TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER

DEPARTMENT: PLANNING AND COMMUNITY ENVIRONMENT

DATE: MARCH 17, 2008

CMR: 173:08

SUBJECT: POLICY AND SERVICES COMMITTEE RECOMMENDATIONS FOR APPROVAL OF UPDATED BELOW MARKET RATE PROGRAM (BMR) ELEMENTS

RECOMMENDATION
The Policy and Services Committee (P&S) and staff recommend policy changes to the Below Market Rate (BMR) Program (see Attachment A), preparation of implementing legal documents, including revised deed restrictions and other enforcement and disclosure documents, and further analysis of program elements identified under Goal #2 of Attachment A as part of the next Housing Element revision.

BACKGROUND
Over the past three years, City staff and a consultant team analyzed the City’s Below Market Rate (BMR) Program, adopted in 1974 and governed by Policy H-36 in the Housing Element of the Comprehensive Plan. The study undertaken by staff and the consultant team included an economic and policy analysis of the program intended to maximize the effectiveness of the BMR Program though the increased production of affordable owner and rental units. The analysis provided expert advice regarding improvements in legal documents, program enforcement and methods of increasing the efficiency of routine administrative procedures. The study was also intended to provide an objective and statistically reliable view of the program from the perspective of the BMR owners.

In December 2006, after completion of the preliminary study, the Human Relations Commission (HRC) discussed the report recommendations. Generally, the HRC was supportive of the overall study recommendations but did not specifically act on the report or on any particular policy recommendations. The HRC was primarily concerned with the BMR ownership program and, in particular, the limited appreciation allowed under the current appreciation formula. Subsequently, staff worked closely with the Palo Alto Housing Corporation (PAHC), the City’s contracted BMR Program administrator, and the consultant team to develop a set of recommendations based on the study conclusions for program improvements. The BMR Committee of PAHC’s Board of Directors reviewed the study in June 2007 providing additional input regarding potential modifications to the BMR Program. Staff developed its recommendations and forwarded the BMR
Study to the Policy and Services Committee for discussion at the September 2007 meeting.

One key recommendation of the BMR Study was preparation of a BMR ordinance to codify Policy H-36 in the Housing Element. On March 10, 2008, the Council approved a BMR ordinance that identifies the purpose and authorizes the adoption of procedures to assist in the implementation of the program. Modifications to that ordinance may need to be prepared to address specific developer requirements and affordability standards for owner and rental units if recommended policy changes to the BMR program are adopted as part of this recommendation.

**DISCUSSION**

**Policy and Services Committee (P&S) Review:** The P&S Committee discussed the BMR study and staff recommendations on September 11, 2007. Attachment d is the action minutes for that meeting with the policy changes and actions recommended by P&S. The Committee supported the staff recommended Policies 1b through 1k in Attachment A and recommends adoption of those policies to the City Council. The Committee discussion focused on Policy 1a, which recommends that appreciation for ownership units be increased from the current one-third of the percent change in the Consumer Price Index (CPI) to the full CPI. Although the Committee supported the recommended change to the full CPI, there was discussion of retroactively applying the change in the appreciation formula for current BMR unit owners. The Committee did not forward a recommendation to the full Council but referred this issue to the Planning and Transportation Commission (PTC) for further discussion and recommendations regarding the retroactivity of the appreciation formula to the date each owner purchased their BMR unit. The Committee also recommended that the City Council direct staff to further analyze and make recommendations on Policies 2a, b and c listed under Goal #2 of Attachment A as part of the next Housing Element revision. Finally, the Committee requested that the PTC review and comment to Council on the viability of further pursuing each of these three new policy proposals.

**Planning and Transportation Commission (PTC) Review:** The PTC met on October 10, 2007 to discuss the BMR Study recommendations and the specific referral from P&S regarding appreciation retroactivity for current BMR owners. Staff described the deliberations of P&S and explained the issues the retroactive application of additional appreciation that would affect most of the BMR units in the program since there are only a few that are currently receiving full CPI. Several BMR unit owners addressed the Commission and urged support for the retroactive appreciation. The PTC unanimously supported the concept of full CPI appreciation for all of the existing BMR units that are currently not receiving full CPI appreciation. The PTC recommended approval of the staff recommendations list on Attachment A. The PTC also had several additional recommendations for either modifying the BMR Program or that warranted further study. These included:

- Evaluating possible methods to address the impact of increased homeowner dues on BMR homeowners
- Developing a cap on BMR unit appreciation
- Eliminating the depreciation deduction for unit improvements
- Modifying preference criteria to provide a preference for City and PAUSD employees
- Providing periodic review of the BMR program to ensure optimum operations
- Exploring “rounding up” fractional units on projects with less than 30 units
- Changing policy to allow developers to provide smaller BMR units than the market rate
component only if more units are provided that equal or exceed the square footage from the original requirement

Staff will study the last item as part of the Housing Element update; the other PTC recommendations are being considered currently as part of the implementation of the BMR study.

**Staff Recommendation:**
Staff recognizes the concern about the effect upon BMR owners of the low appreciation realized under the current one-third of CPI appreciation formula that has been in place since 1983; however, staff continues to recommend against a retroactive increase to the BMR appreciation rate for current owners for the reasons described in both the P&S and PTC attached staff reports. Further analysis has since been completed on:

- The effect that the retroactive application of the full CPE would have on the overall policy objectives of the BMR program as a whole,
- The likelihood of loss of units in specific projects if resale prices exceed what buyers will pay;
- The relationship to the condition of older units at resale; and
- How the retroactive change would be actually put into place if adopted.

Staff continues to recommend that an incentive mechanism, which would increase resale prices, for units which are in good condition at resale will be a more effective approach in addressing the City’s overall program objectives, but still provide benefits to long-term owners who have had the low appreciation. Staff has developed a proposed BMR Home Maintenance and Replacements Credit; this credit would provide additional funds to sellers based on how long their unit has been under the one-third of CPI formula and on the condition of the property at resale.

Staff proposed an incentive reward system based on the condition of BMR units at resale in the October 11 staff report to the PTC (see page 4). Since then, staff has explored this concept in more detail and tested it using different variables such as length of ownership, condition of unit at purchase and at sale, and has concluded that it is a viable concept which would benefit both sellers and the BMR program as a whole. This system would provide sellers with a financial benefit at resale based on each year of one-third CPI appreciation. If the unit is determined to be in good repair and condition, the seller will receive full credit. The amount of the credit will be reduced if the unit needs repair by the estimated cost of bringing the unit up to reasonable standards for resale.

Staff believes that the Home Maintenance & Replacements Credit is preferable to a blanket retroactive appreciation increase because it addresses the maintenance issues with the aging BMR housing stock while offering a financial incentive to owners to take good care of their units. The maximum amount of the credit is based on the length of time the unit was owned by the seller under the one-third of CPI formula, so long term owners would have a greater benefit similar to the concept of the retroactive CPI proposal. To be fair to an owner who purchased a unit that was already in deteriorated condition, the total estimated repair and renovation costs would be allocated only to the seller’s period of ownership. For those very low-income owners who have no financial capacity to repair or renovate their unit, staff proposed a limited renovation loan program (see page 7 of the P & S staff report).
Staff proposes an annual credit of $1,500 per each year of ownership as a workable amount. The longest a current unit has been under the one-third CPI is 24 years; this means the current maximum credit would be $36,000. While this would be less than the increase to a typical 24 year old unit with the retroactive CPI, it is still a significant sum of money given that the owner needs to only have performed the normal maintenance, repairs and replacements expected as part of home ownership.

Staff believes that adoption of a retroactive full CPI would have several problematic effects including:

- A fundamental policy, to serve homebuyers from a broad range of incomes from very low income to the upper moderate category, would be eroded. Presently, very low and low income homebuyers can achieve home ownership by purchasing the lower-priced resale BMR units. Incorporating some $40,000 to $50,000 into the resale price by giving the current owner more appreciation will price these units out of reach to a large segment of the buyers now on the waiting list since currently these potential buyers cannot afford the high prices of new BMR units.

- The additional resale proceeds will not be enough for owners to purchase market rate units in Palo Alto or in the Bay Area especially for the owners who are already living on limited retirement incomes.

- There is no benefit to the BMR program as a whole from the adoption of the retroactive appreciation.

- Retroactive appreciation not tied to the condition of the unit gives the same financial reward to the seller whose unit has been allowed to deteriorate as it does to those sellers who have invested in good upkeep and renovation.

- Projects where the BMR units have limited buyer appeal will become much more difficult to resell with the retroactive appreciation added into the resale price;

- Units must be resold in a timely manner under the current deed restrictions or else the City has to make the choice to take title itself or release the unit from the program;

- Projects with a history of large special assessments will have resale prices which will approach prices for brand new units and, if in poor physical condition, they will not sell at all.

There are eight developments with a total of 63 BMR units where the BMR units have deficiencies that reduce buyer appeal, including a past history of large special assessments, poor location, small square footage or rooms, unattractive layouts, and / or high original sales price. In some cases, all of these factors are present, and in others, only one or two apply. PAHC has found these units challenging to sell; most buyers on the waiting list would rather just wait for something better. If the physical condition of one of these units is also poor, then almost no one is willing to buy that unit. Factoring retroactive appreciation into the resale price will compound PAHC’s difficulty in finding buyers for this portion of the BMR housing stock. With lower resale prices in the past due to the one-third CPI formula, the City has been able to recoup its expenditures when forced to acquire units to prevent their loss from the program. With the addition of the retroactive appreciation, the City might have to use housing funds to write down the resale price to lower levels to resell certain units.
Attachment G describes the credit proposal in more detail and provides a few samples of calculations comparing additional BMR unit value derived under the staff recommended credit to the retroactive appreciation at full CPI.

**RESOURCE IMPACT**
There will be no impact to the General Fund with implementation of any of the potential BMR program changes; however, there could be a significant impact to the Housing Fund if the retroactive appreciation for existing BMR unit owners is approved. To avoid these potential costs, the City Attorney has advised staff that any retroactive appreciation program would need to be implemented at the time of sale of the residence. This would avoid revising deed restrictions since the legal costs of modifying the deed restrictions for individual properties would be extremely significant for the City.

**POLICY IMPLICATIONS**
The overall focus of the BMR Study was to identify policies and procedures which would make the BMR program a more effective and efficient tool to address Palo Alto’s affordable housing needs. Broad housing policies were examined as well as routine procedural matters in administration of BMR unit sales. Several of the new policies from the study are based on two common underlying principles:

1) New residential expansion and development should contribute at some level towards solutions to the City affordable housing problems; and

2) The BMR program should contribute more effectively to the creation and preservation of affordable rental housing to a much greater degree than in the past.

A rewrite of the BMR Program sections of the Housing Element would more clearly support these two guiding principles of the BMR Program.

**ENVIRONMENTAL REVIEW**
The BMR Study recommendations pertain to the administration of the BMR housing program which is categorically exempt under Section 15326 of the California Environmental Quality Act (CEQA).

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ATTACHMENTS
A. BMR Program Update: Summary List of Staff Recommended Actions for Council Approval
B. Inventory of BMR Units [Completed and Occupied Units and Pipeline]
C. City Manager’s Report dated September 11, 2007 to Policy and Services Committee
D. Minutes from P&S Committee meeting of September 11, 2007
E. Staff report to PTC dated October 10, 2007
F. Minutes from PTC meeting of October 10, 2007
G. Description of Home Maintenance and Replacements Credit
H. Below Market Rate Housing Program Economic/Policy Analysis and Recommendations
   Prepared by Keyser Marsten Associates, Inc. and Anderson & Associates (City Council Only)

COURTESY COPIES
Palo Alto Housing Corporation, Marlene Prendergast, Executive Director
Bonnie Packer, Palo Alto Housing Corporation Board of Directors
Lanie Wheeler, Palo Alto Housing Corporation Board of Directors
Silicon Valley Association of Realtors
Home Builders Association of Northern California, Southern Division