Episode 17: How does affordable housing financing work?

Welcome to Dwellings, a podcast from the City of San José Housing Department, where we talk with experts about ending homelessness, building affordable housing, and exploring housing policies at the city and state level. I'm your host Jeff Scott. On today's episode, I'm joined by Rachel VanderVeen, Deputy Director of the City of San Jose Housing Department, to talk about how financing an affordable apartment in the City of San Jose works.

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Jeff Scott: We are joined today by Rachel VanderVeen. She's a deputy director in the City of San Jose Housing Department. And Rachel has graciously agreed to talk to us today about affordable housing finance. Welcome, Rachel.

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Rachel VanderVeen: Hello, thank you so much for having me today.

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Jeff: Well, thanks for joining us, and Rachel, can you start off by letting our audience know what your role is? What do you do for the City's Housing Department?

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Rachel: Sure. So I serve as the deputy director for the Housing Department, and I manage multiple groups within the department. And my primary responsibilities are to manage the Residential Development Division and the Rent Stabilization Program and our Administration Team. And so through that, the most significant responsibilities are to manage our new production and program for affordable housing, and then also to oversee our rent control requirements for the city. And so those are my two primary responsibilities.

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Jeff: There's always a lot of talk in the media around Silicon Valley about affordable housing, the need for more. It seems like there's a constant need for more. What are some of the financing tools at your disposal to help make it possible for us to build more new, affordable housing?

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Rachel: So the tools that developers use most frequently to build affordable housing are the low income housing tax credit and the tax credit is a federal program that allows developers to bring in investors from outside who receive tax credits for in exchange for their investment in the affordable housing development. Secondly, there are multifamily revenue bonds that are paired with tax credits that are distributed through the state of California. And so those two tools, tax credits, can actually be used alone or with bonds. But those are the most critical tools and heavily used in that, putting together the financing necessary to make affordable housing happen.

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Jeff: What do you mean when you say that the bonds can be paired with tax credits? Can you explain that a little bit more?

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Rachel: Right. So the state has a program where they allocate bonds that can be used for a specific development. When those bonds are allocated, the same project also can receive 4% tax credits. So the two come together as a pair and provide two different types of financing that work really well to make an affordable housing development work.

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Jeff: So what's a 4% tax credit? What does that mean in plain English?

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Rachel: What that means is the investor they can actually purchase tax credits themselves, and they can use those to offset their tax obligation as a company or a bank, whatever the industry may be, and the 4% tax credit, the 4% refers to the value, and there's 4% and 9%. And so with 9% tax credits, you can actually receive even more value from the tax credits versus the 4%.

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Jeff: When these tax credits are paired with bonds, who issues the bonds and who is responsible for paying them back.

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Rachel: The local jurisdiction is the most common issuer. So in this case, in our case, the city of San Jose, actually issues bonds. There are also some additional outside issuers is kind of what we call them, but there's different agencies that do have the authority to issue bonds as well. But in the case of the city of San Jose, we typically are going to be the issuer of the bonds when the bonds are issued, then that provides funding that goes to the developer and provides the funds necessary to for example, for construction costs for the development itself.

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Jeff: How or by whom are those bonds paid back?

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Rachel: So the bonds are paid back in a couple of different ways if they are used for construction? Many times they're actually some portion of them may be paid back when the project is refinanced to permanent financing which means after the building is built and tenants move in, then the financing is actually restructured into permanent financing. So sometimes some of the bonds are paid off as soon as the permanent loan is put in place. But other times the schedule is put together where the bonds are in place for many years. And those are paid by the developer over time as just regular payments on the on the development.

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Jeff: So here's a question. Im sure, a lot of people are wondering, why is it so complicated? You're talking about tax credits and pulling in investors through those tax credits and having bonded issuances and then having to pay back those bonds. Whereas I think a lot of us just used to borrow some money to buy a house or borrowing money to build a house. So what is it about the nature of affordable housing that causes it to become a little bit more complicated, to line up the financing?

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Rachel: Well, that is a good question. Typically, for a real estate, there's two types of investment that are made. And this is not affordable housing. It's just general real estate. So typically there's debt and equity. And so, a, you know, if a developer wants to build a building, they're going to be looking for debt from a bank just like, you know, if I wanted to go buy a house, I would go to a bank and get a loan. And so the debt works very similarly. But the equity is is a little bit different where it's a little bit higher risk. And you may have an investor who really wants to make a higher return in a shorter period of time on their equity investment. So that is how a typical real estate transaction is put together. In the case of affordable housing, instead of having debt and equity, there's still debt. There are first mortgages that developers receive on these buildings that they get from banks that we're all very familiar with. Bank of America and Wells Fargo, Bank of the West is just our general banks that we're very familiar with. But the equity is something that is not necessarily going to happen for an affordable housing development, because in the in the long term, the rents are limited. And so there's not going to be as much incentive or payoff for someone to put equity into the into the real estate deal. So instead, that's where the bonds and the tax credits come in and really serve as that piece of the financing. So I guess it's a long way of saying it is, It's similar to how real estate is developed in for both market and affordable, but for affordable it's very difficult to have an equity investor come in without these tools of tax credits and bonds.

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Jeff: In the city of San Jose, there are also other ways that the city itself raises money that will then be spent or invested on affordable housing. I'm thinking of Measure E, which the voters passed a couple of years ago. I believe there's a commercial linkage fee that's assessed to commercial developments. I think there may be some sort of a inclusionary housing fee that market-rate developers pay in all these different sources of funding go into at least partially go into helping to pay for new affordable housing. Right. So can you let us know or can you explain to us, aside from the tax credits and bonds, how did how do these other fees, how do these other sources of funding kind of complement the bonds and the and the tax credits you just explained?

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Rachel: So in affordable housing financing, what we refer to as this remaining piece is gap financing. So what you do is you take a look at the total cost of development for the affordable housing development. You look at the first lender, you look at that debt, and then you consider how much money you can raise through tax credits and bonds. And then typically there's a gap, a gap between the total cost and then that stack of financing. We call that the gap that needs to be filled by a local agency. So the city of San Jose, we'll take a look at that gap and will provide a loan with very favorable terms to the affordable housing developer to make it happen. And we're going to use all those different sources that you just mentioned. If it be measure E bonds or commercial linkage fees. Money raised through our inclusionary program. Those are all different funds that we will use to provide a loan to the developer for the gap that remains.

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Jeff: You just said that the loan that the city would make in that case to try to cover that gap is tends to be pretty favorable to the developer. Can you explain what that means? Because I think a lot of us are familiar with a typical residential mortgage where we get a mortgage, we pay it back over time, 30 years or some other period of time in roughly equal installments each month. So how do these loans that you're describing differ from a traditional mortgage?

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Rachel: Yeah. So these loans are called residual receipt loans. So what that means is instead of paying a regular payment every month, what the developer can do is take a look at the operating costs versus the rents that were collected for any given year and determine how much money was is remaining after paying all of that debt and other obligations on the property. What happens then is there's a calculation made on the remaining amount, and if there is a remaining amount, it's split between the developer and the city, and that piece pays back the city's loan. So what that means is that there is no actual specific payment that's due and instead the cost of the development is calculated. And let's say that there's a year that for some reason rents were low, then that year they do not have to make a large payment to the city. If there's nothing left over, then their payment to the city could actually be zero and that would be acceptable.

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Jeff: But at some point the loan would be paid off, correct? Perhaps if the properties refinanced or if they reached the end of their financing, then at some point one would assume that loan will ultimately be paid back in some form. Is that correct?

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Rachel: Yes. So that loan will be paid back by the end of the term. And many times for these developers, it's after 15 years, there's an opportunity for refinancing. As I mentioned earlier, many of the deals include tax credits and tax credits are invested on a 15 year basis. And so what happens is, after all the obligations and all the needs are met for the tax credit investor, after 15 years, it's very common that they actually exit the deal and find another another opportunity to invest. And so after 15 years, there is a good opportunity to refinance the whole project. And so that provides a great opportunity for paydowns for the city or even just restructuring so that the city's portion can be paid off more quickly.

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Jeff: And I understand that when a developer refinances an affordable housing project, it's common that part of the conditions of that refinance are the extension of the period of affordability, so that in exchange for refinancing, they have to agree to keep the rents at an affordable level for a certain number of additional years. Is that correct?

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Rachel: Yes. In exchange for the loan that the city makes to the developer, there's an affordability restriction that's placed on the property. And that restriction is initially put in place for 55 years. And for 55 years the apartments in that building, the rents are determined by the original structure of the of the deal. So rents must be limited to specific income levels. And so when there's an opportunity to refinance, that's very common for the city to request additional time for that restriction. So if it started out 55 years, it is very likely that we could ask for an additional 15 years when they refinance.

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Jeff: And so I just want to go back to something you just mentioned just a moment ago about the rents being restricted and what exactly that means, because that obviously plays into how much income the developer is going to derive and how much how much they're able to pay back to the city over time. So can you give us some examples? Of what the income thresholds might be different levels of affordability for what we're generally calling affordable housing.

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Rachel: The way affordable housing works, as I mentioned, is that the rents in the development are limited by income. And so, for example, if you think about a four person household in the San Jose right now, rents for a low income unit would be limited to a household who earns $84,000 a year. Now we also have extremely low income households, which is a priority for our department and for a household of four. That would be a family who makes $50,000 a year. And if it's just one person, it could actually be someone who's making around $35,000 a year. So there is a range in income levels in many of our developments, but it is a stated city council priority that 40% of all of our funding provide units that are affordable to our extremely low income families.

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Jeff: Okay, so as the way I understand it, and you just touched on a couple of the levels, I believe there's extremely low which is the lowest income level. Then there's very low income there's low income and I think then there's moderate income. And so each one of these income levels, if I understand that correctly, has a slightly higher threshold like extremely low would be the lowest income very low, we would allow for a slightly higher income, low income again could have a slightly higher income again, and a moderate income. Can we have the highest income if that so if as I have that correct. And so my question for you is when a developer, an affordable housing developers putting together a deal and trying to pencil it out and make sure it works. Well, they often have a mix of different income levels in their unit, so maybe a handful of low income units and a handful of very low income units, maybe a few moderate income units, to try to make the deal work financially.

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Rachel: Yes, it's very common to have a mix within the development. So a typical mix is actually a third, a third, a third, that's how I like to think about it. So a third are going to be affordable to our extremely low income households. A third to our very low income and a third to our low income. It's actually very uncommon for our developments to fund at the moderate income level for rental housing, typically we would do moderate income for sale or other programs. But we don't have very many moderate income households that are receiving funding in these apartment buildings.

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Jeff: And what about a what about a market rate developer a traditional housing developer who's building market rate apartments to rent out? Will, they oftentimes include some low income apartments that have restrictions on their rent. Is that an obligation they have? You know, why would they do that if they do that at all?

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Rachel: So the city has an inclusionary housing requirement, and that requirement states that market rate developers are required to provide some form of affordable housing. So developers have many choices. They can do that by actually building affordable units into their development, or they can also provide land and dedicate land so that affordable housing development can be built somewhere else, or they can partner with an affordable housing developer and have the affordable units built adjacent to the market rate units. So there's actually several different options. And what we do is work with the market rate developer to make sure, as they are building market rate housing, affordable housing is also being built at the same time.

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Jeff: So for developers who don't want to develop affordable housing or they feel like their project won't pencil out if they put in affordable housing, is there a fee that they can pay to the city in lieu of building the actual units themselves?

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Rachel: Yes, the ordinance also allows developers to calculate a fee based on the number of square feet of market rate development that they're building, and they can choose an option of paying a fee. Then those fees are taken by our team, and we invest them into a affordable housing development that's coming up in our pipeline. So that is an option.

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Jeff: And do we ever have situations where we have affordable housing developers who are doing more than just housing? So Im thinking. One thing that I see a lot of is I see apartments going in around retail or restaurants based? So there's some sort of a mixed use of the real estate development. Does that also hold true for affordable housing development that sometimes it's part of a mixed use development?

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Rachel: It can be. There's a recent example of an affordable housing development that was just completed called Quetzal Gardens and on the bottom floor, Quetzal Gardens there are there's a great open space for SOMOS, which is someone's maker, which is a nonprofit. There's also a credit union there and an incubator for small businesses. And so all of those are actually in the same building as the affordable housing units. So that's one example. We have had other commercial spaces built in the same building again with affordable housing, such as a childcare center, or even a 711 or you know other small retail spaces. So that is something that can happen. Our team really gets excited when we get when we see partnerships between nonprofits and affordable housing developers because we think it's a wonderful idea to have nonprofits have space that they know they can count on into the future, but also can run programs that provide great support to the people living in the affordable housing development and in the neighborhood.

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Jeff: And as far as the companies or the organizations that actually put these deals together, the developers, it sounds like it's typically nonprofits that will get into the affordable housing development or are there any market rate developers for profit companies that also build affordable housing? Or is it really a specialty that is reserved for nonprofit developers?

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Rachel: We have both nonprofit and for profit developers who specialize in affordable housing. And so it really can be either or. It's not limited to nonprofit developers. I would just say that for profit developers have to make a choice and decide if this is how they want to like that. They want to develop an expertise and work in this space. Either way, we've had great successes with affordable housing, development being built, and we really value partners with both for profit and nonprofit developers.

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Jeff: And I know the city, San Jose, really our entire region, Silicon Valley, it's just so expensive. We're all very well aware of how expensive it is. Land acquisition, materials, labor. It's all much more expensive here in our area than it is in much of the United States. Does that make it does that make the process of affordable housing finance more complicated, more difficult? Or if I went to some other city and some other part of the country, would it be pretty similar to what we're seeing with the process, be pretty similar to what we're seeing here.

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Rachel: The high cost of development in San Jose and actually in the Bay Area region has become a challenge. As I stated earlier, there's layers of financing, right? So we have the first lender and then we have the bonds, the tax credits and then the gaps that financing. And many times what happens with the high cost is that it makes gaps really large. It makes them large, large enough where it may be difficult for the city or the county to come in and provide that level of funding. It also has proven to be less competitive for state resources such as the the bonds. And so what's happened is because the costs are higher here, there's less of an interest to or those projects are just less competitive. So it has become a problem. We're trying to work through it on a policy point, but also by trying to think about innovative ways to bring down cost because we really need to be thinking about how to lower those numbers and not just continue to watch them climb year over year because it really is becoming a barrier to the Affordable housing development itself. This is just allow the costs to just continue to climb. So we're looking at innovative technologies such as modular construction or mass timber construction. There's different methods out that are available to affordable housing developers that we want to explore and just understand. If there's a way to start to bring those costs back down.

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Jeff: It sounds like getting more affordable housing built in this area is not an easy task. And I know that your department is always facing a lot of pressure to get more housing built. So I don't envy the position that you're in, but I certainly respect all the work that you and your team is doing. Do you have anything else that you wanted to add about affordable housing finance?

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Rachel: Sometimes when I think about affordable housing finance, I feel like it's layers in a cake. So you have many different layers that all have to come together at the right time. One of our layers is our lending ourselves. But that can't do it alone. We need to understand what it takes to make sure the private lenders are willing to invest in affordable housing. We need to make sure we have tax credit investors and that our bonds can be we can access them and get the secure allocations through the state through different policy decisions that are made there and then of course, our funding needs to come in as well. So it's just important for us to understand how it all comes together so that in the end, it will be complete.

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Jeff: Well, thank you, Rachel. We appreciate your time and it was a pleasure talking with you and thanks for being so informative about your explanations with regard to affordable housing finance. I know it's a difficult subject.

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Rachel: Thank you

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Jeff: Thanks so much Rachel, for joining me on today's episode. To learn more about Affordable Housing Financing, please visit our website at www.sjhousing.org. Thanks for listening to Dwellings, the City of San José Housing Department podcast. Our theme music is "Speed City," composed and performed by Ettaine Charles. Thanks to San José Jazz for letting us use your music. If you like the show, please subscribe and share with your friends and family. If you're looking for more ways to get involved with housing and homelessness response, please check out the show notes. You can follow the Housing Department on social media. We're on Twitter and Facebook at S J city housing. If you have questions or comments about today's episode, please send them to housingcomms@sanJoseca.gov. Our artwork is by Chelsea Palacio. Dwellings is produced by me, Jeff Scott and Jose Chavez and the Housing Department.