projects and units as it has in the past, it will not start to lose units for quite a while. This is due to the long affordability period (55 years) required for projects funded with redevelopment tax increments. Once affordability restrictions expire building owners are free to do what they like with the buildings. They can maintain affordability, become market rate buildings, sell the property, etc. Exhibit 15 below shows how many City-assisted units will be available and need to be monitored over the next 80 years if no additional units are added.

Exhibit 15: Number of City-Assisted Units Available Over Time



Source: San José Housing Department's housing asset management database

Data Is Gathered and Stored in an Online Database

Building managers are required to submit many documents to Housing each year including property insurance information, tenant rent and income information, fair housing information, bond compliance information and financial information. While the Department's online database is not completely up to date, much of that information does appear to be collected and stored in the online database.

Annual Rent Roll Verifications

The City is required to maintain up to date information about building tenants to ensure that building managers are filling units with tenants who meet income qualifications at the time of initial occupancy, that rent charges are appropriate, and that tenants continue to meet income requirements.[28]

These objectives are met by asking building managers to provide "Rent Roll" verifications to Housing on an annual basis. The Rent Rolls detail information for each unit in the building including, name of occupants, number of tenants, rent and utility charges, Section 8 voucher information, unit size, income group

[28] IRS regulations prohibit the City or building managers from evicting tenants who no longer income-qualify for a unit in 100 percent affordable developments from buildings that receive tax credits.

targeted, move-in date, income at time of occupancy, and current income. Housing then uses this information to compute whether rent charged exceeds State or City mandated maximum charges, whether rents could be increased, reported vacancy, and how many tenants are over the income qualifications.

While the City cannot make someone move out when their income rises, in the past, the City has sent notifications to over-income tenants that they are occupying a unit that would otherwise be available to low income residents and according to the Department, these letters did encourage some over-income tenants to move out.

Mathematical Errors

We found that the computations in the Rental Compliance Worksheets were often done outside of the Microsoft Excel workbooks that they are contained within and/or completed incorrectly by building managers. This is inefficient and, as we found in each of the eight sampled projects, leads to mathematical errors in the Rent Roll reviews.

In one case, we found a large number of mathematical errors in computing total rent charged, maximum rent allowed, and the number of over-income tenants. These errors had led the Housing Department reviewer to determine that the building in question was a "problem project" with many units occupied by over-income tenants and being overcharged rent. After correcting for the errors we found, we could see that while the property was still out of compliance with rent charges, it was a much smaller problem than the Housing Department reviewer had identified. When problems like this are identified, Housing staff work with building managers to bring rent in line with requirements.

We discussed the problem with the Department and they agree that increasing automation and improving staff comfort level with software used should significantly reduce staff time and improve the accuracy of reviews of Rent Rolls.

Recommendation #9: To ensure accuracy in Rent Roll reviews, we recommend that further automate the process where possible and provide increased training to compliance staff.

Physical Building Inspection Processes Can Be Improved

The Department provides health and safety code inspection services to all multifamily developments that it has helped fund. The Department aims to provide these inspections every one to two years depending on the age of the facilities, targeted group of tenants (building with special needs tenants are reviewed more frequently), and inspection history (properties with past problems should be inspected more frequently.)

Inspections are supposed to be standardized, with inspection findings uploaded into the Department's online database for management review. Inspectors are expected to inspect for condition of the exterior of the building, landscaping, outdoor common areas such as parking lot, interior common areas such as laundry rooms, and a portion of units (generally a minimum of 15 percent of project units).[29] Inspectors are also obligated to note any deficiencies or violations of the health and safety code which they will provide to the property manager and follow up upon to ensure that corrective action occurs in a reasonable amount of time.

The Department has experienced staffing issues in this program and we found that inspections were not consistently meeting the Department's written procedures nor were they always entered correctly into the Department's online database. According to the Department, new staff is on board and is working to bring all inspections up to date.

Incomplete Inspection Records

Inspections were sometimes listed in the database as having occurred, but no evidence of the inspections was found. It is unclear if the inspections actually occurred and were just not correctly entered or if they never occurred. We found several instances like this in 2011.

Minimum Inspection Standards not Met

We also found that some inspections occurred but did not meet the Department's minimum inspection standard. Inspections of buildings with more than four units are supposed to include inspection of the common areas, the exterior of the building and at least 15 percent of the units (10 percent during much of our sampling period). Between 2011 and 2013, at least three facilities inspections did not meet this sampling minimum.

Lack of Follow-up

Some inspections found deficiencies but appear to have never followed up on the deficiencies. Whenever a deficiency is found, building managers are supposed to be notified and an inspector is supposed to come back within a short time period (depending upon the type of deficiency found) to ensure that the problem has been fixed. Most facilities with noted deficiencies did receive follow-up inspections but we found three facilities with noted deficiencies that were not resolved through follow-up inspections. The deficiencies noted that were not re-

[29] Some projects receive federal HOME funding which stipulates the inspection schedule that the City must adhere to. Other funding sources are less prescriptive. The percentage of units to inspect also varies depending if the project has received HOME funding or not and has increased over time to its current minimums of 15 percent of units for non-HOME funded projects and 20 percent of units for HOME funded projects.

inspected included multiple inoperable or missing smoke detectors and blocked egresses, both considered urgent in nature and according to the Department "must be addressed immediately."

As part of our recent audit of Code Enforcement, we found that Code Enforcement visited an affordable housing development under Housing's domain at least 10 times during fiscal year 2012-13 without informing the Housing Department of the problems it was finding.[30] Housing had inspected the property in February 2012, and had identified a number of issues including graffiti in common areas, broken smoke detectors, and gutters falling off the carports. The Housing Department has stated that due in part to the safety issues it had found, the property was being refinanced with a change in ownership at the time of the Code Enforcement inspections. We feel that improved coordination between the two Departments in cases like this would improve the situation for tenants living in these facilities. Housing inspectors and Code Enforcement are inspecting to the same criteria. Improved communication would be beneficial.

Recommendation #10: We recommend that the Department continue to improve inspection management by

a) Monitoring more closely the frequency of inspections,

b) Minimum sampling of inspections and inspection follow-up to ensure that tenants are kept safe and physical building quality is maintained, and

c) Periodically reviewing the building inspection information in its salesforce.com database to ensure that inspection records are complete and accurate.

[30] Another problem property had been a Housing funded development, but its affordability restriction ended in 2011.

Conclusion

San José consistently ranks as one of the least affordable cities in the country. Affordable housing is seen as a critical issue by City Council, staff, business leaders and the public. The Housing Department has worked for over two decades to increase the supply of affordable housing in the City but sits at a difficult time without the major funding source it previously relied on, redevelopment funds. The program with the biggest impact on increasing the supply of affordable housing has been asset management of the multifamily rental portfolio which is financed in part, with City funds. We reviewed portfolio monitoring and found that the Department can do more to ensure adequate repayment, and sufficient monitoring of tenants and building quality. We also reviewed the much smaller first-time homebuyer program and found issues in income documentation and the addition of new household members in order to qualify for those loans. We made a number of recommendations that should increase the sustainability of funding for affordable housing programming, improve the monitoring processes for multifamily developments, and improve the single family loan programs.

RECOMMENDATIONS

Recommendation #1: We recommend the Housing Department update its single family loan procedures to ensure:

a) More stringent reviews of all assets and income of ALL adult household members,
b) That new household formation not be allowed as a way to income qualify for loans except in cases where all adult household members appear as co-applicants on the loans and title to the property, and
c) That any inconsistencies be thoroughly investigated and the results of the investigation be thoroughly documented in the application file to ensure that problematic files are not uncovered in the future.

Recommendation #2: We recommend that City loan officers receive periodic training on how to conduct loan origination file reviews and the potential risks involved in approving ineligible applicants.

Recommendation #3: To ensure that loan agents do not recommend ineligible households, we recommend that the City provide mandatory training, as the Department has done in the past, on the City's eligibility and loan application requirements to loan agents working in the condo facilities that the City has targeted for down payment assistance.

Recommendation #4: To increase perceived equity in the City's Homebuyer Program, we recommend that the City increase its public outreach for homebuyer programs and maintain a homebuyer interest list.

Recommendation #5: We recommend that the Department ensure that it has easy access to all relevant legal documents, including deals between other parties that can create repayment obligations "ahead" of City loans in priority.

Recommendation #6: Conduct annual residual receipt analyses for all relevant projects.

Recommendation #7: Work with project owners to obtain up to date annual cash flows for all relevant projects. Use those cash flows to help create and inform a Housing loan portfolio cash flow.

Recommendation #8: Review job classification requirements for staff working in the Asset Management team and make changes as necessary to ensure that the team has the appropriate skill level necessary to complete the complex work required.

Recommendation #9: To ensure accuracy in Rent Roll reviews, we recommend that further automate the process where possible and provide increased training to compliance staff.

Recommendation #10: We recommend that the Department continue to improve inspection management by

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c) Periodically reviewing the building inspection information in its salesforce.com database to ensure that inspection records are complete and accurate.

APPENDIX A

List of Active Developments Through 2012 That Still Have Affordability Restrictions

Developer	Development Name	Original Loan Amount	FY Funded	ELI Units	VLI Units	LI Units	Mod Units
ROEM Development Corporation	Monte Vista Gardens	4,900,000	2000-2001	12	64	38	0
ROEM Development Corporation	Monte Vista Gardens Sr. I	4,045,000	2001-2002	7	61	0	0
ROEM Development Corporation	Shiraz Senior	3,895,000	2002-2003	0	60	0	0
ROEM Development Corporation	Rose Garden Seniors	2,775,000	2002-2003	18	47	0	0
ROEM Development Corporation	Gadberry Court	1,800,000	2002-2003	19	35	0	0
ROEM Development Corporation	Summer Breeze	10,926,418	2003-2004	30	18	111	0
ROEM Development Corporation	Hacienda Villa Senior	5,327,838	2003-2004	20	59	0	0
ROEM Development Corporation	Monte Vista Gardens Sr. II	4,779,328	2003-2004	0	48	0	0
ROEM Development Corporation	Oaks of Almaden	7,240,416	2004-2005	125	0	0	0
ROEM Development Corporation	Corde Terra Village	21,084,426	2006-2007	0	273	25	0
ROEM Development Corporation	Bella Castello	4,265,000	2006-2007	10	58	19	0
ROEM Development Corporation	Corde Terra Village Senior	14,122,816	2009-2010	199	0	0	0
ROEM Development Corporation	Orvieto Family	10,462,232	2011-2012	23	68	0	0
ROEM Development Corporation	Brookwood	8,013,881	2011-2012	21	62	0	0
ROEM Development Corporation	Rosemary Family		2011-2012	0	19	163	0
ROEM Development Corporation	Rosemary Senior		2011-2012	11	20	74	0
CORE Affordable Housing	Parkside Glen		1998-1999	0	36	144	0
CORE Affordable Housing	Palm Court Seniors	2,232,728	1998-1999	0	66	0	
CORE Affordable Housing	Vista Park Sr. I	2,837,429	1999-2000	0	82	0	0
CORE Affordable Housing	Vista Park Sr. II	2,368,000	2000-2001	0	82	0	0
CORE Affordable Housing	Lenzen Housing	4,985,337	2002-2003	0	22	66	0
CORE Affordable Housing	Markham Plaza II	2,825,295	2003-2004	151	0	0	0
CORE Affordable Housing	Markham Plaza I	2,751,219	2003-2004	152	0	0	0
CORE Affordable Housing	Pollard Plaza	12,966,246	2004-2005	0	80	49	0

APPENDIX A

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Developer	Development Name	Original Loan Amount	FY Funded	ELI Units	VLI Units	LI Units	Mod Units
CORE Affordable Housing	Delmas Park	7,548,789	2006-2007	26	41	56	0
CORE Affordable Housing	Art Ark	5,671,852	2006-2007	42	104	0	0
CORE Affordable Housing	Paseo Senter I	6,943,800	2007-2008	35	80	0	0
CORE Affordable Housing	Paseo Senter II	5,939,550	2007-2008	31	68	0	0
CORE Affordable Housing	Belovida	21,264,325	2011-2012	48	136	0	0
CORE Affordable Housing	Cornerstone	6,627,531	2011-2012	14	31	7	0
CORE Affordable Housing	San Carlos Senior	2,973,834	2011-2012	30	64	0	0
JSM Enterprises	Miranda Villa	1,900,000	1995-1996	0	55	53	0
JSM Enterprises	La Fenetre	875,000	1995-1996	0	10	40	0
JSM Enterprises	Plaza Del Sol	2,514,890	1996-1997	0	16	63	0
JSM Enterprises	Verandas	3,371,146	1998-1999	0	19	73	0
JSM Enterprises	Arbor Terrace	2,416,795	1998-1999	0	36	49	0
JSM Enterprises	Le Mirador	4,474,713	1999-2000	0	57	83	0
JSM Enterprises	Sienna Senior	4,364,525	2000-2001	0	56	83	0
JSM Enterprises	Quail Hills Sr.	3,225,600	2000-2001	0	58	37	0
JSM Enterprises	Villa Torre I	5,092,000	2001-2002	0	31	71	0
JSM Enterprises	Terramina Square	10,649,301	2002-2003	0	48	108	0
JSM Enterprises	Villa Torre II	5,986,000	2002-2003	0	27	60	0
JSM Enterprises	Villaggio Sr.	4,703,000	2002-2003	0	24	54	0
JSM Enterprises	Villa Solera	7,548,000	2003-2004	0	20	79	0
JSM Enterprises	Las Ventanas	16,232,773	2005-2006	35	39	165	0
JSM Enterprises	Oak Tree Village	10,540,000	2005-2006	0	53	121	0
First Community Housing	Guadalupe Apts.	1,948,000	1985-1986	0	63	23	0
First Community Housing	Paula Street	1,497,387	1991-1992	0	10	0	11

APPENDIX A

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Developer	Development Name	Original Loan Amount	FY Funded	ELI Units	VLI Units	LI Units	Mod Units
First Community Housing	Rincon De Los Esteros	10,577,732	1994-1995	0	135	62	49
First Community Housing	Troy Apartments	2,692,036	1995-1996	0	14	16	0
First Community Housing	Creekview Inn	1,015,443	1999-2000	10	14	0	0
First Community Housing	Craig Gardens	4,848,210	2002-2003	9	0	80	0
First Community Housing	Betty Anne Gardens	5,129,744	2003-2004	8	67	0	0
First Community Housing	El Paseo Studios	4,019,475	2003-2004	10	88	0	0
First Community Housing	Gish Apartments	2,475,000	2006-2007	20	14	0	0
First Community Housing	Casa Feliz Studios	1,170,073	2008-2009	31	7	1	0
First Community Housing	North Fourth Street	13,211,739	2009-2010	70	80	48	0
First Community Housing	Curtner Gardens	5,042,845	2011-2012	125	40	13	0
Housing Authority of the County of Santa Clara	De Rose Gardens	1,400,000	1989-1990	0	0	0	76
Housing Authority of the County of Santa Clara	Villa San Pedro	691,875	1992-1993	0	0	100	0
Housing Authority of the County of Santa Clara	Avenida Espana Gardens	1,872,000	1993-1994	0	84	0	0
Housing Authority of the County of Santa Clara	County Children Shelter	1,500,000	1993-1994	0	132	0	0
Housing Authority of the County of Santa Clara	Lucretia Gardens		1993-1994	0	16	0	0
Housing Authority of the County of Santa Clara	Julian Gardens		1993-1994	0	9	0	0
Housing Authority of the County of Santa Clara	Morrone Gardens	1,802,332	1995-1996	0	102	0	0
Housing Authority of the County of Santa Clara	Pinmore Gardens	1,490,000	1995-1996	0	51	0	0
Housing Authority of the County of Santa Clara	Poco Way	6,733,258	1996-1997	0	126	3	0

APPENDIX A

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Developer	Development Name	Original Loan Amount	FY Funded	ELI Units	VLI Units	LI Units	Mod Units
Housing Authority of the County of Santa Clara	Huff Gardens	989,181	1996-1997	0	27	44	0
Housing Authority of the County of Santa Clara	Villa Garcia		1997-1998	0	59	21	0
Housing Authority of the County of Santa Clara	Blossom River	5,616,680	1998-1999	0	49	94	0
Housing Authority of the County of Santa Clara	Villa Hermosa	1,343,000	1999-2000	0	99	0	0
Housing Authority of the County of Santa Clara	Helzer Court	7,211,000	2000-2001	0	73	81	0
Housing Authority of the County of Santa Clara	El Parador Senior	7,370,000	2001-2002	0	124	0	0
Community Housing Developers	Meadows	1,163,891	1992-1993	0	28	12	0
Community Housing Developers	The Grove	1,690,224	1993-1994	0	27	13	0
Community Housing Developers	Canoas Terrace	2,750,603	1997-1998	0	45	67	0
Community Housing Developers	Willow Glen Sr.	9,979,871	2001-2002	0	132	0	0
Community Housing Developers	Tierra Encantada	4,000,000	2004-2005	14	62	16	0
Community Housing Developers	Almaden Family	13,775,000	2006-2007	0	0	123	0
BRIDGE Housing Corp.	YWCA Villa Nueva	4,080,000	1993-1994	0	62	0	0
BRIDGE Housing Corp.	Almaden Lake Apartments	6,339,260	1994-1995	0	143	0	0
BRIDGE Housing Corp.	Ohlone Court	3,800,000	1997-1998	0	134	0	0
BRIDGE Housing Corp.	Mabuhay	9,650,000	2002-2003	14	80	0	0
BRIDGE Housing Corp.	Oak Circle	6,100,000	2003-2004	15	0	83	0
Eden Housing	Hillview Glen	7,200,000	1994-1995	0	123	14	0
Eden Housing	Casa de Los Amigos	351,428	1994-1995	24	0	0	0
Eden Housing	Catalonia	2,250,000	1995-1996	0	11	39	0
Eden Housing	Eden Palms	6,000,000	1996-1997	0	108	35	2

APPENDIX A

List of Active Developments Through 2012 That Still Have Affordability Restrictions

Developer	Development Name	Original Loan Amount	FY Funded	ELI Units	VLI Units	LI Units	Mod Units
Eden Housing	Ohlone Chynoweth Commons	5,200,000	2000-2001	17	139	36	0
Eden Housing	Ford and Monterey - Phase I		2011-2012	19	1	0	0
Eden Housing	Ford and Monterey - Phase II		2011-2012	38	21	15	0
Charities Housing Development Corp. of Santa Clara County	Pensione Esperanza	3,420,000	1999-2000	29	79	0	0
Charities Housing Development Corp. of Santa Clara County	Sunset Square	6,701,025	2002-2003	29	80	0	0
Charities Housing Development Corp. of Santa Clara County	Homesafe	3,750,000	2002-2003	24	0	0	0
Charities Housing Development Corp. of Santa Clara County	Kings Crossing		2011-2012	42	50	0	0
Charities Housing Development Corp. of Santa Clara County	Archer Studios	4,903,907	2011-2012	16	25	0	0
Seven Hills Properties	Cinnabar Commons	27,022,423	2005-2006	29	51	163	0
Mid-Peninsula Housing Coalition	Vivente I	125,000	1985-1986	0	0	29	0
Mid-Peninsula Housing Coalition	Vivente II	125,000	1985-1986	0	0	29	0
Mid-Peninsula Housing Coalition	Homeport	140,000	1990-1991	0	0	15	0
Mid-Peninsula Housing Coalition	Santa Familia	297,220	1992-1993	0	71	7	0
Mid-Peninsula Housing Coalition	Milagro	702,134	1993-1994	0	14	0	1
Mid-Peninsula Housing Coalition	Baker Park	3,245,000	1995-1996	0	42	56	0
Mid-Peninsula Housing Coalition	Girasol Seniors	527,000	1998-1999	0	59	0	0
Mid-Peninsula Housing Coalition	Italian Gardens	4,851,000	2001-2002	33	83	0	30
Mid-Peninsula Housing Coalition	Arbor Park Community	2,536,458	2001-2002	7	39	28	0
Mid-Peninsula Housing Coalition	Hillsdale Townhomes	5,000,000	2009-2010	17	18	12	0
EAH	Parkview Family	4,513,899	1997-1998	0	36	54	0
EAH	Parkview Seniors	5,005,405	1998-1999	0	139	0	0

APPENDIX A

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Developer	Development Name	Original Loan Amount	FY Funded	ELI Units	VLI Units	LI Units	Mod Units
EAH	Don de Dios	1,740,000	1999-2000	0	54	13	0
Housing Partners	Villa Savannah	3,450,000	1998-1999	0	28	108	0
Housing Partners	Stonegate	3,210,000	1998-1999	0	24	94	0
Housing Partners	Summercrest Villas	3,757,000	2002-2003	0	13	52	0
Affirmed Housing Group	Fairways at San Antonio	9501778	2009-2010	26	58	86	2
Pacific West	McCreery Courtyards		2011-2012	46	46	0	0
Family Supportive Housing, Inc.	New San Jose Family Shelter	6,291,000	2010-2011	143	0	0	0
For the Future Housing	Taylor Oaks Apartments	5,504,685	2011-2012	6	52	0	0
The Related Company	El Rancho Verde		2001-2002	0	557	139	0
Unity Care Group, Inc.	Northrup	1,520,000	2006-2007	34	0	0	0
Unity Care Group, Inc.	Roundtable	2,125,000	2007-2008	7	0	0	0
EHC	Little Orchard	3,550,614	2003-2004	260	0	0	0
Corporation for Better Housing	Brooks House	3,325,000	2002-2003	0	62	0	0
Innvision of Santa Clara	Montgomery Street	700,000	1996-1997	0	84	0	0
Innvision of Santa Clara	Julian Street Inn	860,000	1997-1998	50	0	0	0
Innvision of Santa Clara	Commercial Street Inn	447,150	1997-1998	0	0	0	0
Innvision of Santa Clara	The Villa	757,000	1999-2000	20	6	0	0
Innvision of Santa Clara	Hester Apartments	425,000	2006-2007	8	8	0	0
Fairfield Residential LLC	Turnleaf	2,951,000	2003-2004	0	16	136	0
KDF Villa Monterey, LP	Villa Monterey	2,950,000	2002-2003	0	36	83	0
HIP	Calvin	171,071	1990-1991	0	0	1	0
HIP	Donna	171,071	1990-1991	0	0	4	0
HIP	1713 Ross	171,071	1990-1991	0	0	4	0
HIP	1726 Ross	171,071	1990-1991	0	0	4	0

APPENDIX A

List of Active Developments Through 2012 That Still Have Affordability Restrictions

Developer	Development Name	Original Loan Amount	FY Funded	ELI Units	VLI Units	LI Units	Mod Units
HIP	1731 Ross	171,071	1990-1991	0	0	4	0
HIP	Minnesota	171,071	1990-1991	0	0	1	0
HIP	Hoffman - 5629	348,426	1992-1993	0	4	0	0
HIP	Hoffman - 5668	348,426	1992-1993	0	4	0	0
HIP	Hoffman - 5684	348,426	1992-1993	0	4	0	0
HIP	Burning Tree	297,153	1999-2000	0	0	1	0
HIP	Roewill	382,500	2003-2004	6	0	0	0
HIP	Curtner	171,071	2008-2009	0	0	1	0
First United Methodist Church	Vintage Tower	2,670,000	2003-2004	0	30	29	0
Chai House II, Inc.	Chai House II	2,350,112	1984-1985	13	0	0	57
Bill Wilson Center	Peacock Commons	1,917,445	2011-2012	10	17	0	0
Mercy Housing California III, L.P.	Plaza Maria	1,500,000	1995-1996	0	13	39	0
Giovanni Center		979,120	1985-1986	0	24	0	0
City of San José	127 and 110 #22 Roundtable - NSP		2011-2012	0	7	0	0
Homebase Homes, Inc	Homebase	115,000	1990-1991	0	0	12	0
Total		**589,829,126**		**2,338**	**6,865**	**4,134**	**228**

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: Sharon Erickson
City Auditor

FROM: Leslye Corsiglia

SUBJECT: **AUDIT RESPONSE – HOUSING DEPARTMENT LOAN PORTFOLIO**

DATE: May 1, 2014

Approved [signature] Date 5/7/14

This memorandum is in response to the recently completed audit of the Housing Department's Loan Portfolio. We appreciate the professionalism of the City Auditor's Office and commend their efforts to learn and to appreciate the complexities of managing over $750,000,000 in affordable housing assets, which are governed by a myriad of State and federal funding regulations. For the past several months, the Auditor and Housing staff worked cooperatively toward the mutual goal of identifying ways to improve Department operations.

Overall, we agree with the audit findings and have already taken a number of actions to facilitate their implementation. In spite of recent staffing challenges made necessary by the elimination of redevelopment, the Housing Department is pleased that the audit verifies that it ably maintains a strong portfolio of loans, grants, and affordability restrictions through active management and monitoring. It is important to note that the City is unusual in that it has one of, if not the, largest repaying affordable housing portfolios in the State. This portfolio has enabled it to survive the elimination of redevelopment and to continue to facilitate limited production of new affordable homes. And, where other localities have needed to fund housing operations out of the General Fund or with other revenues post redevelopment, San Jose's Housing Department is self sustaining.

The Housing Department is regularly audited and has received many positive audits and reviews from State and federal agencies. We recognize the importance of adhering to regulations and are used to following detailed operating practices and procedures to meet the requirements of our funders. Accordingly, the Department will diligently work to implement the audit's proposed recommendations in an expeditious manner.

The Auditor's Recommendations and the Department's specific responses to those recommendations are provided below.

<u>**Recommendation #1**</u>**:** We recommend the Housing Department update its single family loan procedures to ensure:

a) More stringent reviews of all assets and income of ALL adult household members,

b) That new household formation not be allowed as a way to income qualify for loans except in cases where all adult household members appear as co-applicants on the loans and title to the property, and

c) That any red flag items be thoroughly investigated and the results of the investigation be thoroughly documented in the application file to ensure that problematic files are not uncovered in the future.

Administration Response: The Administration concurs with the recommendation. As stated in the audit, the number of homeownership loans the Department administers has dropped significantly, as funding sources have been depleted. In the future, the Department anticipates approving 25-50 new loans a year; updated requirements will apply to these new loans.

We agree that the Department's policies and procedures were unclear, resulting in a staff interpretation that only the loan applicants needed to submit complete asset information, as opposed to all members of the household. The Department will update its procedures to clearly state the documentation that all adult family members must provide before eligibility can be determined.

This change will be complemented by incorporation of a new more restrictive definition of household formation. We concur that requiring new household members to be co-applicants on the loan both eliminates any perceived eligibility issues and allows for new household formation, such as in the case of a new marriage.

We also agree to update the policies and procedures to incorporate additional best practices that strengthen our loan review, and to appropriately document in the file any issue that raises a concern, including an explanation of the underwriting decision.

Recommendation #2: We recommend that City loan officers receive periodic training on how to conduct loan origination file reviews and the potential risks involved in approving ineligible applicants.

Administration Response: The Administration agrees with the recommendation and has already taken action to address the issue. On April 9, 2014, the Assistant Director held a half-day session with the homeownership loan origination staff and management. At this session, each potential risk was thoroughly discussed and a strategy to mitigate each one was developed. As discussed in the response to Recommendation #1 above, the Department's policies and procedures will be updated to include these new processes.

The Department will also require that all homeownership underwriting staff take a homeownership underwriting class that provides training on secondary downpayment loans and will ensure that ongoing training is prioritized.

Recommendation #3: To ensure that loan agents do not recommend ineligible households, we recommend that the City provide mandatory training, as the Department has done in the past, on the City's eligibility and loan application requirements to loan agents working in the condo facilities that the City has targeted for downpayment assistance.

Administration Response: The Administration agrees with the recommendation. The Department will provide mandatory on-site training for development-specific homeownership program within 90 days. This includes BEGIN, Inclusionary, and Habitat for Humanity programs.

Recommendation #4: To increase perceived equity in the City's Homebuyer Program, we recommend that the City increase its public outreach for homebuyer programs and maintain a homebuyer interest list.

Administration Response: The Administration agrees with the recommendation. While we do not believe there is a problem of inequity with the Department's administration of its homebuyer programs, we do agree that reestablishing an interest list may be helpful for current homeownership programs. All potential applicants of homebuyer loan programs administered by the City are required to complete homeownership training conducted by the City's nonprofit homeownership partner, Project Sentinel. The Housing Department will direct Project Sentinel to maintain an interest list for all of our homeownership programs. Individuals on this list will be provided with information regarding our programs and, as opportunities become available, we will request that Project Sentinel provide it to all persons on the list. In addition, the Department will use its updated website to continue to provide updated information on available homeownership opportunities as they become available.

Recommendation #5: We recommend that the Department ensure that it has easy access to all relevant legal documents, including deals between other parties that can create repayment obligations "ahead" of City loans in priority.

Administration Response: The Administration agrees with this recommendation. Most repayment obligations that may be senior to the City's loan repayment obligations arise from the borrowers' Limited Partnership Agreements (LPAs). While the Department routinely obtains LPAs at construction closing, to ensure the City has ready access to these documents, staff will conduct a formal request for all LPAs and amendments to be provided in electronic format for every City-funded project. The Department will also establish a "Multifamily Loan Document Index" that lists the specific loan documents that staff will be required to obtain and retain for every City-funded project. The Index will also specify the storage media format (electronic, and/or paper) and the specific location of where each document will reside. The collection and storage of documents for our transactions—which number in the dozens for each development—is a staff-intensive function. Therefore, the Department will ensure that it identifies the appropriate staffing necessary to address its document storage requirements.

Recommendation #6: Conduct annual residual receipt analyses for all relevant projects.

Administration Response: The Administration agrees with the recommendation. As noted by the Auditor, in order to increase efficiency in staff's determinations of annual payments due, the

Department has developed and begun to use a new form detailing each project's annual residual receipts calculation according to the City's methodology. The form is to be submitted by project owners' third-party auditors in 2014, and in future years, incorporated as its own page into each project's official audit. The Department is already in the process of developing iterated guidelines on how to submit calculations, and will develop the necessary process to ensure that this information is received and appropriately reviewed. Further, in order to implement a process to review calculations for projects most likely to result in residual receipt payments to the City, the Department will formalize its draft framework by which it can prioritize its reviews to maximize the impact of staff time spent on the collections function. In addition, the Department has developed a Request for Proposals to select an Asset Management Consultant that will assist the City in refining its current prioritization methodology. Finally, the Department is evaluating its staffing to ensure the ability to analyze and seek payments due to the City.

It is important to note that loans are due in full only at their maturity; therefore, if an owner does not pay an amount due in a given year, the full principal due—and interest on the amounts outstanding—would be collected in full at maturity.

Staff does not agree with the auditor's assessment of the amount of payments due for the one project of 12 audited that did not make its full payment in the years reviewed. The Department has determined that the correctly calculated amount due is only $50,000, rather than the $260,000 cited in the audit. This difference arose because the date on which project cash distributions for 2012 occurred happened after the 2012 audit was finalized in early 2013. The process involved in determining amounts due demonstrates the detailed knowledge of real estate operations and sophisticated analysis with which the Department's staff is charged. Staff's issuance of further guidance on the preparation of these calculations should assist in making audit contents as accurate and complete as necessary so the City can rely on submissions and reduce time spent on analysis.

Recommendation #7: Work with project owners to obtain up to date annual cash flows for all relevant projects. Use those cash flows to help create and inform a Housing loan portfolio cash flow.

***Administration Response*:** The Administration agrees with the recommendation. As stated in our response to Recommendation #6, the Department will focus on the collection of calculations for residual receipts payments due to the City. With this information, and with additional information to be requested from project owners about their future plans, the Department will develop a more robust process for projecting annual residual receipts and loan pay-offs to ensure adequate funds are available to cover staff costs to service and monitor its portfolio. This process will incorporate more nuanced variables (such as depth of affordability, anticipated financial restructuring date, end of tax credit compliance period, age of the loan, and prior repayment history) into the revenue projection methodology. To assist with this effort, the Department will utilize the services of an Asset Management Consultant as mentioned in Recommendation #6.

Recommendation #8: Review job classification requirements for staff working in the Asset Management team and make changes as necessary to ensure that the team has the appropriate skill level necessary to complete the complex work required.

Administration Response: The Administration agrees with the recommendation. The Housing Department will review existing job specifications to determine if modifications to existing classifications are desirable and/or if a different classification is better-suited to the specific tasks of financial document review and verification of residual receipt calculations. The Department will also evaluate the staff and management structure for Asset Management. As a means to partially address this need, the Department's FY 2014-15 Budget includes funding for a new Development Officer position to oversee the Multifamily Asset Management team, providing additional resources to answer staff's questions, seek information from borrowers, and escalate priority collections and compliance issues to senior management. The Department is also determining if there are additional staffing needs given the need to manage the growing loan portfolio and the projected workload for upcoming transactions.

Recommendation #9: To ensure accuracy in Rent Roll reviews, we recommend that the Department further automate the process where possible and provide increased training to compliance staff.

Administration Response: The Administration agrees with the recommendation. The Department will revise its current Microsoft Excel-based rent roll tool that property owners are required to use with the intention of minimizing data entry errors by staff and by property management companies. As there can be hundreds of tenants per property, each with perhaps a dozen fields of data, the total amount of data that staff works with is significant. Greater automation will reduce the likelihood of input and analysis errors. Staff will be trained on the use of this tool and the Department will roll out the revised tool to property owners and management companies.

As mentioned in the response to Recommendation #8, the Department will be hiring a Development Officer to add oversight to the Multifamily Asset Management team. This manager will be responsible for reviewing rent roll calculations and ensuring accuracy before projects with rent or income discrepancies are forwarded to management for action.

Recommendation #10: We recommend that the department continue to improve inspection management by

a) Monitoring more closely the frequency of inspections,
b) Minimum sampling of inspections and inspection follow-up to ensure that tenants are kept safe and physical building quality is maintained, and
c) Periodically reviewing the building inspection information in its salesforce.com database to ensure that inspection records are complete and accurate.

Administration Response: The Administration agrees with the recommendation. The Department will utilize the capability of the recently-completed Inspections component of its cloud-based Multifamily Loan Management System. Specifically, the Department will take the following actions:

a) Monitor frequency of inspections - New reports have been created that upload in real time the status of inspections so that the Department can ensure that it is meeting its inspection frequency targets. In addition, the Department has shifted funding to enable deployment of an additional .5 FTE inspector for this effort. While this is less than the two full-time inspectors previously deployed prior to budget reductions, addition of this half-time position to Asset Management will allow management to cross-train staff so that the Department will always have trained staff available to perform multifamily project inspections.

b) The Department's new cloud-based system allows management to review detailed inspection results for all inspections on-line. This ease of access allows management to review individual inspection results. New reports have been created that summarize monthly inspection activity. These reports will be summarized and provided to executive management in the form of a Quarterly Inspection Report.

c) Since the entire inspection record for all newly-completed inspections are available on-line, management can now periodically drill down to look at individual inspection data input by an inspector to ensure inspections are performed according to established procedures. A new report will be developed that flags all inspections with missing data.

In addition, the Department now has access to the Code Enforcement database. The Housing Inspector has been instructed to check the Code Enforcement System prior to performing an inspection on any project. The Department will revise its written inspection procedures to incorporate these and other measures to ensure appropriate coordination with Code Enforcement to ensure maximum efficiency of inspection resources.

In closing, I want to again thank the Auditor's staff for their efforts to improve the Department's complex loan management functions. The Audit provided new ideas and bolstered previously-identified strategies that will aid the Department in the fulfillment of its mission. Most importantly, these practices will help ensure that the City maintains a healthy loan and property portfolio so that the thousands of current and future residents in these homes will continue to have safe and healthy places in which to live and prosper.

This memo has been coordinated with the City Manager's Office, Budget Office, and City Attorney's Office.

LESLYE CORSIGLIA
Director of Housing