CITY OF OAKLAND

AGENDA REPORT

TO: Office of the City Administrator and the Agency Administrator
ATTN: Deborah Edgerly
FROM: Community and Economic Development Agency
DATE: July 12, 2005

RE: **A REPORT AND RECOMMENDATIONS ON POLICIES FOR HOMEOWNERSHIP PROGRAMS AND DEVELOPMENT OF AFFORDABLE OWNER OCCUPIED HOUSING**

SUMMARY

This report provides the City and the Redevelopment Agency with an analysis of the reasons for the lack of homeownership applications for the last Affordable Housing Notice of Funding Availability (NOFA), discusses current affordable homeownership programs and current housing policies, and makes recommendations to improve the efficiency and effectiveness of efforts to expand homeownership opportunities for low and moderate income households. Because these policies and recommendations apply equally to the City and the Redevelopment Agency, this report uses the term "City" to cover both entities and the term "City Council" to cover both the City Council and the Redevelopment Agency.

This report looks at the effectiveness of the two primary affordable homeownership programs, the First Time Homebuyer Programs used for the purchase of existing homes (such as the Mortgage Assistance Program (MAP) and the Public Safety Employees and O.U.S.D. Teachers Downpayment Assistance Program (DAP)), and the Affordable Homeownership Development Program (AHDP). AHDP is used for the development of new affordable owner occupied units. The report focuses primarily on the development of affordable owner occupied housing, whether it is an effective use of limited affordable housing funds, and whether current programs can be modified to address limitations of the program.

While this report discusses a wide range of issues and recommendations, staff has identified one issue in particular as most critical to this discussion. **There is a fundamental trade-off between the goal of providing homebuyers with the opportunity to accumulate equity and move up in the housing market, and the goal of restricting sales prices on owner occupied housing to ensure continuing affordability to low and moderate income households**. While it is possible to design programs to achieve either of these objectives, it is extremely difficult to accomplish both, especially in current market conditions.

As a result, staff recommends that the City Council approve the following changes to policy for, and the implementation of, affordable homeownership programs and the development of affordable owner occupied housing units:

1. Establish that the City's primary objective for its homeownership programs is the expansion of opportunities for lower income households to become homeowners by providing downpayment, second mortgage, and closing cost assistance versus the development of new ownership units with long-term affordability restrictions. Program design should be guided by the most efficient and effective program for achieving this goal.

2. Based on the above goal, reduce efforts to build new affordable ownership housing due to the many obstacles and constraints that are involved. Expansion of ownership opportunities can better be accomplished through the existing MAP ownership program.

3. Shift funds from housing development to the MAP program. An increase of $1 million per year, combined with the re-use of loan repayments, would provide $4 to $5 million per year for homebuyer assistance.

4. Increase the maximum loan amount in the MAP program from $50,000 to $75,000.

5. Continue to encourage development of new owner-occupied housing projects as part of the annual NOFA, but without any set-aside of a portion of the available funding or preference points that boost the competitiveness of homeownership projects. Ownership projects would compete with rental projects on an equal basis, with points for reaching lower incomes, better leveraging of outside resources, etc.

6. To the extent that the City continues to fund development of new ownership housing, structure City assistance as deferred loans that are recaptured (with 3-4 percent interest) when the property is sold, refinanced, or no longer owner-occupied. Affordability restrictions would terminate once the City's subsidy is repaid.

7. For the ownership projects that are currently stalled, modify the terms of the assistance to eliminate permanent resale controls and restructure the financing as loans to be repaid with interest when the homes are sold or refinanced.

8. Grant authority to staff to use Low/Mod funds to cure defaults and resell housing in order to protect Agency investments. These would be short-term uses of funds that will be recovered from the property sale, and therefore should not reduce the Agency's ability to fund development projects funded through the NOFA process.

Staff is requesting that the Community and Economic Development Committee forward this report, with recommendations, to the City Council meeting on July 19, 2005 for final resolution.

Staff plans to issue the annual Notice of Funding Availability (NOFA) for housing development funds in early September in order to ensure that the City Council can make awards in February 2006 to permit leveraging of funds from the Low Income Housing Tax Credit program and other sources. Resolution of the issues discussed in this report is needed before the NOFA can be issued.

FISCAL IMPACT

As this is an informational report and recommendations on housing policies, there are no immediate fiscal impacts. The programs that would be affected by these policies use existing Low and Moderate Income Housing Funds and HOME funds. Acceptance of some of the recommendations in this report could result in a reprogramming of $1 million in already-appropriated funds from the Housing Development Program to the Mortgage Assistance Program. While these funds have been budgeted for allocation through the annual Notice of Funding Availability (NOFA), they have not yet been allocated to specific projects.

BACKGROUND

Supporting the development of housing in Oakland, including affordable housing, is an objective of City Council Goal Number 2 (Build Community and Foster Livable Neighborhoods), Objective 2B (Facilitate the development of housing for all incomes), for Fiscal Year 2005-07. Affordable housing has been a concern of the City Council for many years. Over the past 7 to 8 years, greater attention has been devoted to affordable homeownership as part of the City's affordable housing programs.

At the February 8, 2005 Community and Economic Development Committee meeting, staff presented a report recommending the award of $10.8 million in affordable housing funds through the 2004-05 Affordable Housing Notice of Funding Availability (NOFA) process. In that report, staff noted that no affordable homeownership applications were received, and that several homeownership projects funded in previous rounds were stalled, due to problems with the homeownership program and increased costs, and were seeking extensions on their funding awards. Staff indicated that it would be working with affordable homeownership developers to research proposed changes to the current homeownership development program and to City policy regarding homeownership opportunities. Staff also committed to return to Council before the summer recess with recommendations regarding the City's two primary homeownership programs.

Staff is seeking policy guidance from the City Council at this time in order to ensure that the Notice of Funding Availability (NOFA) scheduled to be published in early September 2005 will reflect the City's priorities and policies with respect to homeownership.

Previous Reports to Council on Homeownership Issues

Since 1998, numerous reports have been presented to the City Council on issues surrounding promotion of homeownership:

- In June 1998, the City Council participated in a working session on affordable housing needs that included discussion of homeownership objectives and programs. The City Council set a target for allocation of housing funds equally between ownership and rental activities.

- In February 2001, the City Council increased the loan limits for the MAP program from \$30,000 to \$50,000, but declined to increase the income targeting from 80 percent of median income to 120 percent of median income.

- In July 2001, a report concerning the allocation of Affordable Housing Bond funds and issues surrounding affordable housing development noted that recent allocations of housing funds had been heavily targeted towards rental housing. Nonetheless, the City Council affirmed that the 50/50 allocation was a goal to be achieved over time. Rather than limiting the 2001 NOFA exclusively to ownership, the City Council accepted a staff recommendation to solicit both ownership and rental project applications, and to award funds primarily on the relative strength of the applications received.

- As part of a report presented to City Council in June 2002, the City Council reaffirmed its goal that affordable housing funds be split 50%-50% between rental and ownership activities. Recognizing that the subsidy requirements for development of ownership housing were requiring City subsidy amounts greater than 40 percent of total costs, the City Council approved a staff recommendation to increase targeting for development of ownership housing from 80 percent of median income to 100 percent of median income.

- In December 2002, staff presented an informational report and recommendations to the City Council on program and policy issues regarding development of new homeownership housing and expansion of ownership opportunities for low and moderate income households. This included reaffirming the City Council's goal of allocating funds equally between rental and ownership housing, modifying the MAP and DAP programs, and giving priority to homeownership development projects located in areas with low ownership rates.

- In March 2004, staff reported that rapid increases in development costs were making development of affordable homeownership projects infeasible within the sales price limits then in effect. The City Council approved a recommendation to increase the income limit for homeownership development projects to 120 percent of median income provided that the average affordability was no more than 100 percent of median income.

- As part of a February 2005 report recommending allocations of funds for the 2005 NOFA, staff included a discussion of continuing issues regarding funding and producing new affordable owner occupied units, and indicated that it would return to the City Council in July 2005 with recommendations and a request for policy direction.

Process for Developing This Report

Since January 2005, staff has met numerous times with a group of developers of affordable owner occupied housing to better understand why no homeownership applications were submitted in the last NOFA, and to develop recommendations to better address the need for more homeownership opportunities for low and moderate income households. These meetings focused a considerable amount of time on policy choices and technical issues that impact on the effectiveness of the current AHDP program. Some of these issues apply generally to development of single family housing on small infill sites, while others pertain specifically to the way in which the City's program is currently structured. A number of issues have required further research. Some of these discussions highlighted contradictions and trade-offs in implementation of the AHDP and the MAP homeownership programs and in policy priorities. This process has resulted in the comments and recommendations provided in this report to assist the City Council in choosing between several well-intended but conflicting goals and policies.

KEY ISSUES AND IMPACTS

City Policy Objectives for Homeownership

Over the years, the City Council has identified a number of policy objectives and guidelines for homeownership programs. These include:

- Increasing opportunities for low and moderate income households to become homeowners
- Increasing the City's homeownership rate (i.e., increase the percentage of households who are homeowners)
- Providing an opportunity for low income homeowners to accumulate some equity
- Maintaining assisted housing units as affordable for the long term, or permanently
- Revitalizing neighborhoods

City Operational Policies for Homeownership Programs

In addition to the broad policy objectives cited above, the City has also put in place a number of operational policies and guidelines governing the use of City/Agency funds for homeownership. These include:

- *Direct homebuyer assistance is limited to 80 percent of area median income (AMI) and* below
- Development of new ownership housing is targeted to moderate income households, with a maximum income of 120 percent of AMI and an average affordability of 100 percent of AMI
- City/Agency development subsidies are limited to 40 percent of total development costs for the assisted units.
- The City seeks, on average, to allocate 50 percent of its affordable housing funds to homeownership activities. This calculation excludes Community Development Block Grant funds used for rehabilitation of owner occupied homes and provision of fair housing and legal services to low income renters.

Restrictions on Use of City and Agency Funds

The funding sources used by the City to promote development of new owner-occupied housing have particular requirements and limitations:

<u>HOME funds</u>, which are federal grants to the City, allow the City considerable latitude in structuring resale controls. There is no set formula; instead, the City can establish guidelines as long as they meet the general goals of providing an affordable sales price and providing owners with a fair rate of return on their investment. However, HOME funds can only be used to assist households with incomes at or below 80 percent of median (roughly $65,000/year), which necessitates subsidy amounts far in excess of 40 percent of total development cost, which is the maximum allowed by current City policy. Unless combined with additional funding from the Redevelopment Agency or non local sources such as CalHFA, use of HOME funds for development of new ownership housing is not practicable.

<u>Redevelopment funds</u> can be used to assist households with incomes as high as 120 percent of area median income (roughly $98,000/year). However, California Redevelopment Law has very strict requirements for resale controls that result in maximum sales prices that are lower than what a moderate income household can actually afford to pay using underwriting criteria typically used by private lenders.

Current Homeownership Programs

The City currently operates two types of homeownership programs that work in quite different ways.

The first-time homebuyer assistance programs are designed to help low and moderate income households purchase existing housing by bridging the gap between market prices and what the household can actually afford. They provide assistance to homebuyers, but do not permanently restrict the affordability of homes. Instead, the City loan is repaid. When first initiated in 1994, the City's Mortgage Assistance Program (MAP) was structured to require that homebuyers repay a (often substantial) share of the home's appreciation to the City when the house was sold or refinanced. Loans can be forgiven if the owner remains in the home for 20 years. In 2001, the program was restructured to require repayment of the loan with simple interest of 3 percent, but with no provision for loan forgiveness.

The City's housing development program provides construction loans to developers of homeownership housing. Upon completion of construction, the loans are converted into grants to enable new homes to sell at affordable sales prices that are considerably less than market value. In return, the City/Agency records permanent resale restrictions against the property that require the homes to be resold at an affordable housing cost and only to low or moderate income buyers. Under this program, the City's funds remain invested in the property and the housing remains affordable permanently.

Current Programs Are Not Meeting Policy Goals

In recent years, there have been signs that the City's housing programs are having difficulty achieving their stated objectives.

1. In the most recent (2004-05) funding round for housing development funds, no applications were received for homeownership projects, despite efforts by staff to encourage such projects. The reasons for this are discussed below.

2. Four projects funded in earlier NOFA rounds (Calaveras Townhomes, Mandela Gateway Ownership Housing, Sausal Creek Townhomes, and Habitat's Edes Avenue development) are now stalled in part because the existing program makes it difficult to leverage outside funds while still complying with the restrictions of State Redevelopment law and City policy. Other factors include rapid increases in development costs (labor, materials and insurance).

3. The Mortgage Assistance Program (MAP) for first-time homebuyers is having a harder time reaching households with incomes less than 70-80 percent AMI. Rapid increases in market prices have expanded the gap between market prices and what is affordable to a lower income homebuyer. The maximum loan amount under the MAP program was increased to $50,000 in 2001, but has not been increased since then and is no longer

sufficient subsidy to afford a standard quality market rate home. While many households have been able to leverage some assistance from the California Housing Finance Agency (CalHFA), even the combined subsidies are rapidly falling short of what is required.

City Policy Objectives are in Conflict

As noted earlier in this section, the City has a number of public policy objectives and internal operational policies that have guided its homeownership efforts. Implementation of homeownership programs requires the City to make difficult choices between competing policy objectives. It is not possible to realize all of these objectives within a given program, because some objectives are directly contradictory to others.

<u>Long-term affordability versus equity/wealth building.</u>
Perhaps the most fundamental trade-off in homeownership programs is between mechanisms to maintain long-term affordability and mechanisms to allow subsidized homebuyers to build wealth through equity appreciation.

For many households, homeownership is the primary way to accumulate assets to move into better housing, to pay for costs of higher education, or to provide a reserve for unforeseen emergencies such as catastrophic medical costs. However, long-term resale controls sharply limit the amount of equity that is accumulated. In Oakland and the rest of the Bay Area, annual price increases of 10 to 20 percent have been the norm for several years. Resale controls that limit sales prices to what is affordable to low and moderate income buyers allow only modest increases of approximately 3 to 5 percent per year. Under some circumstances, buyers could even lose money. As a result, homeowners who purchase homes with long term affordability restrictions could find themselves in situations in which they do not gain enough equity to be able to purchase another home in Oakland without additional subsidy. For these households, homeownership could turn out to be a temporary status rather than the path to the American dream.

The chart in Attachment 1 demonstrates that even with appreciation at much more modest rates than has occurred in recent years, the gap between market prices and affordable prices widens over time. As a result, the amount of appreciation received by buyers of housing with resale controls is insufficient to allow them to purchase another home.

<u>Leveraging versus income targeting.</u>
The City has generally tried to target its housing programs to those with the greatest need, with an effort to reach lower incomes wherever possible. At the same time, the City seeks to maximize leveraging of non-City dollars. These two objectives are contradictory for ownership housing. Targeting ownership projects to very-low and low income households (incomes of $41,000 to $65,000 per year) requires greater amounts of City subsidy, and there are few outside subsidy sources available. When combined with the high costs of building new ownership housing, the subsidy requirements are enormous.

In comparison, rental housing developments serve households with lower incomes and greater needs, while utilizing less City subsidy per unit. The chart in Attachment 2 demonstrates the differences in income targeting and subsidy requirements for recently-approved rental and homeownership developments.

Expand supply versus expand opportunities for homeownership.
Development of new ownership housing is often seen as a way to revitalize neighborhoods by redeveloping vacant lots and other vacant or underutilized sites. In addition to removing blight, there is an expectation that these housing developments will stimulate additional private investment in low income neighborhoods. However, if the principal objective is to provide opportunities for lower income households to become homeowners, this can be achieved far more efficiently by providing mortgage assistance for purchase of existing homes. Compared to development of new housing, the City's MAP program reaches households with lower incomes and requires less subsidy per unit, because many existing homes are not as expensive as newly constructed homes.

The City lacks sufficient resources to increase the homeownership rate
The City Council and the Mayor have declared a goal of increasing the City's homeownership rate by as much as five percentage points (from 41 percent to 46 percent). The MAP program does not contribute to this effort because acquisition of tenant-occupied properties is not allowed due to the substantial relocation benefits that must be paid to displaced tenants. MAP loans are used primarily to assist lower income buyers to purchase properties that are already owner occupied, and thus the ratio of owner occupied units to rental units remains unchanged. On the other hand, while development of new ownership housing raises the ownership rate, the City does not have the resources to assist enough affordable ownership units to make a noticeable difference. In fact, **raising the ownership rate by just one percent would require either (a) development of 3,000 units of ownership housing without any increase in the number of rental units, or (b) conversion of 1,500 rental units to ownership**. With annual funding of $8 million to $10 million for housing development, at best the City might produce 100 units of ownership housing each year. Expansion of the homeownership rate is far more likely to come about as a result of development of market rate housing.

The City's limits on subsidy amounts make development of ownership housing difficult
Owner occupied housing is more expensive to develop than rental housing, and costs are driven up even further by insurance to protect against potential claims for construction defects. At the same time, it is harder to leverage outside funding for ownership housing, in part because there are fewer funding sources and in part because the City's current program makes it harder to leverage those sources that are available.

The City has a long-standing policy, reaffirmed several times by the City Council, to limit City funding to 40 percent of total development cost. The combination of higher development costs, fewer outside subsidies, and limitations on the amount of City financing works together to make affordable ownership projects less feasible.

In 2002, the City modified targeting requirements in homeownership developments to increase from a **maximum** of 100 percent of median income to an **average** of 100 percent with a maximum of 120 percent of median. This reduced the amount of subsidy required, and was adopted in part to ensure that projects would be able to remain within the 40 percent subsidy standard. As development costs continue to increase faster than incomes, and as interest rates rise (reducing the amount of private debt that can be supported), the amount of City subsidy needed is again close to exceeding the 40 percent limit.

If the City's program were modified as recommended in this report, it would be easier to leverage outside funding sources, thereby making development feasible without exceeding the City's subsidy limit.

Obstacles and Constraints to Implementation of Affordable Ownership Housing Programs

CEDA staff's meetings with developers of affordable housing identified the following constraints to providing affordable ownership housing.

<u>The cost of developing ownership housing is extremely high and continues to rise</u>
Several factors make ownership housing more expensive. Homeownership projects are often built at lower density than rental projects, which increases land costs on a per unit basis. Ownership projects tend to use higher grade materials and feature more amenities, which also adds to the cost. Most important, however, is the continuing risk of lawsuits by homeowners associations over construction defects. State law makes developers and contractors liable for a period of ten years after construction. The cost of insurance against such claims has skyrocketed, adding anywhere from $20,000 to $100,000 to the cost of a home. To protect against these claims, developers often set aside a reserve fund to make repairs even after the units are sold. Covering the cost of these reserves also adds to total development costs.

To some extent, it has been possible to reduce the real cost of developing housing by using sweat equity and donated labor and materials, as is the case with projects developed by Habitat for Humanity. However, while this succeeds in making homes affordable to families with incomes as low as 60 percent of median income, it does not resolve the issues associated with long-term resale controls that are discussed below.

<u>There is only a limited ability to leverage outside resources for ownership projects.</u>
There are fewer sources of subsidy funds for ownership developments than for rental projects. While there have been some new programs introduced by the State for homebuyer assistance, for the most part these are not permanent subsidies that can be used to reduce sales prices to an affordable level. Instead, they provide assistance to homebuyers to purchase market rate housing, but require repayment when the home is sold. There is no federal tax credit program for ownership comparable to the Low Income Housing Tax Credit program, which has been a major source of funding for rental housing for nearly 20 years. As a result, City subsidies up to 40 percent of total development cost are barely adequate to make a project feasible.

Developers need to stay involved in ownership projects long after units are sold.
Many developers have found that new homebuyers are unclear about the division of responsibility between the developer and the new buyer for such items as maintenance and replacement of building components. Additionally, developers have found that devoting time to maintaining an ongoing relationship with homeowners associations is also a good way to prevent issues from developing into construction defect litigation. As a result, developers have had to respond to homebuyer issues for many years after a development is completed and sold. Unfortunately, this requires developers to allocate staff resources for which no independent funding stream exists.

Specific Problems with Implementing Long-Term Resale Controls

Apart from these general issues, discussions with developers, lenders and others have identified specific concerns regarding implementation of the City's current homeownership development program, which, consistent with California redevelopment law, requires long-term resale controls on Agency-assisted developments. While resale controls are intended to ensure that subsidized ownership units remain affordable to and occupied by low and moderate income households for at least 45 years (or under the City's current program, for the useful life of the property), such provisions have a number of drawbacks.

Resale restrictions shift most of the risk to low and moderate income buyers.
Because of the way that restricted sales prices are determined, buyers end up assuming all of the risk associated with fluctuations in mortgage interest rates. When interest rates rise, maximum allowable sales prices are reduced. Under these circumstances, the homeowners could end up losing some or all of their equity, even during periods when market prices are escalating rapidly. As discussed below in the "Alternative Recommendations" section, it is possible to protect homeowners/sellers against such risk, but only with additional costs to the City.

Resale restrictions may act as a disincentive to maintain and upgrade homes
Because resale controls are driven by changes in median income and interest rates, and not by changes in market values or the condition or amenities in the property, there are few incentives for assisted homeowners to invest in upgrading their property.

Resale restrictions are difficult for buyers to understand
Resale restrictions limit sales prices on the basis of a formula that depends primarily on two factors – median family incomes for the metropolitan area, and interest rates for first mortgages, neither of which can be predicted in advance. Prices also are independent of any trends for market rate housing. Buyers often do not fully understand that while their (unassisted) neighbors may be experiencing double-digit appreciation in the value of their homes, assisted buyers are required to sell their homes at much less than fair market value.

Redevelopment law requires excessive subsidies for development of affordable homes
California redevelopment law requires that price-restricted ownership housing developed for moderate income households (up to 120 percent of median income, or roughly $98,000/year)

must be sold at an affordable housing price, defined as a price at which monthly housing costs do not exceed 35 percent of 110 percent of median income. The statue explicitly requires that housing costs include property taxes, insurance, maintenance, homeowners association dues, and an allowance for maintenance. As a result, in order to remain within the 35 percent limit, the amount available for mortgage payments is significantly reduced, and the necessary subsidy is increased.

A major consequence of this formula is that it assumes that moderate income households can only afford mortgages in amounts that are much lower than what is actually available from conventional mortgage lenders using standard underwriting guidelines. The result is that the resale restrictions required by State redevelopment law reduce sales prices to a level far below what households are actually able to afford.

Other funding sources are unwilling to subordinate to City restrictions
In general, the City has an interest in ensuring that its resale controls have a senior lien position, so that even in the event of a foreclosure the units would have to be sold at an affordable housing price. Many lenders are unwilling to subordinate their financing to these restrictions. Underwriting requirements of the secondary mortgage market (through FannieMae and FreddieMac in particular) often do not allow for resale controls. And some State housing programs do not allow resale controls, or at a minimum make such controls difficult to use.

In the absence of subordination by the lenders, there is a substantial risk that if the homeowner defaults on the first mortgage, the City will lose both its investment and its affordability controls. At present there is no budget authorization that would allow the City to expend funds to cure any defaults on the first mortgage or to repurchase the home and sell it to another qualified purchaser.

The City's desire to ensure that units will remain affordable even if the homeowner defaults on the first mortgage makes it difficult to leverage outside funds. The City's long-term affordability restrictions limit the ability of developers to leverage non-City funds for homeownership developments.

Resale controls are more difficult to administer
Because of their inherent complexity, resale controls require more staff resources to implement. Far more staff time must be devoted to explaining the requirements and resale formulas to homeowners, lenders, realtors and prospective buyers. Enforcement of the resale controls is more difficult than simply qualifying borrowers and requiring repayment of City subsidies as in the MAP program. Because the resale restrictions limit the value of homes to less than fair market value, additional staff time must be devoted to ensuring that owners do not refinance for amounts greater than the (restricted) resale price.

PROPOSED CHANGES TO CITY POLICIES AND PROGRAMS

As discussed above, existing programs to develop owner-occupied housing for low and moderate income households are encountering a number of difficulties. Staff therefore proposes that the City Council consider the following changes to its affordable housing policies and these programs:

1. Establish that the City's primary objective for its homeownership programs is the expansion of opportunities for lower income households to become homeowners by providing downpayment, second mortgage, and closing cost assistance versus the development of new ownership units with long-term affordability restrictions. Program design should be guided by the most efficient and effective program for achieving this goal.

2. Based on the above goal, reduce efforts to build new affordable ownership housing due to the many obstacles and constraints that are involved. Expansion of ownership opportunities can better be accomplished through the existing MAP ownership program.

3. Shift funds from housing development to the MAP program. An increase of $1 million per year, combined with the re-use of loan repayments, would provide $4 to $5 million per year for homebuyer assistance.

4. Increase the maximum loan amount in the MAP program from $50,000 to $75,000.

5. Continue to encourage development of new owner-occupied housing projects as part of the annual NOFA, but without any set-aside of a portion of the available funding or preference points that boost the competitiveness of homeownership projects. Ownership projects would compete with rental projects on an equal basis, with points for reaching lower incomes, better leveraging of outside resources, etc.

6. To the extent that the City continues to fund development of new ownership housing, structure the City's assistance as deferred loans that are recaptured (with 3-4 percent interest) when the property is sold, refinanced, or no longer owner-occupied. Affordability restrictions would terminate once the City's subsidy is repaid.

7. For the ownership projects that are currently stalled, modify the terms of the assistance to eliminate permanent resale controls and restructure the financing as loans to be repaid with interest when the homes are sold or refinanced.

8. Grant authority to staff to use Low/Mod funds to cure defaults and resell housing in order to protect Agency investments. These would be short-term uses of funds that will be recovered from the property sale, and therefore should not reduce the Agency's ability to fund development projects funded through the NOFA process.

SUSTAINABLE OPPORTUNITIES

In order to incorporate sustainable development principles pursuant to City Council Resolution No. 74678, C.M.S. adopted on December 1, 1998, developers are required to submit a *Sustainability Statement* outlining the economic, environmental, and social equity benefits of their projects. Staff will continue to encourage developers to follow and, when possible, broaden the sustainability plans outlined in their applications for City gap financing.

Economic: Homeownership helps build wealth for low income people; some programs more so than others. New affordable homeownership projects will expand the affordable housing inventory in Oakland and generate construction and professional services contracts. Expanding the existing MAP program will enable more low income households to become homeowners by purchasing existing homes.

Environmental: As urban infill projects typically located near mass transit and neighborhood amenities, these developments provide housing that is not dependent on constant use of the automobile and is an alternative to urban sprawl. When low income households use the MAP program to purchase an existing unit, the effect on the environment is similar.

Social Equity: Shifting funds to homebuyer assistance enables more low-income families to become homeowners. Homeownership has a positive impact on the quality of life for families and residents and the neighborhood through pride of ownership.

DISABILITY AND SENIOR CITIZEN ACCESS

All housing development projects receiving federal funds are required to construct and set aside unit to be occupied by persons with disabilities (Federal Section 504 regulations). This means that at least 5% of newly constructed units will be available to persons with disabilities. The State's Title 24 and the Americans with Disabilities Act require consideration of person with disabilities in design and construction of housing. In all rental units and some ownership housing types, those requirements include accessible units and facilities. Furthermore, developers will be required to devise a strategy to effectively market housing units to the disabled community and present this strategy as part of their Affirmative Fair Marketing Plan. The City has incorporated strategies to effectively market housing units to the disabled community and seniors as part of its MAP program.

While the City's homeownership programs are open to seniors, in practice very few first-time homebuyers are seniors.

RECOMMENDATIONS AND RATIONALE

Given the limitations and constraints noted in this report, staff is recommending that the City no longer require long-term affordability restrictions on ownership developments. Instead, the City's funds would be recaptured and made available for new affordable housing activities. Justifications for and consequences of such a program change include:

Development of Affordable Ownership Housing is not Increasing the Homeownership Rate

As discussed above, development of new ownership housing units is having a negligible effect on the City's homeownership rate. Increasing the overall number of homeowners can better be pursued by encouraging market-rate development of new ownership housing for moderate and middle income households, while providing purchase assistance to lower income families.

Resale Controls Limit Opportunities for Lower Income Homeowners

The use of long-term affordability controls prevents low and moderate income buyers from realizing the full benefits of conventional homeownership. First, the sales price formula required by State law puts all the risk associated with increases in interest rates on the homebuyers. Under some circumstances, low and moderate income homeowners could find themselves unable to sell their homes without losing some or all of their original investment.

Even without the risk from interest rate changes, the resale formulas will still sharply limit equity build-up compared to conventional homeownership. Purchasers of homes in City-assisted developments are likely to find that they do not get enough appreciation from their homes to be able to afford to buy a market rate unit. This could result in the family either returning to rental housing, or moving out of the area in search of more affordable homeownership.

Providing Assistance to Purchase Existing Homes is a More Efficient Use of City Funds

After careful consideration, staff has concluded that shifting funds from development of ownership projects to assistance for purchase of existing homes will better serve the City's policy goals of expanding homeownership opportunities for lower income households. Expansion of the Mortgage Assistance Program (MAP) will serve more households than continued development of new ownership housing. This would provide better targeting to those with lower incomes, and with better prospects for homeowners to be able to move from assisted entry level homeownership to unsubsidized ownership. The reasons for this are as follows:

- The MAP program is better suited to building equity for homeowners. Under current guidelines, MAP funds are provided as deferred loans with a simple interest rate of 3 percent. When the house is sold, the City's loan is repaid with this interest. This formula results in only modest financial gains for the City, but it provides a greater share of the appreciation to the homeowner rather than to the City. Because most of the equity appreciation is retained by the homebuyer, it becomes easier for a household to sell a home, repay the City's loan, and still have enough left to purchase another home.

- Increasing the loan limit under the MAP program will help the program close the widening gap between housing costs and what low income households can afford. The loan limit has not been increased in five years, and it is becoming increasingly difficult to reach households with incomes less than 80 percent of median income unless they make substantial downpayments or are able to secure substantial subsidies from State programs.

- Even with an increase in the amount provided for MAP loans (from $50,000 to $75,000), the MAP program will require less subsidy per unit than development of new ownership units. This will allow a greater number of households to be assisted with the same limited resources. In addition, households with lower incomes will be better served, because the MAP program reaches lower incomes than new construction of ownership housing.

- One drawback to this approach is that first-time homebuyer assistance for existing homes does not meet State requirements for production of affordable housing within redevelopment areas. The Agency would therefore have to meet those requirements primarily through the production of rental housing.

Restructuring Development Subsidies Makes the Program More Efficient and Effective

Restructuring the Affordable Homeownership Development Program to provide subsidies in the form of repayable loans instead of grants with long-term affordability controls has the following advantages and drawbacks:

- From an administrative standpoint, the program is far easier for buyers to understand than the complex formulas that are used for resale controls. Use of deferred loans with a stated interest rate more closely matches practices in the private market.

- Deferred loans are more understandable to private lenders and make it easier to leverage outside funding.

- A loan program has lower administrative costs than the costs of administering long-term resale controls.

- A potential drawback to this approach is that some City subsidies might not be recovered when homes are resold. In cases where the cost of development exceeds market-rate prices, a portion of the City's financial assistance is used to cover this gap ("development cost subsidy"). This is a permanent subsidy that cannot be recovered even with deferred loans, because it represents costs in excess of market value. When resale controls are used, this is not a problem, because in return for that permanent subsidy the City gets long-term or permanent affordability. With deferred loans, only the portion that covers the gap between market price and affordable price is recovered; the development cost subsidy will be lost.

- It should also be noted that if developments are structured to require recapture of the subsidy rather than continuing affordability restrictions, these units will not meet State requirements for production of affordable housing in redevelopment project areas unless the recaptured funds are used to assist an equivalent number of units in the redevelopment project area.

Providing Staff with the Flexibility to Cure Defaults Will Protect City Funds

Finally, staff is recommending that the Redevelopment Agency grant authority to staff to use Low and Moderate Income Housing Funds on a short-term basis to protect Agency investments in cases of default and foreclosure.

- Authorizing the use of the Low/Mod Income Housing Funds to cure defaults will protect Agency investments by allowing the Agency to intervene in a timely fashion. When a property owner receives a notice of default and pending foreclosure, there is only a period of 90 days in which the owner or a subordinate lender can take action to prevent the foreclosure sale from going forward. Without advance budget authority, it will be necessary to schedule, prepare and present a staff report and resolution, which in itself can take two months or longer, leaving little time to actually resolve the default situation and prevent a foreclosure sale. If the unit goes to foreclosure, the Agency will lose the funding invested and any affordability controls on the unit. The unit then would become a market rate unit.

- This policy would entail authorization to use already allocated funds on a short-term basis for this purpose. Funds would be recovered long before they are needed for outstanding commitments.

Implications for Wood Street Station Project

The issues discussed in this report have a substantial bearing on the feasibility of ensuring the long-term affordability of ownership units in the proposed Wood Street Station development. The Conditions of Approval for that project provide the Redevelopment Agency with the option to purchase some of the ownership units and record resale restrictions for a period of 45 years. This is contingent on the Agency providing sufficient subsidies to write down the sales prices to an affordable level. As discussed in this report, the use of long-term resale controls will sharply limit the appreciation that will be received by purchasers of those units. Without sufficient build up of equity, homebuyers may find it difficult, if not impossible, to eventually move up to other, unsubsidized ownership housing. Staff will return to the Agency with a complete analysis and discussion of this issue, and possible options for the Agency, once tax increment projections are completed and target sales prices are known.

ALTERNATIVE RECOMMENDATIONS

Combine Grants for Development with Loans for Interest Rate Risk

If the City wishes to continue to support the development of ownership housing with long-term or permanent resale controls, this can be achieved in ways that reduce the risk to homeowners that they will lose their original investment even when market prices are increasing, due to increases in interest rates. However, this can only be achieved by shifting that risk onto the City and creating a contingent liability of uncertain magnitude.

The City could restructure its program so that houses are sold initially at affordable housing cost as defined by State redevelopment law. Maximum prices allowed when houses are resold would be indexed to increases in the median income. This would allow for annual appreciation of roughly 3 to 4 percent.

The Agency could protect homebuyers from interest rate risk by agreeing to provide subsequent buyers with a deferred loan to cover the gap between the indexed sales price and the (potentially lower) price required by State law. Depending on future movement of interest rates, the Agency loan would either be repaid when the house is sold again, or would be rolled over to the next buyer. If interest rates rise again, the Agency may need to provide additional funds with each subsequent resale, thereby reducing funds for other housing programs. In years of high turnover and rising interest rates, very large sums of cash could be needed. As this circumstance would be hard to predict, the Agency would need to fund a large Affordable Housing reserve.

While this approach would protect homebuyers from losing their equity, it also would create an open-ended commitment by the Agency whose total cost cannot be estimated in advance.

In addition, even though such an approach would protect owners' equity investments, it would not ensure that upon resale they could purchase another house. If market prices continue to rise much faster than the restricted sales price, owners will still not have sufficient funds to afford a market rate home in Oakland.

Staff recommends against pursuing this alternative.

Additional Modifications to the MAP Program

Currently, newly developed homeownership units can be targeted to moderate income households with incomes up to 120 percent of median income, so long as the average targeting and affordability in each project is no more than 100 percent of median. The MAP program is restricted entirely to households with incomes at or below 80 percent of median income.

If the City Council wants to continue to provide some level of assistance to moderate income homebuyers, it could raise the income limit from 80 percent to 100 percent of median income. Should the Council chose this option, staff recommends that maximum loan amounts be tiered, so that moderate income households would only be eligible for $50,000, while low income households would receive up to $75,000.

ACTION REQUESTED OF THE CITY COUNCIL

Staff has outlined a number of policy issues and choices for the City Council to consider, and has provided recommendations as to how to proceed. Staff requests that the City Council adopt a motion to approve staff's policy recommendations to (a) modify the existing homeownership development program from resale controls to repayable loans, (b) shift $1.0 million in funding from the Housing Development Program to the Mortgage Assistance Program (MAP), (c) increase the MAP program's loan limits to $75,000, and (d) grant staff authority to use Low and Moderate Income Housing funds on a short term basis in cases of default. Based on the City Council's final policy directions, staff will return with specific legislation to implement the approved changes.

Respectfully submitted,

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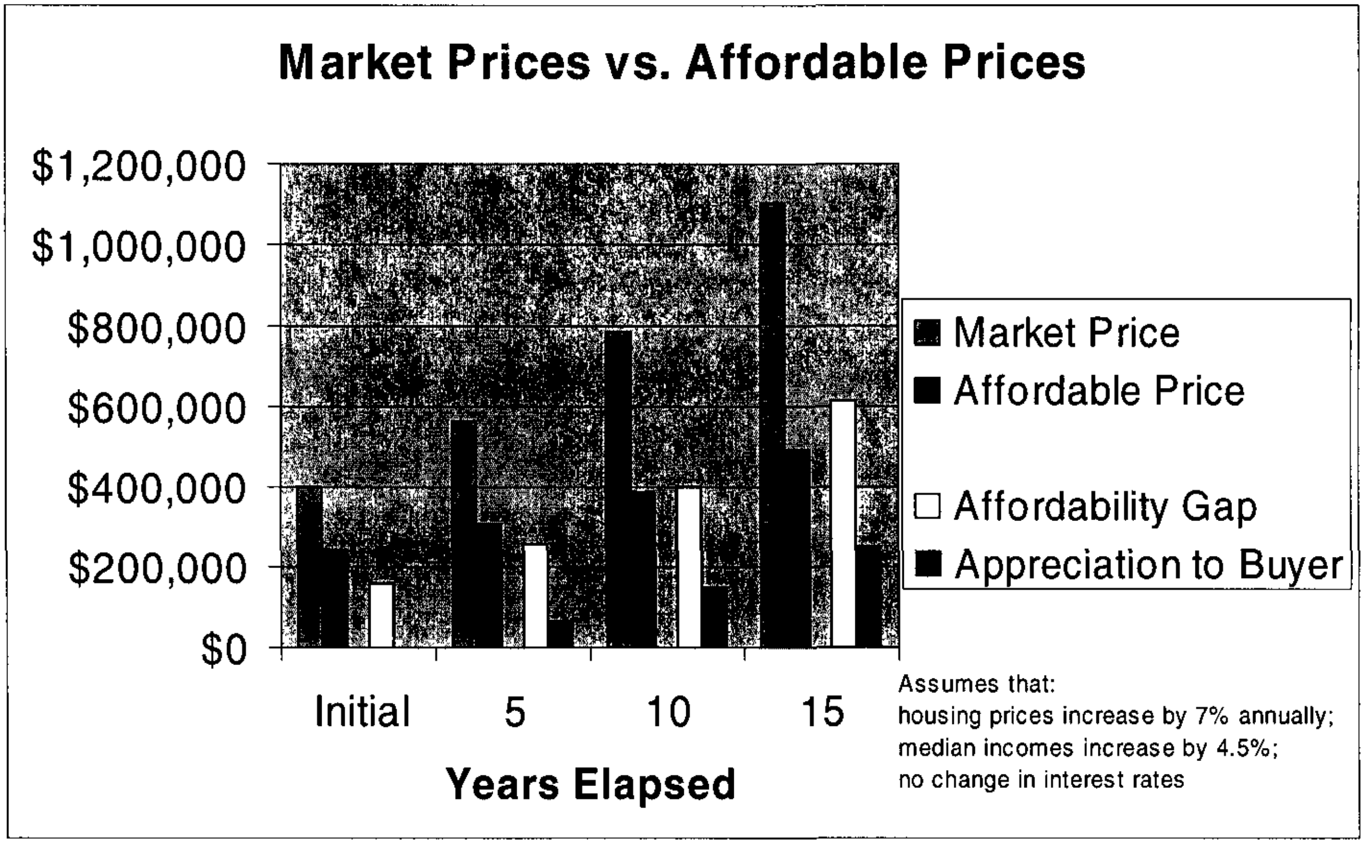
APPROVED AND FORWARDED TO THE
COMMUNITY AND ECONOMIC DEVELOPMENT COMMITTEE

OFFICE OF THE CITY ADMINISTRATOR
AND THE AGENCY ADMINISTRATOR

Attachment 1

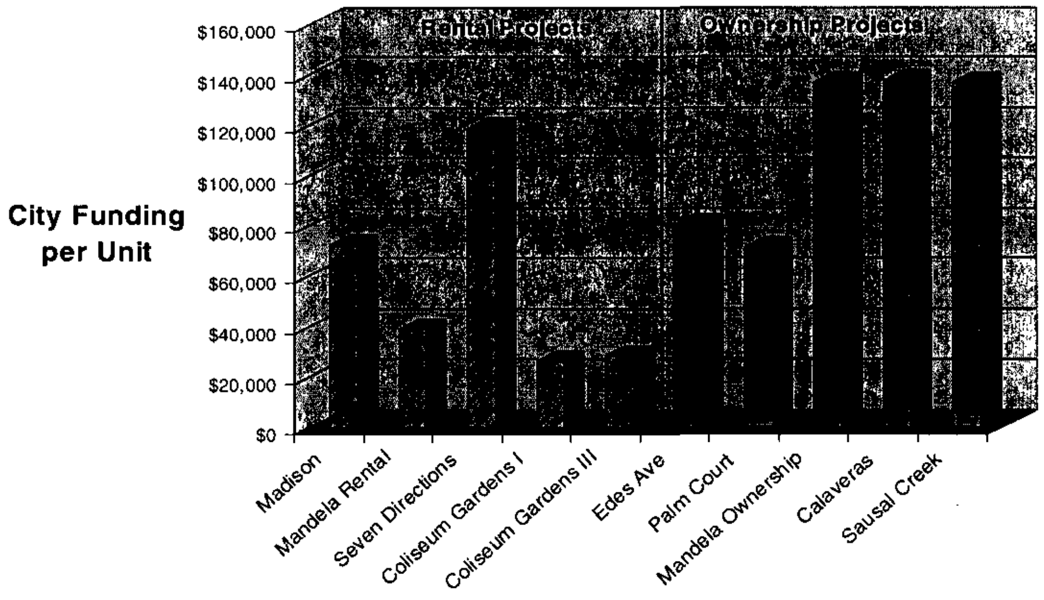
Resale Restrictions Restrict Equity Accumulation and Prevent Purchase of Another Home



Attachment 2

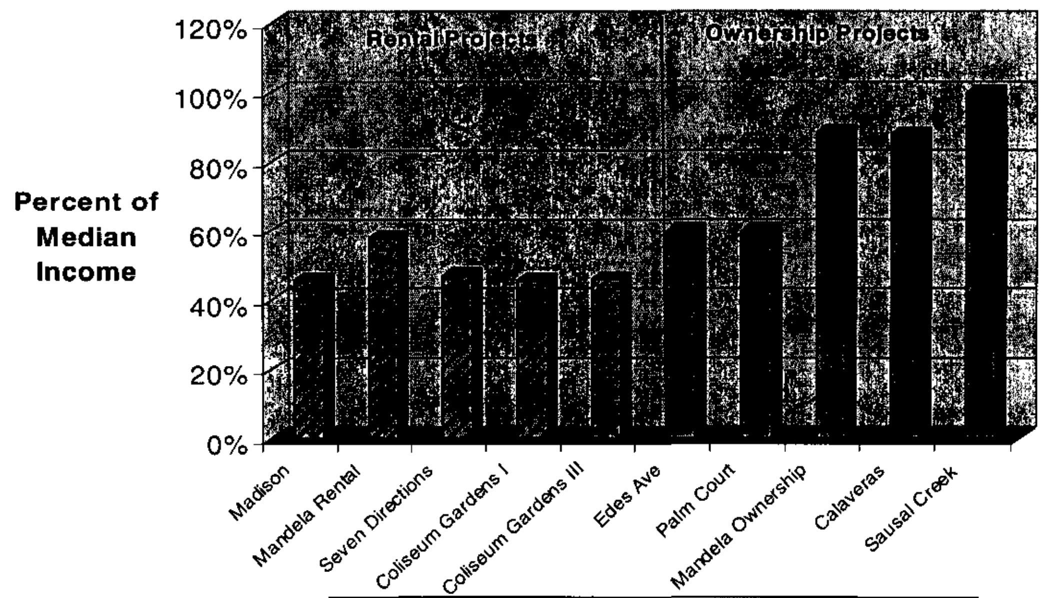
Homeownership Developments Require More Subsidy and Provide Less Affordability than Rental Housing Developments

Per Unit Subsidy for Current Projects



Rental Average $56,833 Ownership Average $112,656

Average Income Targeting of Current Projects



Rental Average 48% Ownership Average 79%