



# Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Jacky Morales-Ferrand

**SUBJECT:** SEE BELOW

**DATE:** October 29, 2020

Approved

Date

**10/29/2020**

**SUBJECT: APPROVAL OF THE MULTIFAMILY UNDERWRITING GUIDELINES**

## **RECOMMENDATION**

- (a) Accept the staff report on the proposed underwriting guidelines.
- (b) Adopt a resolution approving changes and additions to the Underwriting Guidelines developed by the Housing Department for use in underwriting and structuring affordable housing transactions and adopted by Resolution No. 78761 to add sections clarifying policies regarding resyndication and refinancing, City and County land acquisition for affordable housing and community engagement and change to policies regarding residual receipts and foreclosure and loss of subsidy.

## **OUTCOME**

Approval of the proposed Underwriting Guidelines will establish clear requirements to address risk and project feasibility related to underwriting affordable housing developments. Clear requirements will generate a higher level of predictability, enhanced customer service and efficient lending practices for those dedicated to building affordable housing in the City of San José.

## **BACKGROUND**

The Housing Department will use the Underwriting Guidelines to communicate expectations of the City with developers, borrowers, and other lending institutions regarding key project financing, development and operating parameters. The Underwriting Guidelines will also be used by the Department to evaluate projects that are submitted to the City in response to Notices of Funding Availability applications.

The City's Underwriting Guidelines were last updated in August 2018. The Underwriting Guidelines were created to ensure projects in San José serve the interests of the City as well as considering the interests of affordable housing developers and lenders. Key policy changes made included establishing a maximum City gap loan, ensuring affordability restrictions continue on ground lease projects if developers sell, and expediting closing processes.

This update provides greater clarity and consistency in the negotiation of transactions. The Underwriting Guidelines will reduce the time spent on negotiations and will identify items that will be brought to the City Council for approval. The Mayor and the City Council adopted a goal of building 10,000 affordable units by the year 2023. While additional resources are needed to meet this goal, the proposed Underwriting Guidelines will provide guidance in a more effective and efficient way to allocate City funding.

The Department held several outreach meetings with developers to elicit feedback on underwriting policy proposals as well as discuss how the City could work with developers more effectively. The feedback from these meetings was used to refine the Underwriting Guidelines consistent with City goals.

## **ANALYSIS**

The Director of Housing has the authority under the municipal code to adopt Underwriting Guidelines. However, in the interest of communication with the City Council and public, and the important step in implementing the Affordable Housing Investment Plan, staff is presenting only key changes to the Underwriting Guidelines to the City Council.

The Housing Department strives to fund affordable housing projects as quickly and efficiently as possible when funds are made available. Establishing Underwriting Guidelines facilitates the funding of affordable housing in the following ways:

- Consistency among funders – Developers must use multiple funding sources to finance an affordable development. The Housing Department aligned its guidelines to ensure that funding sources could be easily invested in developments with multiple funders.
- Clarity for Developers – Developers can structure projects to meet the guidelines at early stages in the development process.
- Expedited Closing Process – Projects that are structured with consistent and aligned terms that meet the Underwriting Guidelines can go through the documentation and closing process more quickly.

### **Proposed Policy Recommendations to the Underwriting Guidelines**

The proposed policy recommendations to the Underwriting Guidelines are focused on clarifying several policies and underwriting procedures. Some of the key changes in the proposed Underwriting Guidelines (**Attachment A and Attachment B**) are summarized below:

1. **Resyndication/Refinance/Rehabilitation**: The updated Underwriting Guidelines establishes how the City will assess requests for resyndication, refinancing, and/or the rehabilitation of developments where the City has a financial or non-financial interest in the development. In any of these cases the City's new Cash-Out policy will apply. Refinancing existing affordable housing developments are many times designed to replace the original loans with new loans and pulling out equity as cash.

The proposed cash out policy states that if a developer requests a transaction to take out cash of the development, three assessments will be completed:

1. the financial health of the developer;
2. the rent burden of existing residents; and
3. a physical needs review of the property.

Cash out will be split on a 50/50 basis with the City and the proceeds will be applied to outstanding interest on the existing City loan. Finally, a developer may apply for a waiver of the cash out portion to receive a greater portion of the cash if the developer can demonstrate an effort to invest in the new development of affordable housing in San José or make a greater investment in the property. Additional changes include a clarification on the City's expectation of consideration for all transactions. For example, if a developer requests consent for a refinance, the City will request an extension of the affordability restriction terms. Developer fees will be limited to 10% of the total construction cost for rehabilitation of the development, and the rent burden on residents will be considered as a part of the analysis of the transaction.

2. **City/County Acquisition Policy (Section 8.3)**: In cases when the development is seeking funding from both the City and the County, one of the two agencies will hold the ground lease, ensuring long-term affordability. The City of San José will purchase the land in the following cases:
  - a. the land was originally owned or financed by the City of San José;
  - b. the County of Santa Clara has not assisted the developer with acquisition and does not intend to own the land; or
  - c. the City of San José has more soft funding in the development than the County of Santa Clara.

3. **Residual Receipts with HCD (Section 9.8):** Generally, when the City is the junior lender to the development, the loan will be repaid through 50% of the net operating income (project income-project expenses). However, if there are other junior lenders, this income will be divided proportionately to the loan amount provided by each for repayment. The City requires a payment of fifty percent (50%) of Net Cash Flow as a Residual Receipts payment per the calculation. Currently, the California Department of Housing and Community Development (HCD) states that projects that include funding from HCD with calculations of residual receipts will need to adhere to HCD Uniform Multifamily Regulations (UMR) 8314(a2) requiring a 50/50 split: 50% to the Developer, and 50% divided to soft lenders. The proposed change to the Underwriting Guidelines will apply this requirement to the residual receipt payments. The City will not allow for 100% of residual receipts to pay any deferred developer fee in a priority to the City.
4. **Foreclosure and Loss of Subsidy (Section 3.5):** Generally, the City's affordability restrictions are set at a specific area median income (AMI) level for the duration of the restriction. Investors are requiring the affordability restrictions to "float up" to a higher AMI level in the case of loss of subsidy or foreclosure. The underwriting guidelines will be amended to allow the float up of affordability levels to a maximum of 60% AMI at the discretion of the City Council. These provisions will be applied to new tenants only.
5. **Community Engagement:** Developers are recommended to develop a community engagement plan for affordable housing developments. This plan will propose the sponsor to consider the following:
  - a. the diverse cultural and linguistic needs in various neighborhoods in San José;
  - b. develop culturally and linguistically relevant communication materials reflective of those communities; and
  - c. engage with the proposed community, its residents, and surrounding businesses that may be impacted by the proposed development to adequately address their concerns.

The policy recommendations are intended to address changes in policies from other funders and to improve the performance of existing policy practices for underwriting purposes. The Housing Department's objective is that the proposed policy modifications will provide clearer guidance to the development community, facilitate a more efficient underwriting process, and reduce the risk exposure to the City of San José.

## **CONCLUSION**

The update to the Underwriting Guidelines will provide clarity regarding expectations for developers when approaching a Resyndication/Refinance/Rehabilitation, clarifying the roles of the City and County when placing ground leases on proposed developments, update to the residual receipt splits when the development receives HCD funding, parameters for affordability restrictions that may increase in case of loss of subsidy or foreclosure and recommending developers develop a community engagement plan. Each of these updates will result in clarity for developers interested in developing affordable housing in San José while reducing risk exposure to the City.

## **EVALUATION AND FOLLOW-UP**

City Council will be informed of project specific data and underwriting recommendations when the Housing Department returns with approval of funding commitments for the development. Additionally, a quarterly report summarizing all actions taken by the Director of Housing under the Delegation of Authority are provided to the City Council in an information memo and are posted on the Housing Department [website](#).

Staff will incorporate the proposed changes into the previously adopted Underwriting Guidelines and publish the updated version on the Department website. Developers seeking funding from the City may access the Underwriting Guidelines to provide clarity and predictability for future transactions.

## **CLIMATE SMART SAN JOSE**

The recommendation in this memo does not affect Climate Smart San José energy, water, or mobility goals.

## **PUBLIC OUTREACH**

The Housing Department met with a wide range of stakeholders while developing the proposed Underwriting Guidelines. Staff held a series of Developer Roundtables to present the Department's policy findings and recommendations and to obtain feedback and endorsement from developers and property managers.

Staff hosted several meetings with stakeholders. The input below is a summary of the key issues and recommendations made regarding the proposed Underwriting Guidelines:

- *Resyndication/Refinance/Rehabilitation* - The acquisition and rehabilitation of projects are complicated and often have numerous issues, therefore some developers requested to

eliminate restrictions. Developers stated that the City should continue to have more fluidity for these transactions. Other developers appreciated staff addressing the cash-out policy. Developers want a win-win situation and believe the cash-out policy is reasonable and it should be widely accepted amongst stakeholders.

- *City/County Acquisition Policy* – Developers are seeking clarity for this issue and were supportive of a proposed policy.
- *Float Up for Foreclosure and Loss of Subsidy* - Developers deferred to lenders and felt it was important for the lenders to provide feedback. Staff reached out to lenders who were identified by the affordable housing development community. Lenders stated that they would most likely consider the float up on a case by case basis. Developers stated that their lenders focus on the operational subsidy and ensuring the Project Base Voucher and County-paid services are still being paid for in order to make projects work.

**Public Outreach Meetings:**

NAME	DATE	TIME	LOCATION
Developer Roundtable I	12/04/2019	4:00 – 6:00	City Hall
Lenders Roundtable	02/28/2020	2:30 – 4:00	City Hall
Developer Roundtable II	03/05/2020	2:30 – 4:00	MLK Library
Developer Roundtable III	03/05/2020	2:30 – 4:00	MLK Library
Developer Roundtable IV	10/16/2020	3:00 – 5:00	Virtual Meeting

**COORDINATION**

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

**COMMISSION RECOMMENDATION/INPUT**

This item was not heard by the Housing and Community Development Commission, as reviewing the specific terms for underwriting affordable housing developments do not fall under the functions, powers, and duties of the Commission described in Section 2.08.2840 of the San José Municipal Code.

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**CEQA**

Not a Project, File No. PP17-009, Staff Reports, Assessments, Annual Reports, and Informational Memos that involve no approvals of any City action.

/s/

JACKY MORALES-FERRAND  
DIRECTOR, Department of Housing

For questions, please contact Rachel VanderVeen, Deputy Director, at (408) 535-8231.

**Attachment A** – Summary of Proposed Changes

**Attachment B** – Resyndication/Refinance/ Rehabilitation Policy

## Underwriting Guidelines Updates

2018 Update	Current Language	Proposed Language
<b><i>Policy Update</i></b> <b>Category: Loan Terms and Condition</b>  <b>Section 3: Subordination of Affordability Restriction</b>	<p>In lieu of subordinating the affordability restriction, the City may allow a 60-day standstill and a float-up of affordability levels up to 60% Area Median Income (AMI) upon foreclosure (as required for feasibility).</p>	<p>At the discretion of the City Council, the City may allow the float up of affordability levels, to a maximum of 60% AMI, if necessary, for feasibility, in such cases where there is a loss of subsidy or foreclosure.</p> <p>The City's float-up language to apply to "New Tenants" in case of loss of subsidy only.</p>
<b><i>New Policy</i></b> <b>Category: Financing Options and Fees</b>  <b>Section 2: Refinance, Resyndication/ Rehabilitation, Cash-out Policy</b>	<p>No Policy in last underwriting update</p>	<p>Explicit Policy (Attachment B)</p>
<b><i>Policy Update</i></b> <b>Category: Permitting Adjustments</b>  <b>Section 9: Residual Receipts Update</b>	<p>The City shall require a payment of fifty percent (50%) of Net Cash Flow as a Residual Receipts payment per the calculation. However, if there is additional soft financing, the City may require the total share of Net Cash Flow for Residual Receipts payments to all Residual Receipts lenders to increase up to two-thirds (<math>\frac{2}{3}</math>). Of this <math>\frac{2}{3}</math> of Net Cash Flow, the portion of Residual Receipts payments going to the City will be determined on a pro rata basis of the total gap financing.</p>	<p>California Department of Housing and Community Development (HCD): Projects that include funding from HCD, the calculation of residual receipts will need to adhere to HCD UMR 8314(a2). The City will not allow for 100% of residual receipts to pay any deferred developer fee in a priority to the City.</p>



<p><b><i>Policy Update</i></b>  <b>Category: Ground Lease Policy</b></p> <p><b>Section 8: City/County Acquisition Policy Section</b></p>	<p>This policy clarifies the guidelines on determining which agency will hold the ground lease.</p>	<p>In cases when the development is seeking funding from both the City and the County, one of the two agencies will hold the ground lease, ensuring long-term affordability. The City of San José will purchase the land if:</p> <p>The land was originally owned or financed by the City of San José</p> <p>The County of Santa Clara has not assisted the developer with acquisition and does not intend to own the land</p> <p>The City of San José has more soft funding in the development than the County of Santa Clara</p>
<p><b><i>New Policy</i></b>  <b>Category: Underwriting Guidelines Operations</b></p> <p><b>Section 5: Community Engagement Plan</b></p>	<p>No Policy in last underwriting update</p>	<p>All project sponsors are recommended to develop a community engagement plan to include the followings but not limited to: identify communities with diverse cultural and linguistic needs in various neighborhoods in San José, develop culturally and linguistically relevant communication materials, engage with the proposed community, its residents, and surrounding businesses that may be affected by the proposed development to adequately address their concerns. Track the engagement progress to report and refine engagement strategies as needed.</p>

**CITY OF SAN JOSE POLICY  
RESYNDICATION, REFINANCE, REHABILITATION & CASH-OUT POLICY**

<b>RESYNDICATION, REFINANCE, REHABILITATION POLICY</b>	
<b>1.1 Purpose</b>	The purpose of this Policy is to establish guidelines for how the City will assess requests to Resyndication, Refinancing, and/or the Rehabilitation of developments where the City has a financial or non-financial interest in the development. In any of these cases, the City's Cash-Out Policy will apply.
<b>1.2 Eligible Projects</b>	This policy will apply to any project currently being managed by the City of San José's Asset Management team, where the City has a City Loan, City Issued Bond with a Bond Regulatory Agreement, City Affordability Restriction, and City Ground Lease. All Sponsor loans must be in fully compliant in order for the City to consider any refinance or resyndication/rehabilitation projects. An application will be required to be completed for all transactions.
<b>1.3 City Council</b>	Staff has a limited authority through the Director's Delegation of authority. Therefore, many request will have to be brought before City Council for approval. Transactions that require the subordination of the City affordability restriction, cash-out, or material changes to a current loan may require that the request be heard by City Council.
<b>1.4 Consideration</b>	The City expects consideration for all transactions.
<b>1.5 Examples of When Policy Applies</b>	<ul style="list-style-type: none"> <li>• The City of San José is the Issuer of the Bond</li> <li>• City has a Construction, Permanent, or Acquisition Loan</li> <li>• There is an Enforceable Bond Regulatory Agreement in place, but there is no longer an outstanding Bond.</li> <li>• There is an Enforceable City Affordability Restriction in place, but there is no longer a Construction, Permanent, or Acquisition Loan.</li> </ul>
<b>1.6 Developer Fee</b>	<ul style="list-style-type: none"> <li>• The City will only allow for a Developer fee to be taken out that is proportional to the amount of rehabilitation. Developer fee should be no more than 10% of total construction cost of the rehabilitation.</li> </ul>

## RESYNDICATION, REFINANCE, REHABILITATION POLICY

<p><b>1.7</b> Rent Burden</p>	<ul style="list-style-type: none"> <li>• For Developments that are taking on additional debt to the property, the Developer will need to assure that the additional debt that will not cause additional rent burden to its current tenants.</li> <li>• The Developer will need to provide a plan of action that will address “Rent Burden” if any of their current residents are paying 50% or more of their gross income in rent.</li> <li>• The action plan should include, solutions such as: <ul style="list-style-type: none"> <li>○ Lowering of AMI to meet the income level of current tenants</li> <li>○ The creation of a rent reserve to help cover rent burdened tenants</li> <li>○ Property management plan that demonstrates a clear effort to address rent burdened tenants.</li> </ul> </li> </ul>
<p><b>1.8</b> Affordability Restrictions</p>	<p>For request for refinance or resyndication, the City will require a minimum of an additional 15 to 25 years extension of the affordability restriction, based on the nature of the transaction.</p>
<p><b>1.9</b> Bond Redemption</p>	<p>The City of San José shall be the issuer of all bonds financing for multifamily housing rental projects within the City. Please refer to City Council Policy for Bond Issuances for more information about this policy.</p>
<p><b>1.10</b> Outside Issuer</p>	<p>In general, the City does not allow for the outside issuance of any multifamily Bond Issuance without City Council approval.</p>
<p><b>1.11 CASH-OUT POLICY</b></p>	
<p>In general, The City of San José will allow a Sponsor to secure new loans for financing or refinancing the acquisition/rehabilitation of a Project, but only if the City of San José determines in its sole discretion, that such financing/refinancing is necessary to ensure the viability of the Project. Under City Documents, a Sponsor must obtain The City of San José prior written consent for such new financing/refinancing, encumbrance of a leasehold estate, subordination of any City of San José existing liens, and/or prepayment of existing debt. Therefore, to ensure the financial viability and sustainability of a Project, a Sponsor is generally not permitted to obtain a loan in an amount that exceeds the amount necessary to acquire/rehabilitate a Project, which is commonly known as a “<b>Cash Out.</b>”</p>	

## RESYNDICATION, REFINANCE, REHABILITATION POLICY

If Sponsor would like to seek the City's consent in obtaining a new loan for conducting an acquisition/rehabilitation, resyndication or refinancing, and will be taking "cash out", the proceeds will be subject to a split between City and Developer 50/50, with the City's portion being applied to outstanding interest and the project must meet three criteria:

### Cash-Out Requirements:

- 1) The City has performed a satisfactory analysis of the financial health of Developer/Sponsor. Three years of Audited Financial Statements will be required.
- 2) The Development must be analyzed for rent burdened and this analysis must be reviewed, addressed, and approved by the City
- 3) A Physical Needs Assessment must be completed, and approved as satisfactory, by the City of San José.

Waiver Type	Cash-Out 50/50 Waiver
Reinvestment in Future Developments	<ul style="list-style-type: none"> <li>• The City of San José may consider a waiver to the 50-50 split of "Cash-Out" by allowing the Sponsor to take a greater portion of the Cash-Out, if the Sponsor can demonstrate that Cash-Out proceeds will be used by the Sponsor to invest in future affordable housing developments in the City of San José, currently being planned by the Sponsor within the next five years.</li> <li>• Subject to review by the City, the Sponsor will need to provide a copy of all current and proposed developments where the Cash-Out will be used. The Sponsor will also be required to assure that the Cash-Out appears on the audited financials of the Sponsor as a development loan.</li> </ul>
Reinvestment in Proposed Development	<ul style="list-style-type: none"> <li>• The City of San José may also consider waivers, subject to City of San José's review of supporting documentation, that result in an increased net public benefit to the subject property, where a Sponsor commits to reinvest all Excess Proceeds into the development. Such requests must demonstrate that the proposed uses justified by recent Capital Needs Assessments ("CNA") approved by City of San José, feasible underwriting, Sponsor capacity, and long-term cash flow projections.</li> </ul>