

**From:** Melinda Cotton [mailto:mbcotton@hotmail.com]

**Sent:** Tuesday, January 18, 2022 1:01 PM

**To:** Tom Modica <Tom.Modica@longbeach.gov>; Oscar Orci <Oscar.Orci@longbeach.gov>

**Cc:** Mayor <Mayor@longbeach.gov>; Council District 1 <District1@longbeach.gov>; Council District 2 <District2@longbeach.gov>; Council District 3 <District3@longbeach.gov>; Council District 4 <District4@longbeach.gov>; Council District 5 <District5@longbeach.gov>; Council District 6 <District6@longbeach.gov>; Councilmember Roberto Uranga <district7lb@gmail.com>; Council District 8 <District8@longbeach.gov>; Council District 9 <District9@longbeach.gov>; CityClerk <CityClerk@longbeach.gov>; Linda Tatum <Linda.Tatum@longbeach.gov>

**Subject:** Important to define "Affordable Housing" expense references in understandable \$\$\$ (Dollar) Terms - not Obscure "Area Median Income (AMI)" type language

**-EXTERNAL-**

Hello Mr. Modica and Mr. Orci,

The public really needs your help in making the term "Affordable Housing" understandable.

For example in the "Middle Income Workforce Housing Financing" memorandum attached and on the Council Agenda today, what is supposed to explain the term "Moderate Income Households" uses the incomprehensible language below - this should be expressed in real world terminology of Dollars (\$\$\$) and current income ranges, not by using the percentage of "Area Median Income (AMI)":

"Moderate income households are those households earning between 81 to 100 percent of the Area Median Income (AMI) and "middle-income" households earning between 101 percent and 120 percent of AMI."

Please add into your explanations of housing cost the actual income ranges you are referencing. It's important for government to be understandable and transparent.

Thank you.

Sincerely, Melinda Cotton

Date: January 13, 2022

To: Thomas B. Modica, City Manager



From: Oscar W. Orci, Director Development Services



For: Mayor and Members of the City Council

Subject: **Middle Income/Workforce Housing Financing**

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Supply and access to adequate and affordable housing continue to be among the biggest challenges in Long Beach (City) and communities across the State. Over the past several years the City Council has discussed this issue at great length and taken many actions to address the housing shortage, including creating policies and programs (Revenue Tools and Incentives for the Production of Affordable and Workforce Housing, Everyone Home Long Beach, Inclusionary Housing, Enhance Density Bonus Ordinance) that provide opportunities to develop affordable housing in the City. On November 16, 2021, the City Council approved the General Plan Housing Element, which demonstrates the City's ability to accommodate the projected 26,502 housing units needed over the next planning cycle (2021-2029). Almost 60 percent of these units are targeted toward affordable households, including approximately 16 percent designated for moderate income households. Moderate income households are those households earning between 81 to 100 percent of the Area Median Income (AMI) and "middle-income" households earning between 101 percent and 120 percent of AMI. Available federal, state and local funding sources are largely targeted at households with incomes at or below 60 percent AMI. Funding for moderate income/workforce housing is not generally available.

Recently, local governments, including Long Beach, have received requests from Project Sponsors (Sponsors) and Joint Power Authorities (JPA's) to participate in a relatively new bond-financing structure for moderate/middle-income rental housing projects. These transactions are 100 percent financed by bonds as well as exempt from property taxes during the bond term. The bonds are issued through a JPA (the owner) to acquire high-end new rental property with a portion or all units allocated to moderate/middle-income households. The bonds are structured in two parts: Series A Bond, which pay for acquisition, financing, reserves, construction and other costs; and, Series B Bonds, which is given to the Sponsor/Project Administrator which initiated the transaction. The Sponsor and the JPA typically receives upfront and ongoing fees in this financing model. This financing structure is relatively new and untested. Thus, there is no historical data on its long-term impacts to the housing market or local governments that participate.

Generally speaking, local governments have the right to purchase the property at the end of the bond term or during the certain period of time during the bond term, since properties are purchased on their behalf. Since some bonds are not fully amortized (interest only payment) growth in operating income is needed to repay the bonds. If that growth does not occur, a

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project can go into foreclosure or debt repayment would be needed from the sale of the property which could leave little to no funding left for the local government entity that did not collect the property tax revenue.

Given the modest rent discounts, consideration should be provided to maximizing rent discounts while minimizing risk by covering bond debt, operational expenses and recovering the lost property taxes. Rents should be provided for households earning 80% AMI with 55-year deed restricted units to receive Regional Housing Needs Allocation credit. Reserve accounts with escalators should be established to pay for ongoing property maintenance during the entire bond term. Bonds should be fully amortized (principal and interest) in order to reduce the debt at the end of the bond term. These transactions should include an annual fee to recover property taxes that would otherwise be lost.

A whitepaper (“JPA Bond Proposals for Government-Owned Middle-Income Housing in California”) prepared by CSG Advisors, a leading financial advisor on housing revenue bonds, HR&A Advisors, a national real estate economics firm, (Attachment A – Final JPA), and the California Housing Partnership describes in greater detail the bond financing structure, including challenges/risks as well as considerations for decisionmakers when evaluating such proposals has been attached for your review. The whitepaper also includes a brief discussion on the recently passed Assembly Bill 787 that allows up to 25 percent cities moderate income Regional Housing Needs Allocation credit for project below 100 percent AMI.

On February 16, 2021, the City Council requested the City Manager to develop a proposed policy for participation in the Middle Income/Workforce Rental Housing Programs. On January 18, staff will be providing the City Council with recommendations for future middle-income/workforce housing financing.

ATTACHMENT A – FINAL JPA

CC: CHARLES PARKIN, CITY ATTORNEY  
DOUGLAS P. HAUBERT, CITY PROSECUTOR  
LAURA L. DOUD, CITY AUDITOR  
LINDA F. TATUM, ASSISTANT CITY MANAGER  
TERESA CHANDLER, DEPUTY CITY MANAGER  
MEREDITH REYNOLDS, DEPUTY CITY MANAGER FOR RECOVERY  
APRIL WALKER, ADMINISTRATIVE DEPUTY CITY MANAGER  
MONIQUE DE LA GARZA, CITY CLERK  
DEPARTMENT HEADS

To: California Local Governments  
Date: November 2021  
Re: **JPA Bond Proposals for Government-Owned Middle-Income Housing in California**

### ***PURPOSE OF THIS MEMO***

During the last two years, local governments in California have been inundated with proposals to authorize government-owned middle-income housing funded by tax-exempt bonds and paired with an exemption from property taxes. Proponents argue that these proposals will help local governments meet housing demand in the “missing middle” – i.e., households who earn too much to qualify for subsidized housing, but not enough to afford market-rate housing. The proposals are sponsored by Joint Powers Authorities (“JPAs”) that serve as conduit issuers of financing on behalf of local governments. JPAs work with private sector real estate investors acting as asset managers.

To date, approximately \$5 billion of such bonds have closed to buy 9,000 apartments at an average investment per unit over \$540,000, with a portion of such units restricted for middle-income households. The total financing is quickly dwarfing the \$3.7 billion in annual allocations of Low-Income Housing Tax Credits for low- and very low-income households in California.

Yet these proposals involve a type of unrated bond, ownership structure, asset management roles, and affordability levels which have rarely been used before. They create major risks for the projects themselves and the long-term affordability for which all local taxing entities are foregoing property tax revenues. The JPA proposals do not fully describe these risks but rather emphasize the potential windfall when local government gain control of the buildings (typically between the 15<sup>th</sup> and 30<sup>th</sup> year of bond financing) and limited liability. There is no current limit on the number of such potential transactions or the fiscal or real estate risks this program will create in California.

Our organizations – leading advisors and consultants on affordable housing for public agencies in California and nationally – have been asked by more than a dozen local governments to evaluate these proposals, identify issues and challenges, and make recommendations. Having spent decades working on affordable housing financing for public agencies, we are highly committed to finding solutions that create and maintain affordability at a wide range of income levels. We are equally committed to doing so in ways that are effective and safe in the long run, and do not result in enormous and avoidable problems. Our organizations are independent and have no financial stake one way or the other in local government decisions on these projects. Our experience is described in an Appendix. Our only purpose and role are to help address affordability and financing needs in ways that will be successful and sustainable long-term for the projects, their tenants, their communities, and local governments.

Given the importance of this issue, we have worked together to outline the major features of the JPA proposals, their potential risks and the specific conditions and criteria under which we collectively believe local governments can safely and prudently consider proposals for such government-owned middle-income housing. Especially since no State law regulates government-owned middle-income housing bond programs to assure meaningful affordability benefits, in the way that State law now governs housing owned and financed by housing authorities, these criteria are essential for local governments reviewing these proposals. More specifically these three criteria are:

1. The local government *believes that government-owned middle-income housing is itself a good idea and would itself be willing to own and finance such developments on these terms with this same type of debt – whether or not the JPA was involved.*
2. *The direct affordability benefit, on units where rents are being reduced more than 10% below existing rents, is greater than the total local property taxes all taxing entities would receive if the property were sold to a private owner.*
3. *To avoid the project being extraordinarily risky – and jeopardizing its future affordability – the project must be able to pay off all debt without relying on future income growth. The debt service coverage ratio (the reasonably projected cash flow compared to the debt and related payments required to amortize all debt) must therefore be at least 1 to 1 from the beginning.*

### **PART ONE: JPA PROPOSALS FOR GOVERNMENT-OWNED MIDDLE-INCOME HOUSING**

While the individual proposals differ slightly, each involves the following eight structural elements. Our focus is on the fundamental features being proposed, recognizing that there are continuing variations and changes as these proposals evolve in response to local concerns.

1. **Require local government use its power to purchase, own and finance property through the JPA.** By joining the JPA program, the local government’s authority to own and finance **public facilities** -- such as city halls and parks, and which has almost never been used for rental housing – is transferred to the JPA. The JPA uses that local government power to acquire large, generally high-end apartment complexes. Such governmental authority has rarely been used for housing, and almost always by experienced housing authorities.
2. **Restrict rents at limited discount to market rents for middle income households.** In return for agreeing to government ownership and the resulting exemption from property taxes, a portion of the units are restricted to tenants typically earning 80% to 120% of Area Median Income (“AMI”) for as long as the bonds are outstanding (i.e., typically 15-30 years). The percentage of units for different income brackets varies from one proposal to the next, as does the reduction from current market rents. The maximum rent has typically been set at 35% of the maximum income, as opposed to the 30% of maximum income (net of tenant-paid utilities) required by federal and state housing programs. (In response to this concern, some proposals now show rents at 30% of maximum income or have focused benefits on lower income tenants).

While some projects provide a significant reduction from current market rent for units restricted below 80%, there is generally little or no reduction for units at 120% of AMI. Such 120% units are effectively at market rates and would be the same regardless of the program.

The cash flow assumptions require significant ongoing *growth* in net operating income on both restricted and market units to repay the bonds.

3. **Require foregoing the property taxes on such middle-income housing, including on both the restricted and non-restricted units.** The approving local government and all other taxing entities give up the property taxes for both the restricted and unrestricted units as long as the project remains government owned. This has several important consequences.
  - Given that the seller has offered the property for sale, the taxes being foregone are not simply the same amount that has been paid in the past, but the amount a **new private buyer** would otherwise pay based on the sale price today (and any proposed rehabilitation). This is often substantially greater than the past taxes.
  - The local government is not the only taxing entity impacted. The total amount foregone by K-12 and community college school districts (or back-filled by the State), counties and other taxing entities not involved in the approval process is five to eight times greater than that lost by the local government. In each of the proposals we have examined, the **total property taxes foregone** by all taxing entities **are greater than the annual reduction in rents, often by significant margins.**
  - While some recent proposals offer the local government a 'host' fee to make up the reduction from past taxes, they do not cover the far greater lost taxes of other entities.
  - The greater the number of units acquired under these proposals, the more severe the financial impact.
  - From the appraisals we have reviewed, the values and prices being paid for these properties inappropriately include the future value of the taxes the governments are being asked to forego – leading project sponsors to pay the for-profit private sellers more than private buyers might on the open market.
  - Some more recent proposals have sought to compensate the local government itself (but not the other taxing entities), further differentiating the benefits to the local government versus other public agencies and, in many cases, reducing the debt service coverage on the bonds.
  
4. **Utilize unrated tax-exempt bonds with riskier features than almost all affordable and rental housing financing in the United States.** These bond issues have several key features:
  - There is no credit enhancement, unlike publicly sold multifamily revenue bonds for other affordable housing developments; no bank or federal agency provides any security for the bonds.
  - The bonds are structured as interest only (i.e., non-amortizing).
  - The loan to value ratio is more than 100% (compared to a typical maximum of 75% to 80% on bank, Fannie Mae and Freddie Mac financings).
  - The initial debt service coverage ratio, which compares the net income after payment of operating costs to the debt service payments, even on an interest-only basis is less than 1.0.
  - Instead of being able to show the strong positive coverage for fully amortizing debt required by major lenders, the initial income from the JPA projects is far below that needed to amortize the bonds. Instead of the 1.15 coverage required by major lenders, many of these projects start out at less than .70.
  - As a result, unlike virtually all financing for affordable and market-rate rental housing, the debt cannot be repaid based on current net operating income, but depends on assumed future growth.
  - In addition to a Series A Bond to pay for acquisition, financing, reserves and other costs, the structure includes a subordinate Series B Bond. This B bond does not provide any moneys to cover project costs, but is given to the private project sponsor who initiates the deal. This B Bond, effectively a form of preferred equity, carries a tax-exempt interest rate that is typically 10%, and

is required to be paid by the project prior to the local government in the repayment schedule. It is typically structured as a capital appreciation bond that compounds until it is finally paid.

- In the event of a bond default, since there is no credit enhancer, loan servicer or majority holder of the A bonds to make decisions, a committee of bondholders would have to be created to work with the bond trustee to try to arrange a workout or foreclosure sale, with potential losses to bondholders and substantial litigation costs.
5. **Provide an extraordinary level of compensation for the service providers** on such government-owned housing – the JPA, private developer acting as project sponsor and bond underwriter. They receive compensation in the form of up-front and/or ongoing fees and subordinate bonds, which have totaled more than \$10 million on each of the projects we have reviewed.
  6. **No traditional landlord or responsible party.** The projects are structured without financial responsibility by any party for future cash shortfalls. None of the parties – the local government who is the beneficial owner, the JPA and the project sponsor – have any legal responsibility or obligation to provide any funds to cover future problems or debt service. Therefore, if the building does not achieve rent growth expectations or runs into other financial issues, the only monies available are temporary reserves that must ultimately be repaid to bondholders. There is no landlord or owner with any financial responsibility for covering problems.
  7. **Make the local government the beneficial owner of the property, with the right to purchase (and or re-sell) the property in 15 years, after paying off all outstanding bonds.** Since the property is being acquired and the bonds are being issued on behalf of the local government, the local government is the beneficial owner, and has the right after 15 years to purchase the property under a public benefit agreement by paying off all outstanding Series A and Series B Bonds (together with any additional debt that may be incurred under the bond indenture, without the local government's consent). The local government may retain the property or sell it, and may do either without maintaining the affordability for which the project was initially acquired. Indeed, there is a tension between retaining the affordability and such potential gain.

This ownership right may or may not result in any upside to the local government. Proposals assume net operating income (including from rent-restricted units) grows at the same pace as operating expenses -- whereas lenders and California agencies require assuming that expenses grow faster than income. Such projections, with no recessions, problems or unanticipated major repair needs, therefore show highly optimistic windfall returns to local government, as they would for any buyer of 100% leveraged real estate. These assumed returns are highly speculative.

8. **Restrict affordability for the term of the bond on a portion of the units.** Affordability is controlled through a regulatory agreement administered by the JPA. Sample forms of regulatory agreement we have reviewed:
  - Do not allow the local government (or tenants) to have any ability to enforce it;
  - Provide no minimum compliance period, which terminates upon final payment of the bonds;
  - Terminate in the event of foreclosure because of default on the A or B Bonds;
  - Are limited to 'best efforts' at compliance;

- Can be removed if bond counsel for the JPA determines the restrictions are not required to maintain tax-exemption on the on the bonds.

These limitations are very different than the 55-year affordability covenant required for tax credit projects and many other affordable housing programs in California. Projects structured with these minimum terms do not qualify for Regional Housing Needs Allocation (“RHNA”) credit under state law.

Indeed, recently passed AB 787 allows 25% RHNA credit for the units in those projects which are restricted to tenants below 100% of median income, with at least a 10% reduction from current rents and 55-year affordability requirements. Meeting at least this standard is one of the criteria we believe local government would benefit from requiring in evaluating JPA proposals.

## **PART TWO. RISKS INVOLVED IN THESE PROPOSALS**

Although these proposals are being presented as a new approach for addressing housing affordability, the fundamental idea of local governments using tax-exempt bonds to directly acquire market housing has been tried by public agencies in the past. So have efforts to finance apartment projects with unrated housing bonds or using underwriting standards that do not meet market norms.

California local governments should be aware of the results of these past efforts and the problems that have arisen. This is especially important since the success, sustainability and positive reputation of affordable housing in California and the U.S. for the past 40 years has been based on using standard loan underwriting and adequate financial resources, rather than on taking significant financial risks to cover the typical ‘gap’ to acquire or develop housing with below-market rents.

**Reasons for Standard Underwriting Requirements.** Major lenders who make permanent multi-family loans – both for affordable and market-rate housing developments – require the project show that net operating income can amortize all debt with level debt service payments (as on a home mortgage) *without relying on future inflation*. This is required by all major banks, affordable lender consortiums, such as CCRC (the California Community Reinvestment Consortium), Freddie Mac, Fannie Mae and the Federal Housing Administration.

There is a reason why lenders consistently require projects to meet at least 1.15 debt coverage. There is an extensive history of financial problems and defaults on projects which take greater risks, and which have no financial cushion to deal with downturns, recessions, inflation in operating expenses, and needs for major repairs. This is especially relevant for projects such as those proposed, which have 100%+ financing with no equity and no ownership entity with resources or providing guarantees to deal with future problems.

We have outlined in the Appendix decade after decade the extraordinary problems that have occurred when public agencies, bond underwriters and investors, lenders, rating agencies and some of the most successful developers in the country have deviated from standard underwriting requirements – in ways that were in fact *less risky* than these JPA proposals.

The lesson from all these examples is simple. Rather than assume there will not be significant problems, they are in fact likely to occur, and the greater the deviation from normal underwriting standards the more likely this is.

***Should This Past History Be Ignored?*** Proponents of these JPA proposals give four reasons why local governments should not view these projects as risky.

- 1. The Bond Structure Does Not Require Scheduled Amortization of Principal and Funds Large Reserves.** The JPA financings, like interest-only loans prior to the 2008-2009 financial crisis, do not require scheduled amortization. This provides more temporary flexibility as do the reserves funded by bond proceeds. Nonetheless all the principal on the A and B Bonds is required to be repaid, and all the reserves must be replenished and paid back to bondholders. While providing temporary liquidity, these features do not change the fundamental risk of being able to pay back all bond interest and principal. Indeed, the more such reserves are planned to be used, the more the project's net income will need to grow to ever repay those advances.
- 2. That Bond Investors Are Willing to Purchase These Bonds Indicates That the Risks Are Minimal.** Experience over many decades shows that purchasers of unrated municipal bonds have less ability, time and discipline for evaluating the risks of multi-family financings than major banks, Fannie Mae and Freddie Mac. A simple example was in the 1980s when Oxford development, then one of the largest developers in the country, structured 26 issues of unrated bonds for rental projects across the country; investors were more than willing to buy the bonds that were marketed for all of them, , yet all of these 26 defaulted, except one in San Mateo County that CSG helped design with provisions to avoid a bond default. That investors are willing to buy these JPA bonds shows their desire to obtain extra yield in today's low-rate environment while discounting risks, rather than a lack of risk. It was precisely the willingness of bond investors to buy unrated bonds for market-rate housing that led to workouts and defaults for several Pacific Northwest housing authorities.
- 3. These Projects -- Being Purchased at This Time and in California's Housing Markets -- Are Different and Will Be Less Risky.** The demand for rental housing in many markets in California and the rents being commanded are, indeed, at all-time highs. This can lead to the assumption that historical market forces – future recessions, inflation in operating costs, competition from other projects – will not apply and that net operating income will always continue to grow. Such a picture of the future is not new. All the past projects described in the Appendix were undertaken with precisely the same type of optimistic beliefs in future projections.

There are, in fact, particular reasons to be wary of the risks involved today. These current proposals are designed to purchase high-end apartment complexes at a time when income capitalization rates are extraordinarily low; many of these projects are based on capitalization rates of about 4%, and some well below that. That means that the projects are being sold for 25 or more times the current net operating income (before rents are reduced). The last time capitalization rates were so low was in 2006 and 2007 before the national financial crisis, and before that just prior to 1990s real estate recession and the savings and loan crisis. That is, prices are at historic highs relevant to rents. Such prices are driven not only by low interest rates for borrowers but, as project sponsors have indicated to us, by real estate investment funds with significant amounts of capital seeking alternative investments as they shy away from retail and office developments because of the pandemic.

Trying to buy multi-family housing properties at these prices, with no equity and relying on 100% financing – while reducing rents with no other source of funding to cover the affordability gap except the elimination of property taxes – means that the proposals ‘solve’ the affordability gap by relying on assumed future inflation. Like loans made in the run-up to past financial crises, these proposals seek to make financings work by stretching underwriting standards and making optimistic assumptions about the future.

Indeed, there is no better illustration of the uncertainties and risks in these JPA projections than the official Notices posted in October 2021 by the JPA for the first of these transactions in Santa Rosa from 2019. Since issuance, the actual results have varied so much from projections that the JPA has issued multiple notes for additional funds at 10% interest from the project sponsor, and is considering restructuring the entire bond issue. While other JPA transactions have somewhat different provisions for subordination of sponsor and JPA fees, what matters is that *the original revenue projections have not been met, starting just months after closing – let alone for the next 30 years.*

4. **The Local Government Is Not At Risk.** JPA proponents’ simplest answer to the question of risk is that *no party* – neither the local government, the project sponsor nor the JPA itself – bears any legal risk if there is a future problem with the project. That no party, including the local government itself, is legally or financially responsible *is precisely why* local government should care about what may happen.
- The project is being undertaken under the powers of and for the local government to benefit a portion of its future tenants over the long-term – the only public purpose for which it can be undertaken – at significant cost to the local government and all taxing entities. Projects which fail, which run out of cash reserves to pay debt service, operating expenses and repair costs, and especially when they go through protracted default proceedings, typically result in major management and maintenance problems. These adversely affect tenants, neighbors, public safety and the community. And in the event of foreclosure, the affordability for which the local government and other taxing entities forewent all their property taxes, is lost.
  - If tenants or neighbors have problems or complaints, there is only one logical local party to raise them with. Since there is no traditional landlord, it is a government-owned property, the property was purchased on behalf of the local government who approved the transaction and is the beneficial owner, and the local government is the one party with deep pockets who could address the problems, the place to complain and seek help will be the local government’s legislative body. This has happened in numerous cities on publicly acquired properties. Experience has shown that a large, concerned and geographically concentrated group of middle-income tenants worried about conditions at their property can provide a powerful and articulate voice at local council meetings.
  - Problems with these unusually risky financings for middle-income housing can jeopardize support at all levels for the entire affordable housing finance system that all local governments, together with non-profit and for-profit developers, tax credit investors, advocates and others have built for helping very low- and low-income tenants in California.

We have outlined these risks and their consequences to be certain that housing efforts to help moderate and middle-income households are designed in ways that can be sustained in the long run.

### **PART THREE: CRITERIA FOR DECIDING ON PROPOSALS FOR GOVERNMENT-OWNED MIDDLE-INCOME HOUSING**

Following are the key criteria we believe local officials would benefit from using in deciding whether to approve government-owned middle-income housing.

#### **1. Would the local government undertake such ownership and financing itself, regardless of the offer from the sponsor and JPA?**

The power to acquire, own, finance and exempt such apartments from the tax rolls rests with local government and no one else. The local government *should approve such a project if it believes that government-owned middle-income housing is itself a good idea and if it would be willing to own and finance such developments on these terms itself with this type of debt.*

The JPA is solely a **means** for carrying out the project on the local government's behalf, and is a mechanism for limiting the local government's direct legal risk. It is a means, not a reason for undertaking the project. Simply being able to distance itself from the use of its own powers for a project of which it is the beneficial owner is **not** a reason for a local government to undertake the project in the first place.

This criterion is especially important because, while the local government legally has no financial liability, if tenants or neighbors have problems or complaints, they will be raised most likely with the local government, which is the party that approved the transaction, on whose behalf the purchase and financing has occurred, which invested its own and other local governments' foregone property taxes, and which has all the financial upside from the property.

#### **2. Are the housing affordability benefits greater than the foregone property tax?**

Before considering the risks involved in these proposals, the most basic question is whether the affordability benefits are at least equal to the foregone property taxes. This criterion has several key components.

**First, housing affordability is the only reason for considering such a proposal.** The local government should evaluate a JPA proposal **solely** as a means of providing housing affordability, **not as a speculative investment** in the future value of apartment buildings. The only public purpose for which local government can provide its powers for acquiring, owning and financing privately owned apartment buildings is providing affordable housing, rather than speculating on future values in real estate. This should therefore be the basis of its decision.

We stress this point because the proposals received by the local government often focus on the local government's possible upside from reselling the property in the future. We do not think any local government should make decisions based on the speculative returns provided, because of the (i) many market uncertainties involved as to future rents and operating expenses, interest rates and market capitalization rates, (ii) the uncertainties that will affect any such future local government

decision given the need and demand for affordability at the property itself, and most fundamentally, (iii) local government is not in the business of, nor has as its purpose, buying up private properties in the hope of making windfall profits in the future. Indeed, counting on future windfall financial gains to the local government from maximizing sale proceeds run against the very purpose for which it undertook the project: providing housing affordability.

Focusing on the public purpose the local government knows it is achieving in approving such a proposal makes decisions simpler and clearer.

**Second, make certain the affordability benefits are real.** Since affordability is the local government's only purpose for such a proposal, it is important to know what is being achieved.

Given the complexity of the proposals – multiple tiers of units, rents based on 35% of maximum income rather than 30%, uncertainties as to market rents because of the pandemic, often modest reductions compared to those market rents which are often still well above median given the high end nature of the buildings involved, and gradual phase-in of restrictions since existing higher income tenants will not be displaced – it is not particularly easy to measure the actual affordability benefit of many JPA proposals.

From our experience and as required in AB 787 to receive even partial RHNA credit, the only units for which a local government should consider affordability benefits are those restricted to tenants below 100% of median income where rents will be reduced at least 10%. We also think that to assure affordability, rents should be limited to 30% of the maximum of any income band.

Having narrowed down which units are providing affordability, the local government can then measure what would be the rent reduction for tenants in these units.

**Third, target the affordability to meet local needs.** In reviewing JPA proposals, various cities have required that affordability be designed to meet local needs, including focusing on units below 80% of median income where affordability is generally most needed according to each community's Housing Element and RHNA goals, and prioritizing tenant groups such as teachers, public employees and others, whose ability to remain in the community may be especially crucial. Since local taxing entities are paying for the affordability, local government should design it to provide meaningful public benefit. The California Housing Partnership's analysis of proposed rent data from a number of JPA transactions collected by the Los Angeles Times versus median rents indicate that while the proposed rents may offer slight reductions from current rents charged in the luxury apartments being purchased on a portion of the units, they are still above median market rents for the area, leading us to question whether there is any real public benefit in terms of creating access to affordable rentals.

**Fourth, assure the affordability benefits will be provided and maintained.** Since the local government and all other taxing entities are giving up their property taxes to provide such affordability, it is essential to know that the affordability benefits will occur for the duration of the promised period. Therefore, local government should require for any such government-owned middle-income housing:

- the 55-year covenant under AB 787,
- that the local government have the right to enforce such agreement,
- that the local government receive annual compliance reports, and
- since the affordability agreement is the reason local government is providing its powers for the purchase and financing of the property, that the affordability requirements remain, whether or not they may be required for federal tax law.

**Fifth**, compare the affordability benefits against the taxes being foregone. As noted above, the foregone taxes are those that **a private buyer purchasing at the same price** would have to pay.

Since the cost of these foregone taxes falls not only on the local government itself but on other taxing entities as well, and their ability to provide services in the community, the foregone taxes are the total for all taxing entities.

Proponents of these proposals have argued that tax reductions for school districts may be backfilled by the state. We understand, however, that under the current tests in Proposition 98 for public school funding, the state would no longer back-fill such foregone taxes. More broadly, given the plethora of JPA proposals and their ability to convert essentially all market-rate major apartment developments in the state, local governments should take into account all the property taxes that will be lost.

Affordable housing developments for very low-income tenants are, of course, exempted from property taxes in California. What distinguishes these JPA proposals are the much higher level of rents, the modest amount of rental reductions, and the level of risk of these proposals that can jeopardize the proposed affordability.

### **3. Are the financial risks of the project limited and reasonable?**

The one public purpose for which the local government would give its powers to the JPA to undertake such projects – and for which taxing entities are foregoing their property taxes – depends on the project’s future financial sustainability. If the property is foreclosed, the affordability provisions are terminated. This is true of typical tax credit projects as well, but they are structured with standard 1.15 debt coverage, whereas these JPA projects are far riskier and at far greater risk of losing all their affordability.

Such loss of affordability, together with the concern about what happens to the tenants, neighbors, community and complaints to local government itself if there are future problems, means that the local government should **take very seriously the financial soundness of the government-owned project being undertaken on its behalf**.

That the local government itself is not legally and financially responsible, and indeed that no entity is financially responsible for the future of the project, is not a reason to approve such a project. Local governments in California that have gone through past recessions and financial crises and their impacts should be acutely aware of what can happen in real estate and financial market cycles.

As organizations with decades of experience in housing finance throughout California, we think that deviating from the normal underwriting standards of all major banks and federal entities creates serious risks. The greater the deviation, the greater the risk. We particularly think that relying on future growth in net operating income to repay debt is extremely dangerous.

We would therefore not recommend that any local government approve a project where **current net operating income (reduced by the rent restrictions on all restricted units) would not be able to pay level amortizing debt service on all the bonds over a 35-year amortization period.** This standard of 1:1 coverage on what will be needed to pay back the bonds is significantly lower than required by banks and federal entities but is to us an absolute minimum.

That the bonds do not require scheduled amortization and fund reserves is desirable and creates greater flexibility. This is a useful additional feature, not a substitute for the most basic standard of loan underwriting and of local government financing itself – looking at what a project can support today, not relying on how much better one hopes it could do if there is inflation tomorrow.

### **Why These Criteria Are Essential**

The criteria outlined above provide a **minimum threshold**, in our view, for proceeding with government-owned middle-income housing. Whether projects are feasible within these criteria will depend on the prices being paid, the compensation to service providers, the actual economics and the taxes being foregone. **Waiving such criteria does not solve the long-term problem of providing affordability sustainably to targeted income households.**

That proposed financings may not be feasible with even this very minimum level of underwriting standards does not mean that local governments should ignore the needs of tenants in these income groups. Indeed, that local governments are willing to consider foregoing property taxes to help provide affordability for such tenants means that they should find ways of using their tax revenues to address these needs in ways that are financially sound.

There have been various efforts around the country to help meet the needs of households in these income groups, particularly those earning between 60% and 100% of median income who still need help in higher cost urbanized coastal areas. Any local government focused on these needs, especially given the affordability crisis in California, and willing to consider foregoing (or using) its tax revenues to help them, should actively explore more established options that are financially sound.

Proposals for borrowing and spending tens and hundreds of millions of dollars for government-owned middle-income housing are **not a cost-free nor risk-free way** to address these needs. Such proposals should **only be considered where they meet a very minimum standard to assure future sustainability.**

An approach that a local government considering such proposals could follow is:

- First establish these most basic requirements to avoid future problems for tenants, neighbors, projects and communities, and

- Then use a competitive process for selecting service providers who compete on the minimum level of affordability they will deliver, how they will assure long-term affordability, the type of properties that will be targeted, and the compensation that service providers will receive – while meeting and being committed to these most basic requirements.
- The regulatory agreement should give local government the power to enforce all the terms of the regulatory agreement.

What we have learned from many decades of helping local governments deal with housing needs is that precisely because housing is an opportunity-driven activity – as economics change, as owners decide to sell – it is **that much more essential** for government to have a **clear, disciplined approach and standards** for dealing with those opportunities. The Appendix describes what has happened when this has not been the case.

## **APPENDIX**

### **OUR EXPERIENCE IN HOUSING FOR PUBLIC AGENCIES**

**CSG Advisors** has been the leading financial advisor on housing revenue bonds in the United States for each of the last 20 years, according to Securities Data. Headquartered in San Francisco, we have advised public agencies on more than 3,000 multi-family projects; served as HUD's national consultant on complex multi-family bond refunding requests; served as the Resolution Trust Corporation's national financial advisor on all tax-exempt assets from savings and loans; helped design what became the U.S. Treasury's New Issue Bond Program after the financial crisis, financing homes for 110,000 first-time homebuyers and 40,000 affordable rental units; and have represented more than 50 California municipalities on affordable housing since 1980.

**HR&A Advisors, Inc.** is a national real estate advisory, economic development and public policy consultant. The firm was founded in Los Angeles 45 years ago and has deep experience in all aspects of affordable housing needs analysis, and the design of plans, programs, policies, regulations and financing programs to encourage the production of affordable housing. These services are provided to a wide range of governmental agencies, non-profit organizations and institutions. HR&A also works extensively with private developers to analyze the feasibility of new market-rate housing and many other kinds of real estate developments.

**The California Housing Partnership** is a state-created private nonprofit technical assistance organization that creates and preserves affordable and sustainable homes for Californians with low incomes by providing expert financial and policy solutions to nonprofit and public partners. Since 1988, the Partnership's on-the-ground technical assistance, applied research, and legislative leadership has leveraged more than \$25 billion in private and public financing to preserve and create more than 75,000 affordable homes and to provide training to more than 30,000 people.

### **HISTORY OF BOND FINANCINGS FOR RENTAL HOUSING**

Following are some examples of experience with past bond financings for rental housing that were generally structured *with less risky underwriting* than the new JPA proposals. The troubled history of these financings is therefore especially critical in understanding the risks in these new proposals.

- CSG served as the national financial advisor for all tax-exempt assets for the Resolution Trust Corporation, established by Congress in the 1990s to manage failed savings and loan associations. This included over 800 apartment developments, many in the Inland Empire and Southern California generally. We also served as financial advisor to numerous California issuers on restructurings of troubled multi-family bond issues with developers as strong as The Irvine Company and Lincoln Properties.

Like the JPA proposals, these projects had rents close to market rates (based on units rented to households at 80% of median income). Initial loan to cost was sometimes 90% or even approached 100% but, unlike these JPA proposals, not over 100%. Debt to income ratios were sometimes as low as 1.1 to 1, but not, like these JPA proposals, initially negative.

Nonetheless, these projects defaulted, and federal regulatory agencies required that banks not rely on the type of trended rents assumed in these JPA proposals.

- In the mid-2000s, a major, highly regarded national non-profit developer evaluated what had happened on bond financings it had completed without any cash equity, and underwritten at 1.1 to 1 for fully amortizing debt service (far above the approximately .8 or less for fully amortizing debt service on JPA proposals). Competition from newer apartment developments in markets with little constraint on land for new development had weakened rents and created competition; this put pressure on having adequate funds to adequately cover operating expenses.
- Standard & Poor's for several decades issued ratings of apartment developments that – like the JPA proposals – did not have any bank, Fannie Mae, Freddie Mac or other credit enhancer that had underwritten the project and recognized that it was at direct financial risk. Rather such bonds, initially rated A or higher, under S&P's Affordable Housing Program, were simply sold to the public. Again, the loan underwriting was less aggressive than on the JPA proposals, but a significant number of these bond issues defaulted, and Standard & Poor's dropped its ratings on many more.
- Perhaps the example most germane to the JPA proposals is that of housing authorities in the Pacific Northwest. Starting in the mid-1980s, several of these authorities began to purchase existing market-rate apartment developments using 100% tax exempt bond financing and the exemption from property taxes – the same basic model as the JPA proposals.

King County Housing Authority, the most successful of these, used such governmental purpose bonds, but with **several key differences** from the JPA model.

- All these properties had net operating income at least equal to fully-amortized debt service; it did not rely on projections of continuing growth in net operating income to repay debt.
- Properties purchased had relatively modest rents and thus some insulation from competition from new development.
- The Authority set aside monies from its own reserves, not simply bond proceeds that had to be repaid, to cover potential shortfalls, and did indeed have to advance its funds.
- The Authority as the issuer of the bonds had public staff with decades of experience in dealing with apartment development and understanding the risks involved, and.
- The Authority recognized that it was ultimately financially responsible for solving problems that might arise.

Despite these additional safeguards, the Authority did have to advance its own funds on one of these projects. It also learned a hard lesson from the 'turbo-charged' debt repayment structure, requiring all increased net operating income to pay down the bond deb. This feature is promoted as a benefit of the JPA proposals. However, the Authority found that in fact created enormous problems. When major repair needs arose, the Authority could not use the increased

income to address those needs. The Authority ultimately refinanced 5 of these properties solely to remove this feature.

Much more disturbing, however, was the experience of several other Pacific Northwest housing authorities that used 100% bond financing, again with at least positive debt coverage to start. There were numerous project shortfalls, reserves were depleted, with adverse impacts on properties, the authorities and/or bondholders, and at least one authority had to be taken over by its County.

- As a current example, the BondBuyer is replete with stories of defaults and bankruptcies on a series of projects financed by the Illinois Finance Authority between 2016 and 2018 for the non-profit Better Housing Foundation to purchase 5 portfolios of existing apartment developments. By 2019, all 5 portfolios financed, totaling over \$170 million, were in default. Unlike the JPA transactions, these bond issues initially were rated, many with BBB to A ratings from Standard and Poor's. Nonetheless, these defaults are leading to investor lawsuits have drawn the scrutiny of the Securities and Exchange Commission.

This history of bond financings is sobering. When issuers have stretched normal underwriting standards to borrow more money or try to create affordability by taking on more risk the results have undermined – rather than strengthened – support for affordable housing.