TO: HONORABLE CITY COUNCIL  
FROM: CITY MANAGER  
DEPARTMENT: PLANNING AND COMMUNITY ENVIRONMENT  
DATE: JULY 7, 2008  
CMR: 298:08  
SUBJECT: APPROVAL OF AN AREA MEDIAN INCOME-BASED RESALE PRICE FORMULA FOR THE BELOW MARKET RATE OWNERSHIP PROGRAM

RECOMMENDATION
Staff recommends that the City Council approve the resale price formula for appreciation of BMR ownership units based on 80 percent of the percentage change of the area median income as recommended by the BMR Study consultants (Attachment A) to be incorporated into revisions to the BMR Ordinance and/or rules and regulations.

BACKGROUND
At its meeting of March 24, 2008, Council voted (8-0 with Burt absent) to approve recommendations from the Policy and Services Committee, PTC and staff implementing policy changes to the BMR program as described in Attachment E. Council, however, voted to direct staff to return with a resale price formula based on the change in the Santa Clara County Area Median Income (AMI) for the full Consumer Price Index (CPI) resale price formula recommended by the PTC and staff. Council’s specific direction to staff on March 24th was:

“to change going forward to an Area Median Income (AMI) appreciation formula which will be brought back to Council by staff with an analysis and specific recommendations on consent agenda at a later date.”

Council members stated support for an AMI based formula because it would be more likely to provide greater appreciation for BMR owners and also result in resale prices which would maintain the BMR units within the moderate income affordability price range of 80 to 120 percent of AMI, based on the comparative history of the CPI and AMI indices over the last 30 years. A policy of maintaining the units over the long term within the moderate income price range was supported by Council as being more consistent with the original goals of the program than the one-third or the full CPI methods, which have resulted in the units becoming relatively more affordable over time.
DISCUSSION

A modified AMI based resale price formula was recommended by Keyser Marston Associates (KMA) in the BMR Study report (see Attachments A and B). Staff had asked KMA to develop a resale formula that would work well in varying economic cycles and would meet the following criteria, to the extent possible:

- Resale prices should not exceed prices for new BMR units;
- Keep resale prices sufficiently below market prices of similar units;
- Resales price will not be less than the seller’s original purchase price;
- Keep resale prices from dropping far below the moderate income level;
- Provide higher appreciation than the one-third CPI method;
- Encourage better maintenance and capital improvements; and
- Be easy to explain, calculate and administer.

Based on Council’s March 24th direction, staff is recommending that the KMA formula be approved rather than using an unmodified percentage change of the AMI. The KMA proposal is based on 80 percent (or four-fifths) of the percentage increase in the County AMI as published annually by State Housing and Community Development (State HCD). The KMA proposal caps and minimum pricing will help maintain resale prices generally within the moderate income range and provide some cushion for the addition of special assessments and capital improvements onto resale prices without pushing the prices higher than the moderate income level.

Staff believes that caps on BMR resale prices are especially important with an AMI based method given the past history of rapid AMI growth during local economic boom periods. Growth in the median County income does not necessarily equate to a similar growth rate in the household incomes of our waiting list families. Most households interested in Palo Alto BMR ownership, and now on the waiting list, work in occupations where income growth is modest – this is a key reason why they have given up on market rate ownership.

Attachment C illustrates how the AMI has fluctuated as much as ten percent from year to year compared to the lower volatility of the CPI. In the ten years from 1994 – 2003, the AMI increased by 68 percent, but in the last five years, due to changes in HUD’s methodology followed by declining economic factors, the AMI has not increased at all but remained at $105,500. Attachment D provides a detailed retroactive 20-year comparison of the full CPI, the full AMI and the 80 percent of AMI with an example of these formulas applied to a typical three bedroom BMR unit first sold in 1987 and then resold in 2007.

The data from Attachment D is used in the table below to compare resale prices produced by each formula for a sample 20-year old BMR unit being sold in 2008 together with the current pricing for a three bedroom newly constructed BMR unit and the range of affordable prices at today’s interest rates for the typical family sizes that would purchase a three-bedroom BMR unit.
<table>
<thead>
<tr>
<th>Three Bedroom Townhouse BMR</th>
<th>1987</th>
<th>(Based on 1987 – 2008 CPI &amp; AMI History)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Full CPI</td>
<td>KMA: 80% of AMI</td>
</tr>
<tr>
<td></td>
<td>$115,000</td>
<td>$215,300</td>
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</tbody>
</table>

2008 - Affordable Price Guidelines for Lower Moderate Households (80 to 100% of AMI) with Five Percent Down Payment & Current Interest Rates for a 3-Bedroom BMR

<table>
<thead>
<tr>
<th>Person Households:</th>
<th>$206,000 to $273,000</th>
<th>$236,000 to $310,000</th>
<th>$259,000 to $339,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 Person Households:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Person Households:</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>5 Person Households:</td>
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The three formulas produce resale prices that generally fall within the affordability range of 80 to 100 percent of AMI. With the full AMI formula, however, the resale price exceeds the current price for a comparable newly built BMR unit. Most BMR buyers can only manage a five to ten percent downpayment, although there are a few buyers able to make twenty percent or more. The full AMI resale prices would be harder for households at the lower end of the moderate income spectrum to afford without a substantial downpayment. Attachment B illustrates the recommended 80 percent of AMI formula resale price calculation using this same sample unit with the addition of fairly typical adjustments for capital improvements, an assessment and a deduction for some deferred maintenance.

**Full CPI Formula Comparison:** Based on past history, compared to the two AMI-based formulas, the full CPI formula is likely to result in units becoming more affordable than newly built units over the long term. Lower resale prices provide more cushion to help absorb the addition of special assessments, renovation costs and legal costs to preserve units faced with foreclosure and still result in a final resale price that’s within the lower end of the moderate income affordability level. The addition of large special assessments (such as those that occurred at the Redwoods and Abitare) and credits for capital improvements to higher AMI based resale prices may result in resale prices that exceed what buyers on the waiting list are willing, or able, to pay, especially as resale units age. The combination of this concern, together with the AMI’s unpredictability and Palo Alto Housing Corporation’s concerns about the complexity of the formula and higher resale prices was what led staff to recommend to Council that the resale formula simply be increased to the full CPI. In addition, at the present time, the full CPI provides current owners under the one-third CPI a financial reward for signing the new, improved deed restrictions, while few owners may want to switch to an AMI formula until regular annual increases in the AMI resume.

**Transition from Current One-Third CPI Formula:** After approval by Council, proposed changes will be incorporated into the ordinance adopting the recommended BMR program changes. As detailed in previous staff reports, these changes will require an overhaul of the City’s deed restrictions, together with the addition of supporting legal documents to assist in both enforcement and clear disclosure of the program’s rules to prospective buyers and owners.

**RESOURCE IMPACT**
Funds are budgeted in the recently adopted FY 2008-09 budget in the Residential Housing Fund for the cost of contract legal services to prepare new BMR ownership deed restrictions and related enforcement and disclosure documents and to conduct the in-lieu fee study.

POLICY IMPLICATIONS
Council approval of an AMI based resale price formula establishes the policy that the resale pricing method should maintain resale units within the moderate income affordability level over the long term. This policy action, in combination with the approval of the $2,000 annual Maintenance and Replacements Credit for existing BMR units under the one-third of CPI formula on March 24th, clarifies that the City’s goal is that the BMR ownership program is intended to primarily serve moderate income households.

ENVIRONMENTAL REVIEW
The administration of the BMR housing program is categorically exempt under Section 15326 of the California Environmental Quality Act (CEQA).

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CITY MANAGER APPROVAL: ________________________________
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ATTACHMENTS
A. Resale Price Formula for BMR Unit Based Upon 80 Percent of the Change in the Area Median Income (AMI)
B. BMR Resale Price Calculation With 80% of AMI Formula (Sample Calculation)
C. BMR Study: Comparison of CPI & AMI Chart
D. BMR Study: Appreciation Indexes: 20 year Comparison of Full CPI, Full AMI & 80 % of AMI
E. BMR Program Update: Policy Changes Approved by the City Council on March 24, 2008
F. City Council Special Meeting of March 24, 2008: Excerpt from approved minutes for Item #6 Policy and Services Committee recommendations for approval of updated Below Market Rate (BMR) Program (continued from March 17, 2008)
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