



CITY OF SANTA BARBARA

JOINT COUNCIL AND REDEVELOPMENT AGENCY AGENDA REPORT

AGENDA DATE: October 16, 2007

TO: Mayor and Councilmembers
Chair and Boardmembers

FROM: Housing and Redevelopment Division, Community Development
Department

SUBJECT: Revisions To Affordable Housing Policies

RECOMMENDATION:

That Council and the Agency Board consider and approve revisions to the City's Affordable Housing Policies and Procedures.

INTRODUCTION AND EXECUTIVE SUMMARY:

This report presents information regarding recommended revisions to the City's Affordable Housing Policies and Procedures (AHP&P), which were last amended in 2004. Since then, the Council, Housing Programs staff and the City Attorney's office have noted policies and procedures that could benefit from changes. The recommended policy changes have been grouped into the following headings:

- A. State Density Bonus Law
- B. City's Density Bonus Program
- C. Affordability Control Periods
- D. Expanded Income Eligibility Ranges
- E. Buyer Selection and Eligibility
- F. Revisions to the Affordability Covenant
- G. Minimum Unit Sizes

Council is requested to review the recommended changes and to determine which changes to implement at this time. Within each policy category, staff has labeled the policy changes "**SIGNIFICANT**" or "**MINOR**." The minor changes, although important to memorialize in the policies and procedures document, are essentially housekeeping changes that reflect market-condition adjustments to existing approaches or clearly state existing practices. Staff recommends that the Council focus on the significant policy changes, and the staff presentation will take that same approach. A decision matrix is attached in order to help the reader keep track of the recommended changes, again identified as "**SIGNIFICANT**" or "**MINOR**."

For purposes of reference, the most recent (2004) AHP&P (without the proposed changes) can be accessed at the City's site www.santabarbaraca.gov by clicking on "Affordable Housing", then on "Policies and Reports."

DISCUSSION:

A. STATE DENSITY BONUS LAW

1. State Density Bonus Law --MINOR

Significant changes to the state's density bonus law took effect on January 1, 2005. The law requires cities and counties to provide substantial incentives and concessions to applicants who include specified types and amounts of affordable housing in their projects. For example, the law sets limits on the amount of parking that the City may require and allows uncovered parking and tandem parking for qualifying projects; the City may not impose standards stricter than the state law on these projects.

Recommended changes: Add a summary of significant changes in the state's density bonus law, including the newly required incentives and concessions.

B. CITY'S DENSITY BONUS PROGRAM

1. ELIMINATE MARKET-RATE DENSITY BONUS UNITS--SIGNIFICANT

Current policies allow some density bonus units to be sold at market rate, provided that the affordable units are sold at lower prices than otherwise required. For example, the Paseo Chapala project was approved with 12 density bonus units, only eight of which were affordable. Instead of requiring 12 units affordable to middle and upper-middle income households, the City approved eight affordable units priced for moderate and middle income, and the developer was able to sell the remaining four units at market rate.

The idea behind this policy was that that the City would receive fewer affordable units, but those fewer units would be priced lower than otherwise required. The City would receive the same "below market benefit." However, the huge increase in the housing values in the past few years has caused staff to reconsider this policy. The benefit the developer receives from the additional density bonus market-rate units (perhaps selling for over \$1 million) is far greater than the benefit the City receives from having the affordable units priced lower (especially since the City gets fewer affordable units).

This current policy creates a big incentive for developers to propose dense projects with substantial density bonuses. That is clearly not the wish of Council or the public at this time. **Recommended changes:** require all density bonus units to be affordable units; exempt from this change projects with completed applications.

2. Clarify Lot-Area Modifications Not Required for State Density Bonus Units --MINOR

State density bonus law provides that cities may not require approval of a lot area modification as a condition of the approval of the density bonus. The mandated density bonus is automatic, provided the project complies with the state law provisions and that the city approves the project per its development review standards and process.

Staff recommends that the City clarify its density bonus policies by expressly stating that a lot area modification for projects that are consistent with the density bonus policies mandated by state law is not required. The City's Inclusionary Housing Ordinance, as adopted in 2004, already contains this clarifying language. **Recommended changes:** add clarifying language to the City's density bonus program description to state that a lot area modification is not required for density bonus units under the state density bonus program.

3. Simplify Rent Requirements for Density Bonus Rental Units--MINOR

Currently the City's density bonus program sets two different affordable rent levels for density bonus rental units. Units within the first 25% density bonus are targeted to be affordable to households at 70% of "Area Median Income." Where a density bonus of greater than 25% is approved, those units that are above 25% can be rented at higher rents (targeted to 80% of AMI). For example, on a site zoned for 20 two-bedroom rental units, if a 26-unit project is approved, the first four density bonus units would be restricted to rents of \$1,003, while the remaining two density bonus units could be rented for \$1,154. These two rent tiers were designed to be compatible with the intent of state density bonus law. Because state density bonus law has been changed significantly since this policy was adopted, the distinction of above 25% and below 25% is no longer applicable. It should be noted that this proposed change will not affect any of the low income rental projects developed by the City Housing Authority or other non-profit sponsors. The rents required by the subsidy sources such as the City's Redevelopment Agency or low income housing tax credits are lower than these. **Recommended change:** Eliminate the distinction and require all rental density bonus units to be affordable to households at no more than 70% of AMI.

C. PERIOD OF AFFORDABILITY CONTROLS

1. PERIOD OF AFFORDABILITY CONTROLS – OWNERSHIP UNITS--SIGNIFICANT

Recommended changes: Increase the required affordability period for ownership units from 45 years to 90 years and provide the City an option to purchase a unit upon any resale. The affordability period will continue to be a "rolling" period, meaning that at every re-sale, the City will require the buyer to sign and record a new affordability covenant which starts a new 90-year affordability term.

As is true under current policy, the City will have an option to purchase the unit upon any resale within the affordability term. Whenever an owner sells (prior to the expiration

of the 90-year controls), the City may either (a) let the seller choose an eligible buyer or (b) exercise its option to purchase and then re-sell the unit. In either case, the new owner will be required to sign a new 90-year affordability covenant. The 90-year period is recommended based on its apparent compliance with what is known as the “Statutory Rule against Perpetuities” (Calif. Probate Code § 21205.)

2. PERIOD OF AFFORDABILITY CONTROLS – RENTAL PROJECTS--SIGNIFICANT

Recommended changes: For rental projects, increase the affordability period from 60 years to 90 years, and, unless funding constraints make it infeasible to a new non-profit owner, start a new 90-year period upon any sale of the project.

3. Affordability Controls for Housing Authority Projects--MINOR

The Housing Authority of the City of Santa Barbara (HASB) has developed and currently manages the majority of the low-income affordable units in the City. All of the units that the City has financed are subject to long term affordability controls in order to assure continued affordability according to the requirements of the funding source (redevelopment agency funds, federal HOME funds, tax exempt bond funds, etc.). In many cases the City imposes longer control periods than the funding source requires. For example, the federal HOME Program may only require 15-year controls, but the City has imposed 60-year (and soon will be imposing 90-year) controls. The Housing Authority has requested that the City impose affordability controls in accordance with the minimum requirements of the City’s funding source. After the minimum affordability term expires, HASB would continue to rent the units to low income households, but according to its own program policies and requirements (these “non-HUD” program policies are similar to the City’s policies, but not identical). Such a change would give HASB more flexibility in administering the units in the manner they deem best suited to their programs.

Recommended changes: In recognition of the unique charter and close working relationship that HASB has with the City, revise the City’s procedures regarding affordability covenants on City-funded HASB projects. Program-specific requirements would be imposed for the minimum period allowable. For example, if the federal HOME program requires a particular HOME-funded project to be affordable for 15 years, then the City would impose only 15 years of HOME rent restrictions on the project. The affordability covenant would still be for a 90-year term, but (in this example) the remaining 75 years of controls would simply require HASB to administer the tenant selection and rental rates in accordance with their own “non-HUD” program policies for low income rentals.

D. PRICE CALCULATION FOR AFFORDABLE UNITS

Staff has noted that it is often difficult for households within a defined range to actually qualify to buy a unit. For example, the City calculates the affordable sale price using several assumptions: buyers of a three-bedroom unit will have four or five persons in their household; buyers will be able to afford a down payment of at least 10%; and, the buyer's lender will provide a 90% loan-to-value loan without requiring private mortgage insurance. In practice, the buyer of a three-bedroom unit may be a three-person household, and they would be "squeezed from the top" of the income range because the maximum income for a three-person household is lower than for a four- or five-person household. If they could only afford a 5% down payment and the lender required private mortgage insurance (PMI), the higher mortgage amount plus the PMI premium would require a higher minimum income to qualify for the financing, and the buyer would be "squeezed from the bottom" of the income range. The result would be that buyers would only qualify if their incomes happened to fit within a very narrow range of incomes. The policy changes in this section are designed to help correct this problem of narrow income eligibility ranges by lowering the affordable sale price.

The current affordable housing sale prices, calculated under the existing policies, are somewhat lower than they were in 2004. The area median income increased by 3.7% (which would tend to result in higher affordable sale prices), but this effect was more than offset by the increase in mortgage interest rates and homeowner association fees (which would tend to result in lower affordable sale prices).

The following table compares the prices for two- and three-bedroom middle income units in 2004 and under current policies:

	2 Bedroom	3 Bedroom
2004	\$271,800	\$324,200
2007	\$259,400	\$310,400

1. Mortgage Interest Rate Used in Price Calculations--MINOR

The City's method for calculating the maximum sale prices of affordable units includes an estimate for the mortgage interest rate that a typical buyer would pay on a 30-year fixed-rate loan, assuming a 20% down payment. But most buyers of affordable units cannot afford a 20% down payment. The City assumes a 10% down payment in its affordable price calculations. If a borrower is putting less than 20% as a down payment, most lenders require the borrower to either obtain private mortgage insurance (PMI) or obtain a second deed of trust loan for the amount of financing above 80% of value. Either of these options increases the costs to the borrower. However, these extra costs have not been included in the City's affordable price calculations up to this point. Staff estimates that these added costs are equivalent to increasing the mortgage interest rate by one-half percent to three-quarters of one percent (0.5% to 0.75%). The effect of this

change will be to lower the affordable sale price somewhat, thus retaining the affordability despite the increased PMI or mortgage costs. The following table shows the effect of this change on the affordable price of middle income units (the change would apply to all income categories):

	2 Bedroom	3 Bedroom
Current Policy	\$259,400	\$310,400
With this Change	\$248,400	\$297,400

Recommended changes: Increase the mortgage interest rate used in the sale price calculation by 0.5% to account for at least some of the extra costs of PMI or secondary financing. If this adjustment proves to be inadequate to offset the added cost of PMI or secondary financing, staff may recommend a larger interest rate adjustment in the future.

2. Pricing of Three and Four-Bedroom Units--MINOR

The pricing calculation for affordable sale prices includes an adjustment for the number of persons that are assumed to be in the purchasing household. The more bedrooms in the unit, the more people we assume in the household. The area median income is adjusted by household size, so larger households are assumed to have higher incomes. For example, the pricing calculations assume that there will be about 4.6 people in a 3-bedroom unit, and about 6 people in a 4-bedroom unit. These household size assumptions were established by the City about 20 years ago; since then, the state redevelopment law has adopted different (lower) assumptions for 3- and 4-bedroom units. **Recommended changes:** Revise the assumptions of household size used in the affordable price calculations as follows: reduce the number of people assumed to be in the purchasing household for a 3-bedroom unit from 4.6 to 4, and for a 4-bedroom unit from 6 to 5. This change will bring these numbers in line with state redevelopment law. This change will result in somewhat lower affordable sale prices for 3- and 4-bedroom units, which will make the units affordable to a wider range of households. It will have no effect on the number of persons allowed to occupy an affordable unit. The following table shows the effect of this change on the affordable price of middle income units (the change would apply to all income categories):

	3 Bedroom
Current Policy	\$310,400
With Previous Change	\$297,400
With this Change Also	\$281,100

3. Down Payment used in Price Calculations for Low and Moderate Income Units--MINOR

In calculating affordable sale prices, the City has generally assumed that the buyer will pay a down payment of ten percent of the sale price. However, many buyers, especially buyers in the low income and moderate income categories, do not have enough cash for a 10%

down payment. **Recommended changes:** Use a 5% down payment in the price calculations for low and moderate income affordable units. This will have the effect of lowering the affordable sale prices by 5% for these income categories. Buyers could still pay a down payment of ten percent or more, if they can afford to.

E. BUYER SELECTION AND ELIGIBILITY

1. SELECTION OF BUYERS FOR NEW AFFORDABLE UNITS--SIGNIFICANT

Current Policy: Since the AHP&P was last updated there have been several new developments with affordable ownership units, but there was not established policy regarding the selection of affordable unit buyers. The procedure has been that, prior to the initiation of marketing of affordable units, the City works with developers to arrive at a marketing plan which includes advertising requirements and a defined application process. The City has administered lotteries to determine a priority list of potential buyers who meet the minimum threshold criteria for a particular project. As applicant names are drawn, they are numbered sequentially until all names are drawn. Should the first chosen applicant not fully qualify, the applicant next drawn is then considered. This process continues until qualified purchasers are identified for all of the affordable units available. Priority is given to households who live on the South Coast, work on the South Coast, or both. These procedures have worked very well for recent new affordable units. **Recommended changes:** Incorporate these lottery procedures for the marketing of new affordable housing units into the AHP&P.

2. LOCAL EMPLOYMENT AND RESIDENCY PREFERENCE--SIGNIFICANT

The City's Housing Element and Circulation Element contains policies encouraging affordable rental and ownership housing projects to provide a preference to applicants if they live or work in the local area to the extent allowed by law. However, our current Affordable Housing Policies and Procedures do not address this. One concern has been that the law is not completely clear on the circumstances in which such a local preference is allowable particularly concerning when such preferences may constitute an improper form of de-facto discrimination. However, other jurisdictions do provide for such a preference in many cases. **Recommended changes:** For affordable projects without City, Agency, or other public financing, allow preference to applicants who reside and/or are employed within the South Coast area of Santa Barbara County (from Gaviota to the Ventura County line). For affordable projects where the City has provided financial assistance, the City will endeavor to apply a local preference, to the extent such preferences are permitted by federal and state law.

3. Minimum Down Payment--MINOR

Currently the City does not require any minimum down payment. If the buyer could find a willing "sub-prime" lender, they might buy an affordable unit with zero percent down.

As recent experience with sub-prime lenders shows, these types of loans may result in a greater incidence of default. **Recommended changes:** In order to reduce the risk of default on the purchase loan, buyers will be required to provide a down payment of at least 5% of the purchase price.

4. Minimum Credit Scores for Buyers--MINOR

Currently the City does not impose a credit test for prospective buyers of affordable units because we have relied on lenders to reject disqualified applicants. However, the recent sup-prime mortgage crisis made it clear that many marginal borrowers were able to find lenders that would approve them. **Recommended changes:** In order to reduce the City's risk that ownership affordable units will go into foreclosure, each buyer shall have credit scores (from the top 3 credit bureaus) which reflect a strong likelihood that the borrower will meet their financial obligations of homeownership. A credit ("FICO") score of below 620 (that is, within the bottom quartile of credit scores nationwide) shall automatically disqualify a buyer from owning an affordable unit. The credit score requirement may be waived by the Community Development Director on a case-by-case basis for good cause (such as mitigating circumstances for the low credit score).

5. Buyer's Ownership of Other Residential Real Estate--MINOR

Current policy states that buyers shall not own other residential real property at the time of application to purchase the affordable unit and at any time during their ownership of the affordable housing (and City staff regularly checks for other real estate ownership through a subscription to a national database service). In earlier years of the City's housing programs, the City also placed limits on buyers' equity in real estate held during the two years *prior* to their purchase of an affordable unit. The amount of equity was limited to no more than 50% of the purchase price of the affordable unit. This requirement was removed in 2004 because staff felt that any buyer who had recently sold real estate for a substantial gain would choose to buy a market rate unit instead of an affordable unit. However, recent experience has shown otherwise; some buyers who could afford a lower-end market rate condo on the South Coast might still choose to buy an affordable unit in a prime City location. But the City's affordable housing ownership programs are really meant to assist buyers who could not otherwise afford to live on the South Coast. Therefore, staff recommends that the prior policy be reinstated. **Recommended Changes:** The buyer's total equity in residential real property held at any time during the two years prior to purchase of the affordable unit shall not have exceeded fifty percent (50%) of the purchase price of the affordable unit. This prohibition may be waived for a particular buyer by the Community Development Director for good cause.

6. "Residential Real Estate" Defined--MINOR

Questions sometimes arise about whether a prospective buyer can own a leasehold on real property, or a mobilehome or undeveloped residential land. **Recommended changes:** Clarify that the limits on ownership of "residential real estate" shall include

any ownership interest (such as long-term leaseholds), and shall apply to developed or undeveloped residentially-zoned land, and to mobile homes and manufactured housing.

7. Household of Three or More Persons --MINOR

The City requires that buyers of three-bedroom units must be households of at least three persons. Sometimes households which appear to staff to be two-person households attempt to include a third member in order to try to qualify for a three-bedroom unit. **Recommended changes:** For the purpose of qualifying households to buy three-bedroom units, define a three-or-more-person "household" as three or more persons who will live regularly in the property as their primary residence and who are related by blood, marriage, law, or are domestic partners registered with the City. Persons (including sons and daughters) aged 18 or over who live away from home for purposes of either work or study and return to the household periodically will not be counted as household members.

F. OTHER REVISIONS TO THE AFFORDABILITY COVENANT

1. City's Right To Inspect Property--MINOR

The City's affordability covenant states that, when an owner sells the unit, the unit shall be in good conditions. The City may lower the maximum sale price if the new owner will have to spend money to correct damage or very poor maintenance. However, our current affordability covenant does not specifically give the City the right to inspect the units to assure that they are in good condition or that the owner is in compliance with the terms of Covenant. **Recommended changes:** Revise the affordability covenant to give City staff the right to enter and inspect an affordable unit during normal business hours upon at least 72-hours advance notice to the owner. Staff could inspect the unit upon any proposed sale, or where staff has reason to suspect that the owner no longer occupies the unit or that the unit is not being maintained in good condition. An owner's continued refusal to permit inspection will be a default under the covenant.

2. City's Right To Contact Lenders--MINOR

Recommended changes: Revise the affordability covenant to include owner's consent for the lender to provide the City with the current status of the owner's loans secured by the affordable property. This will allow the City to obtain information in a timely manner in the case of default by the owner.

3. Owner Improvements--MINOR

Current policies allow owners to request that the City allow a higher sale price to reflect the value of the owner's improvements to the property. Such request can be after the improvements have been completed. The City reviews the requests on a case-by-case basis, subject to guidelines in the AHP&P. This can lead to misunderstandings in cases where the owner has made improvements that do not conform with the City's requirements. **Recommended changes:** Revise the affordability covenant so that

owners will be required to obtain written pre-approval from the City for the proposed improvements prior to beginning the improvements, in order to be considered for a price increase for such improvements.

4. City Approval of Financing and Refinancing--MINOR

Current policy: The City must approve all purchase financing and refinancing on affordable ownership units and will not approve any refinancing which may result in a greater risk of default by the owner. Where the owner wishes to take cash out of the transaction, the owner's total loans may not exceed 80% of the affordable sale price. Financing which could result in balloon payments or negative amortization will not be approved. Based on experience in the past few years, and the problems brought to light by the current sub-prime mortgage crisis, staff recommends that these policies be further strengthened. **Recommended changes:** Purchase financing and refinancing may only be provided by licensed institutional lenders. When an owner of an affordable unit wishes to refinance, the City will review the owner's credit and may decline approval of the refinancing in cases where the borrower's credit is poor. As a condition of approving any refinancing, the City may require that the owner pay off outstanding installment consumer debt through escrow. The City may approve interest-only loans on a case-by-case basis for borrowers with excellent credit and a favorable loan-to-value ratio. Reverse mortgages will not be permitted.

G. INCREASED MINIMUM UNIT SIZES FOR OWNERSHIP UNITS--SIGNIFICANT

The current minimum unit sizes for affordable units were adopted many years ago and applied to low income rental units and moderate income sale units. When the City adopted the new middle and upper-middle income categories, the minimum unit sizes were not changed. In practice, most ownership projects with inclusionary units have designed the inclusionary units with floor areas substantially larger than the City's minimum unit sizes, but a few have tried to provide the smallest affordable units possible, even when the market rate units are very large. Staff has surveyed local architects and builders and found that most of them believe that the current minimum unit sizes are too small to provide a livable environment of the type expected by homebuyers. Based on their recommendations, staff proposes the following minimum units sizes for ownership units. **Recommended changes:** Adopt the minimum unit sizes for affordable ownership units as shown in the following table:

	Current Minimum Unit Sizes for Ownership Units	Proposed New Minimum Unit Sizes for Ownership Units
Studio:	450 sq. ft.	600 sq. ft.
1 Bedroom:	600 sq. ft.	850 sq. ft.
2 Bedroom:	850 sq. ft.	1,000 sq. ft.
3 Bedroom:	1,100 sq. ft.	1,250 sq. ft.
4 Bedroom:	1,300 sq. ft.	1,450 sq. ft.

However, in the case where all of the units in the project are small and “affordable by design,” the affordable units shall not be required to be larger than the market rate units (based on the average unit size by bedroom count). Note: As is the case under the current policies, the Community Development Director may approve exceptions to these minimum sizes in cases where smaller sizes are appropriate and necessary for the feasibility of the project in light of site constraints and targeted residency.

For a Future Council Meeting: Employer-Sponsored Affordable Housing

The City is seeing a growing number of employer-sponsored affordable housing projects for their employees. As housing prices continue to increase, employers have experienced increasing difficulty in attracting and retaining qualified employees, especially those in the middle and upper-middle income categories. Employer-sponsored housing has its own challenges and needs that differ in some respects from other affordable housing projects, and employers have requested that the City amend its AHP&P to reflect these considerations. This is a large enough task that it merits its own hearing before Council and the possible consideration of a City ordinance to encourage and assist employer-sponsored affordable housing. Staff will be bringing recommended policy revisions back to Council in the coming months.

CONCLUSION:

Council is requested to review the recommended changes to the City’s Affordable Housing Policies and Procedures and adopt the changes that Council deems appropriate.

ATTACHMENT: Decision Matrix

PREPARED BY: David Gustafson, Housing and Redevelopment Manager/Assistant Community Development Director/SBF

SUBMITTED BY: Paul Casey, Community Development Director

APPROVED BY: City Administrator's Office

DECISION MATRIX:

The following table is provided as an aid to discussion and decision-making:

Recommended Affordable Policy Changes	YES	NO
A. STATE DENSITY BONUS LAW---MINOR		
B. CITY DENSITY BONUS PROGRAM		
1. Eliminate Market-Rate Density Bonus Units---SIGNIFICANT		
2. Clarify that Lot-Area Modifications are not Required for State Density Bonus Units---MINOR		
3. Simplify Rent Requirements for Density Bonus Rental Units---MINOR		
C. PERIOD OF AFFORDABILITY CONTROLS		
1. Period of Affordability Controls--Ownership Units---SIGNIFICANT		
2. Period of Affordability Controls - Rental Projects---SIGNIFICANT		
3. Affordability Controls for Housing Authority Projects---MINOR		
D. PRICE CALCULATIONS FOR AFFORDABLE UNITS		
1. Mortgage Interest Rate Used in Price Calculations---MINOR		
2. Pricing of Three and Four Bedroom Units---MINOR		
3. Down Payment used in Price Calculations for Low and Moderate Income Units---MINOR		
E. BUYER SELECTION AND ELIGIBILITY		
1. Selection of Buyers for New Affordable Units---SIGNIFICANT		
2. Local Employment and Residency Preference---SIGNIFICANT		
3. Minimum Down Payment		
4. Minimum Credit Scores for Buyers		
5. Buyer's Ownership of Other Residential Real Estate		
6. Household of Three or More Persons		
F. OTHER REVISIONS TO THE AFFORDABILITY COVENANT		
1. City's Right To Inspect Property		
2. City's Right To Contact Lenders		
3. Owner Improvements		
4. City Approval of Financing and Refinancing		
G. INCREASED MINIMUM UNIT SIZES FOR OWNERSHIP UNITS---SIGNIFICANT		