

TO: HONORABLE CITY COUNCIL

ATTN: POLICY AND SERVICES COMMITTEE

FROM: CITY MANAGER **DEPARTMENT: PLANNING AND
COMMUNITY ENVIRONMENT**

DATE: SEPTEMBER 11, 2007 **CMR: 350:07**

**SUBJECT: RECOMMEND APPROVAL OF BELOW MARKET RATE (BMR)
OWNERSHIP PROGRAM UPDATE RECOMMENDATIONS**

RECOMMENDATION

Staff recommends that the Policy and Services Committee review the consultants' report (Attachment A) and staff recommendations for policy changes to the Below Market Rate (BMR) Homeownership Program, H-36 of the Housing Element of the Comprehensive Plan, and direct staff to incorporate the staff's recommended changes (under Goal #1 of Attachment B), together with existing policy, into a new BMR ordinance and to make related changes to Program H-36 for review and adoption by the City Council. Staff also recommends that a package of implementing legal documents, including revised deed restrictions and other enforcement and disclosure documents be prepared and put into use concurrently with the effective date of the ordinance. Attachment B has a complete list of the policy changes discussed in this report. Additionally, staff is asking for Council direction to further analyze the program elements identified under Goal #2 of Attachment B as part of the next Housing Element revision.

BACKGROUND

Council first adopted BMR requirements on housing developments in 1974 as a policy in the Housing Element. Palo Alto's program has been a success with 179 owner units and 155 rental units in the inventory, together with another 145 new owner and rental units under construction or with approvals. While the BMR program is still operating effectively, enforcement issues have become more prevalent in recent years and problems linked to the program's age have become apparent. Staff and Palo Alto Housing Corporation (PAHC), the program administrator under contract to the City, have been implementing minor changes in rules and procedures in the BMR sales process to address specific issues over the last ten years. However, staff recognized that there was a need for an economic and policy analysis to maximize the effectiveness of the BMR program in meeting the City's affordable housing needs. This analysis would provide expert advice about improvements in legal documents, enforcement and methods of increasing the efficiency of routine administrative procedures.

For the last 30 years, the BMR program has been governed by a short, two-page description in the Housing Element of the Comprehensive Plan. It has become increasingly the norm for communities to adopt an ordinance to govern their inclusionary housing program. In 2003, Planning and legal

staff worked on the preparation of a BMR ordinance intended to codify the current policies in the Housing Element program. Several drafts of an ordinance were completed and that process helped delineate issues that needed resolution. The rigorous process of trying to codify the current Housing Element program made it clear that a number of policy decisions needed to be made before the ordinance could be finalized. Once Council provides policy direction to staff, new and existing policy can be incorporated into an ordinance and the BMR program text in the Housing Element revised to describe the broad policy parameters of the BMR program.

PAHC staff has been closely involved in the BMR Update since its inception. PAHC staff assisted Planning staff in developing the scope of services for the KMA/AA contract, met with the consultants, provided data, and reviewed and commented on drafts throughout the study. On June 26, 2007, the BMR Committee of PAHC's Board of Directors met with City staff to discuss the final consultant report. The BMR Committee focused its discussions on the question of changing the appreciation formula and the overall policy objectives of the program. The BMR Committee supports the proposal by City staff to change from the current one-third CPI to full CPI. The Committee also supports using a methodology that: 1) prevents BMR owners from having to sell at a loss, 2) is easy to administer and explain, and 3) provides greater appreciation than the current formula. PAHC's full Board of Directors reviewed the recommendations from the study at their meeting of July 11th and advised staff that the first priority for the City should be making improvements to the existing program. PAHC strongly supports the consultants' recommendations for the creation of new legal documents to improve enforcement and protect the BMR housing stock.

Funds for consultant and contract staff assistance were approved by Council in the FY 2003-04 budget. In August 2004, after a competitive bidding process, Council approved a \$137,085 contract with the consultant team of Keyser Marston Associates (KMA) and Anderson & Associates (AA). In addition, Planning hired a contract planner and an intern to conduct basic research on the BMR housing stock, to restructure and expand the program inventory and database, and to conduct a survey of current BMR owners. Council was briefed on the objectives and the work products of the BMR Update by the consultant team and staff at a study session held on September 27, 2004.

Consultant Work Program: KMA was asked to make recommendations on how the BMR requirement could be used in more creative and effective ways to help achieve the City's broader affordable housing objectives and to increase the production of affordable owner and rental units. KMA also did an analysis of the adequacy of the BMR in-lieu fee methodology and a comparison with alternative methods. KMA was asked to recommend policies and fee methods that would increase revenues for the Residential Fund. Another key task for KMA was to evaluate the adequacy of the current BMR deed restrictions and to outline the components and content of a best practices set of legal documents as used by other cities. Finally, KMA reviewed alternatives to strict inclusionary BMR requirements with the goal of finding ways to increase affordable rental housing production and support the efforts of non-profit housing developers. Anderson Associates was a subcontractor to KMA and provided review and advice on administrative procedures for handling the waiting list, sales and eligibility rules and methods of handling maintenance standards and capital repairs. AA also evaluated the City's special assessment loan program, which was approved by Council in 2002.

Owner Survey: To obtain an objective and statistically reliable picture of the program from the perspective of the owners, a comprehensive survey questionnaire was developed. The questionnaire was sent to all BMR owners in late 2004. The response rate was excellent with 73 percent of all 169 owners completing surveys. [See Sec. 2.3 and Appendix C of the KMA / AA report for a summary and full analysis of the BMR Homeowner Survey]

Overall, a large majority of the owners are satisfied or very satisfied with their unit, their complex and the BMR program, with many owners extremely grateful for being able to participate in the program. These satisfied owners stated that without the program they would have remained a renter or would have had to leave the Bay Area to buy a home. They place a very high value on living in Palo Alto to be near their work, family or for their children to attend local schools; and on the financial stability gained from owning rather than renting. Many of the highly satisfied owners are involved in local volunteer groups, or work for the city, at Stanford, the medical clinic, in the schools or for local non-profits.

Ten to fifteen percent of all owners described themselves in the survey as “very dissatisfied” or “dissatisfied” with their unit, the complex, the neighborhood or with program rules and procedures. While almost every buyer was very pleased with the original purchase price, about one quarter of the survey respondents were dissatisfied with their projected resale price. Some owners expressed anger about being “trapped” in their unit because they cannot sell it at market rates. For various reasons, they complain that the BMR unit no longer meets their needs, but they cannot afford any other kind of ownership housing in the Bay Area. These owners often have limited options due to current income levels.

Even owners who expressed a high level of overall satisfaction with the program had concerns and suggestions for improvements. The most common concerns of BMR owners are:

- Limited appreciation under the current formula
- Rapid escalation of monthly homeowners association dues
- Fear of major special condominium assessments
- Poor condition of their unit and its appliances, especially at the time of purchase
- Issues related to owners aging in place such as reduced income due to retirement and/or the onset of a disability, or lack of handicapped accessibility
- Lack of understanding of program rules governing refinancing, calculation of the resale price, owner’s maintenance requirements, treatment of capital improvements, guidelines on rental and refinancing.
- Need or desire for a different type of home or location (need for more bedrooms, complaints about the neighborhood or the project, need for accessibility, desire for a private garden or yard or places for children to play)

Monthly HOA Dues and Special Assessments: The City does not have control over the rules or the budgets of the HOAs in which BMR units are located. Condominium associations are regulated by State laws and by project-specific recorded conditions, covenants and restrictions. Each association is governed by its own board of directors elected by the owners. Monthly HOA dues have been increasing significantly each year due mainly to higher insurance costs, more stringent requirements

for capital reserves and higher maintenance costs of older complexes. Problems occur because BMR owners are more sensitive to these costs than most market rate owners. There is a bill being considered in the legislature (AB 952) that would limit the size of certain dues increases and special assessments in projects with BMR units without approval of 50 percent of the BMR owners. Staff has not analyzed this bill and does not have a position on its provisions.

BMR Property Research & Enforcement: A product of the BMR Update is an improved database and better information about the BMR housing stock, such as its physical condition, the extent to which older units need repairs, the frequency of refinancing and the level and type of debt secured by the units. The program database, which contains statistics regarding each unit and all owners, current and past, was expanded and transferred into a different software program that can generate reports more easily.

Problems with Financing, Excess Debt, Title and Occupancy: The property research revealed that there were over 20 different versions of the deed restrictions used over the history of the program. Lack of uniform legal documents is an issue because it complicates enforcement efforts and creates confusion among owners as to which rules apply. For example, deed restrictions in effect prior to August 1993 permitted owners to refinance or encumber their units with additional debt without any notice to, or permission from, the City. Technically, owners that refinanced or took out equity lines of credit secured by their unit with these older restrictions did not violate the rules, even if the new loans far exceeded the unit's limited BMR value. Fifty percent of owners responding to the survey stated they had refinanced at least once and 14 percent reported taking out an equity credit line. Deed restrictions in use since 1993 include a clause requiring City consent to any new financing, yet lenders continue to make loans on these units without requesting the City's consent. As long as owners keep up their loan payments no harm is done, but when owners owe far more than the BMR resale value, there is a much greater likelihood of default and eventual foreclosure. There is a greater risk in these situations that a foreclosure sale could take place without the City's knowledge resulting in the loss of the unit from the program. To date, the five BMR units that went into foreclosure were financed well in excess of their BMR value.

Research of recorded property information revealed over-financing, title transfers, or occupancy problems affecting almost 30 percent of BMR units (50 units). These problems underscore the priority of putting in place improved recorded legal documents. The use of a performance deed of trust, often used with a promissory note, to secure and enforce the provisions of the deed restrictions is becoming a more common tool to ensure that lenders, title companies and potential purchasers are fully aware of and respect a locality's controls over these units. [Sections 4.1 – 4.3 of the consultants' report outlines in detail the content of effective deed restrictions and related enforcement documents.]

DISCUSSION

The first issue area for Council review and action involves matters which affect the existing program and current BMR owners. These include recommendations on: the proposed change in the appreciation rate; establishing a loan program to renovate older units; confirmation of established practices and clarifications of language currently in Program H-36, together with staff's proposal to lower the threshold for the BMR requirement to three units ; and direction to staff for the completion

of the ordinance and new deed restrictions and other legal documents. Secondly, Council is requested to consider proposals that will strengthen the affordable housing requirements that apply to developers, including giving direction as to which proposals should be incorporated into the new ordinance for adoption at this time, which should be studied further as part of the next Housing Element revision and which do not merit further consideration.

Goal #1: Improve Existing BMR Ownership Program

Staff recommends immediate incorporation of the following eleven policies (1A – 1K) into the new BMR ordinance.

Policy #1A: Adopt the Full CPI Appreciation Rate with a Cap on Maximum Resale Value; Continue to Emphasize the Goal of Permanent Affordability of BMR Units

Adopt Full CPI Appreciation Rate: Staff recommends that Council adopt the full percentage change in the CPI as the appreciation formula to calculate the resale price to replace the current one-third of the CPI formula. PAHC concurs with this recommendation. The full CPI fits well with the goal of the BMR program for permanent affordability, while still providing a reasonable financial return for owners on their downpayment. Criteria set by staff for selection of an appreciation formula were:

- Preserve long-term affordability of the BMR units for future buyers
- Increase appreciation for owners over the current one-third CPI formula
- Appreciation should be steady and fairly predictable
- Formula should be easy to explain, calculate and administer
- Avoid methods that could result in owners to selling at a loss
- Keep prices for resale BMR units sufficiently below market prices and lower than prices for new BMR units

The full CPI was used in the early years of the BMR program, but extremely high inflation and interest rates during those years forced Council to act in 1983 to limit appreciation to one-third of the CPI. KMA/AA recommended that appreciation be based on the percentage change in the Area Median Income (AMI), but with floors and caps (described in Section 3.2 of the KMA / AA report and Attachment D to this staff report). Staff does not support the consultants' proposal because it is vulnerable to the vagaries of HUD policy, which can produce extreme fluctuations, both up and down, in the AMI or lack of change at all (as occurred recently for four years in a row). Furthermore, it would be far too complicated to explain to owners and lenders and too difficult to administer. Cities that use AMI-based formulas have had many problems in recent years with owners being forced to sell at a loss due to a drop in the AMI together with an increase in interest rates.

The other commonly used system for pricing resale units is to set their prices the same way newly built units are set, using a "mortgage-based" system. This system backs into a price derived from what a hypothetical household at the program's target income level can afford to pay given a mortgage with then-current interest rates, typical downpayment, property taxes, etc. This method is required where the housing is created under a redevelopment program and it is also how Palo Alto has always set prices for newly constructed BMR units. The drawback when it is used to set resale prices is that it can result in a loss to the selling owner if there is a level or declining AMI, or higher

interest rates or HOA dues, since the calculated resale price would then be lower than the purchase price. An underlying assumption of this system is that older resale units should resell to the same general target income level as the new units. In other words, if a new unit was originally priced to be affordable to households in the 100% to 120% of AMI level, then it should remain priced at that level forever.

Palo Alto's program, using the CPI applied to the original purchase, has resulted in BMR units becoming more affordable over the years. This has been especially true with the units under the one-third of CPI formula. This means that very low and low income households in the 40 to 80 percent of AMI range are able to afford BMR ownership of an older unit. For a four person family, these are incomes from about \$42,000 to \$85,000, well below Santa Clara County's exceedingly high median income of \$105,500. This result is positive in that it has broadened the types of households able to benefit from the program. The lower prices of resale units also gives the City the flexibility to absorb special assessments or other costs to preserve units faced with foreclosure in the resale prices and yet still keep the units affordable. However, to continue this trend indefinitely would eventually bring the pricing down to income levels where most households do not have sufficient financial capacity to handle the long-term demands of ownership at any cost. Returning to the full CPI index will moderate this trend.

Cap on Resale Prices: From 1986 through 2006, the annual increase of the CPI index averaged 3.3 percent and a return to the double-digit inflation and interest rates of the late 1970s and early 1980s does not seem likely in the foreseeable future. However, some kind of cap on the total rate of appreciation or on the overall maximum resale price is recommended by staff for assurance that BMR units will remain affordable. Therefore, staff recommends capping the maximum resale price for each unit type at a price that would be affordable for buyers with a 20 percent downpayment at the top (120 percent of AMI) of the moderate income bracket.

Conversion from Current Formula: If the new appreciation formula is approved by Council, it will be included in the new legal BMR documents to be prepared by the City Attorney. These documents will be put into use with new unit sales and resales of existing units as soon as the documents are ready, which should be when the ordinance is effective. Staff recommends that existing BMR owners be offered the opportunity to benefit from the new appreciation rate going forward, provided that the owners consent to the recording of the new BMR legal documents against their unit. Staff does not recommend applying the new formula retroactively because it would be unfair to those owners who sold before the change became effective.

Policy #1B: Require Essentially Permanent Affordability by Increasing the Term of the BMR Deed Restrictions and the Term of Rental BMR Regulatory Agreements from 59 Years to 89 Years

Since Palo Alto's BMR program inception, a 59-year affordability term has been required for owner units. The 59-year term is not mentioned in Program H-36 of the Housing Element, but it was approved for rental BMR units by Council in 1985 when the BMR program was first applied to rental projects. For owner units, the City's practice is to place another 59-year term on a unit when a new buyer takes title, thus essentially achieving permanent affordability in most situations. In contrast, some communities use 20 or 30 year affordability terms, or even no time restrictions at all,

and then lose substantial numbers of their affordable units. Because BMR homeowners have certain transfer rights without City approval, such as to a new spouse, a longer affordability term would provide greater assurance that these units will remain permanently in the City's affordable housing stock.

While this matter was not studied by the consultants, staff found that it is becoming more common in other localities to set extended or even "permanent" affordability terms. Staff recommends that the affordability term be increased to 89 years for both owner and rental BMR units with the proposed BMR ordinance stating that the City's objective for the 89-year term is to achieve the longest possible length of affordability for both ownership and rental BMR housing.

Policy #1C: Improve the Condition of the Existing, Older BMR Housing Stock with the Provision of Limited City Financial Assistance to Very Low Income BMR Owners of Such Units
[See Section 3.3 of KMA /AA report]

Add a New Housing Element Policy: Staff recommends including in the next Housing Element revision a policy recognizing the need for rehabilitation of the older BMR ownership stock, together with a program for City financial assistance to very low income owners. With this policy and program in place, the City will be better qualified to apply for outside grant programs, should such funding become available.

Continue Pilot Program to Fund Deferred Maintenance and Replacements at Resale on an Interim Basis: Staff recommends standardizing the current pilot program of funding deferred maintenance and replacements installed by the buyer with funds from an increase in the resale price and to continue to utilize this interim strategy until new rules on maintenance, repairs and capital improvements are in place.

Create a Renovation Loan Program for Very Low Income BMR Owners: Low interest, deferred payment loans would be offered to interested owners for repairs, accessibility features, improvements and upgrades to older BMR units (defined as units 20 or more years old). The unit's value would be increased by the amount of the loan and as an incentive to participate in the program; any capital improvements made with the loan funds would not be depreciated. The loans would be repaid at the time of resale. While information from the BMR owner survey and inspections of older units when they come up for resale indicates a real need for this type of assistance, this new program would represent a significant additional work load. Staff would not proceed with this program until after work on the BMR ordinance, legal documents and revisions to the Policy and Procedures Manual was concluded. Staff requests Council direction on whether this program is supported in concept and should be developed further.

Funding for Loans: Staff recommends funding these loans, and the administrative cost of carrying out the loan program, from BMR in-lieu fees deposited to the Residential Housing Fund, which is a non-General Fund source. CDBG funds could also be considered as a funding source for some of these loans. A higher level of BMR in-lieu fee revenues is expected if Council adopts the staff recommendation to lower the threshold of the BMR requirement to three units and if the in-lieu fee calculation formula is updated to ensure that the fees are equivalent to the cost of the provision of

actual units.

Revise Rules Regarding Maintenance, Repair and Improvement Credits and Approval Process: Currently, the deed restrictions contain extremely detailed rules and procedures on maintenance, repair standards and procedures for the verification and depreciation of capital improvements. Staff has found the existing rules ineffective and the procedures time consuming. These rules have served as a disincentive for repairs and improvements and have contributed to the gradual decline in the physical condition of units as they age. The proposed change to the full CPI formula will increase the rate that owners build equity, which will help owners access financing for repairs and improvements. Staff proposes that the deed restrictions contain only general language regarding maintenance, repairs and improvements with more specific details to be contained in the Program policy and procedures manual.

Require Inspections and Warranty Plans: Staff recommends mandating professional home inspections (to be paid for by the seller) and home warranty plans (to be paid for by the buyer) at resale. Currently, virtually no buyers choose to pay for a professional home inspection. Buyers sometimes mistakenly assume that the review of maintenance, minor repair needs and credits for capital improvements conducted by the City's Real Property staff is equivalent to a professional inspection. Professional inspections will encourage sellers to address repair issues in advance of putting their unit up for resale, provide better protection for buyers and protect the City from claims and liability. Home warranty plans will help prevent buyers from having to pay for major replacements or repairs in the first year of ownership. Staff would include these requirements in the new deed restrictions or in sales procedures in the Program manual.

Maintain Existing Special Assessment Loan Program: The Special Assessment Loan Program was authorized by Council in September 2002 in response to major assessments at the Redwoods and Abitare. It provides deferred payment loans at three percent simple interest to owners who have no other way to pay for a major special assessment of \$10,000 or more. To date, only three loans have been made under the program. The eligibility criteria for these loans were written to implement Council direction that assistance be offered on the basis of the owner's financial need. The consultants recommended that the City relax the program's requirements so more owners would be able to qualify for loans. However, staff does not recommend any changes to this program, but staff does concur with the consultants that a review of the eligibility criteria and some modifications to simplify the rules should be done in the event of another major assessment.

[See Section 3.4 of KMA / AA report]

Policy #1D: Increase Efficiency of Program Administration, Clarify Rules & Improve Owner Understanding

[See Section 5 of the KMA / AA report]

Revise Resale Process to Expand Buyers' Financing Options: As the inventory of BMR units expands, it is important to broaden the pool of lenders willing to finance these units. Buyers would benefit from the advantageous loan programs available from CalHFA, and more lenders would participate if the City's legal documents met Fannie Mae guidelines. These entities are now willing to accept extended affordability terms, but units still must be resold promptly. One concept is to

establish a “Notice of Contemplated Sale” process so the time needed for review of a unit’s condition and capital improvements credits does not impact the resale time deadlines in the deed restrictions. Reselling or transferring a BMR unit would become a two-step process with the inspections completed, maintenance and improvements evaluated, title issues resolved and the sales price determined during the first step – after a Notice of Contemplated Sale. Then the selling owner would give the City the official Notice of Intent to Sell that starts the 90 day time period in which the buyer is identified, finds financing and closes escrow on the sale. The new Deed Restrictions will need to describe the revised resale process.

Continue Local Preferences and Waiting List: Since inception, a first preference for households that live or work in the city limits of Palo Alto has been used for the program. Almost all ownership units are sold to a buyer that meets this criteria. To apply to purchase a BMR unit, one must first be on the waiting list maintained by PAHC and, to stay on the list, one must reapply annually. Presently, there are over 500 households on the waiting list; usually units sell to someone within the first 200 names on the list. Staff and PAHC concur that the long-standing waiting list process with a first preference for households who live or work in the city limits of Palo Alto is a fair and appropriate system for identifying potential buyers and no changes are proposed to this policy. Revisions to the Policy and Procedures Manual will be made to more clearly describe waiting list policies.

Improve Disclosure and Continue Education: The City’s consultants strongly recommended that buyers be required to sign a “plain language” disclosure document explaining the BMR deed restrictions and procedures prior to purchase. Typically, the legal counsel that prepares the deed restrictions would work with staff to prepare the disclosure. The City proposes to continue funding PAHC to conduct regular educational workshops and newsletters for the waiting list and BMR owners. Once improvements are made to the program, updated informational handouts and workshops will be needed to inform owners. Staff will work with PAHC to develop these materials.

Authority for Policy and Procedures Manual: Staff recommends that the Council delegate (through a provision in the proposed BMR ordinance) to the Director of Planning and Community Environment (Director) the authority to establish, follow and revise as needed a set of standard, written policies and procedures for program administration, which shall be contained in the revised and updated Policy and Procedures Manual. The current manual will be expanded to cover both aspects of the program administered by City staff, such as negotiations with developers; and aspects of the program managed under the contract with PAHC, such as the waiting list, the sales of new and existing units, standards for approval of transfers of title, refinancing, temporary rental and similar matters.

Policy #1E: Eliminate the “Cost-Based” Pricing Exception Clause for New BMR Units in Program H-36; Continue to Base Newly Built BMR Prices Only on the Mortgage-Based Affordability Formula

Program H-36 states that: *“In all cases, the sales prices should be sufficient to cover the estimated costs to the developer of constructing the BMR unit, including financing, but excluding land, marketing, off-site improvements, and profit.”* The consultants advised that they were unaware of

any other cities that permitted developers to sell BMR units at anything other than prices based on affordable housing costs for the target income level. In practice, it has been rare for developers to request this provision and, due to the exclusion of land and some other costs, in those few cases where the calculations have been made, the sales prices have been about the same or lower than the prices from the affordable housing cost formula. The existing clause in Program H-36 regarding adjustments, appeals and waivers, which will also be included in the proposed BMR ordinance, provides sufficient relief for unusual situations where the application of the BMR requirement would result in severe hardship to a developer. [See Section 3.1.2 and Appendix D of KMA / AA report]

Policy #1F: Require a Customized Analysis of the BMR Obligation for Unusual Housing Product Types or Unique Proposals

Staff does not have sufficient expertise to evaluate the many unique ways developers propose to meet the BMR requirement, for example when rental BMR units are offered for an ownership project. In addition, special expertise is needed to apply the program to special housing product types such as senior assisted living or congregate care projects. With the wide gamut of housing products subject to the BMR program and the broad range of solutions proposed by developers (smaller units, land dedication, off-site units, rental instead of for-sale, in-lieu fees, etc.), many complexities are presented that were not envisioned when the program was only being applied to modest stacked condominium projects. Similar to requiring a developer to prepare a customized traffic study, City policy should require that the developer pay for an independent analysis to evaluate the developer's proposals and help staff and Council determine an acceptable BMR contribution in these situations. This policy was first used on a trial basis with the Bridge / BUILD project when staff had the developer prepare an analysis by an independent real estate economist to determine the number of very low income rental units needed in the Bridge project to satisfy the BMR requirement for the BUILD townhomes. Staff recommends that this policy be incorporated into the proposed BMR ordinance. [See Section 6.5.1 and Appendix E of the KMA/AA report]

Policy # 1G: Clarify the City's Priorities for Satisfaction by Developers of the BMR Requirement

The existing text of Program H-36 lacks clarity about the priority for the alternatives that may be used to satisfy the BMR requirement. Based on past practice, Council should confirm that the City's priorities for compliance with the BMR requirement are listed in order below, with combinations of the alternatives also permitted at the discretion of the Council:

- 1) Provide new affordable housing BMR units distributed throughout the development comparable in size, type and amenities to the market rate units;
- 2) Dedicate buildable land suitable for affordable housing construction;
- 3) Provide new affordable housing units, on-site or off-site, that are not comparable to the market rate units, but are equivalent in value to the provision of strictly comparable new BMR units;
- 4) Provide substantially rehabilitated existing affordable housing units, which are equivalent in value to the provision of strictly comparable new BMR units;
- 5) Payment of a one-time, in-lieu fee for ownership projects; for rental housing developments either a one-time fee or an annual in-lieu fee may be accepted.

Program H-36 states that in-lieu fee payments are to be allowed by the City when no other

alternative is feasible, which is consistent with the priorities listed above. However, staff recommends that the ordinance should be drafted to allow the Director to propose to Council the payment, or partial payment, of in-lieu fees in limited instances where there is a specific use for the fees which will substantially increase the production of affordable housing.

Policy #1H: Lower the Threshold for the BMR Requirement from Five Units to Three Units or Residential Parcels

Staff recommends that the BMR ordinance establish the threshold of three or more units or parcels for the BMR requirement, which was in effect prior to 2002. While thresholds of three, five or ten units are common, many cities now apply inclusionary housing requirements to projects as small as two units and even to individual single family homes. The consultants recommended broadening the application of the BMR program by lowering, or eliminating entirely, the current threshold of five or more units. However, staff does not recommend collecting BMR in-lieu fees on single homes or on 2-unit projects. Staff instead recommends returning to the three or more unit threshold that was in place from 1990 to 2002. The responsibility and cost of addressing the City's affordable housing problems will then be spread more equitably among more land owners, developers and users of the City's limited supply of residential land. [See Section 6.6.4 of the KMA / AA report]

Small Rental and Mixed Use Projects: One original purpose of raising the threshold from three to five units was to encourage small rental and mixed use projects, however in some cases the housing units produced have been very large, over 3,000 square foot condos. Rather than keeping the current five unit threshold, Staff recommends that the BMR requirement for rental housing and mixed use projects with up to six units (six units is just below the level of seven units where, with the basic 15 percent BMR requirement, one BMR unit is needed) could be waived, provided that the units are rentals and their size is within certain modest standards which would be set in the BMR ordinance.

Difference between Threshold for Lots and Units: With the 2002 Housing Element, the threshold in Program H-36 for lots was left at three and for units it was increased to five. This change has resulted in confusion. The present system also motivates developers to split projects into separate applications to minimize the BMR obligation. Staff also recommends that language be included in the proposed BMR ordinance to base the threshold and BMR requirement percentage on the original size of a site at the time development is initiated, so that the BMR requirement for a large site is not reduced merely by dividing the site into smaller parcels for development by different entities in cases when the entitlements are being reviewed and processed concurrently.

Policy # 1I: Conduct Further Technical Study the BMR In-lieu Fee Formula

In-lieu fees are most often used by the City for developments of single family detached and luxury housing. Fees are also accepted for fractional units and for small projects that do not owe a full BMR unit. The current fee rate is simply one-half of the BMR percentage requirement times the sales or appraised value of the market rate units. The consultant advised staff that our present BMR in-lieu fee methodology results in fees that are considerably lower in cost to the developer than the delivery of BMR units, when applied to projects with higher sales values and to luxury housing. KMA evaluated the accuracy of this formula compared to the financial benefit to the developer of

not having to provide BMR units for various types and prices of housing, and compared the City's system to other common methods used by other localities. Additional analysis could enable the City to collect higher fees and generate more revenue for developing affordable housing. Staff recommends that additional consultant analysis be done to exam the fee methodology and alternatives to ensure that it is fully justifiable and equitable. However, to avoid delay in adoption of the BMR ordinance the current in-lieu fee methodology should be incorporated into the ordinance at this time. [See Section 6.2 and 6.46 of the KMA /AA report]

Policy # 1J: Miscellaneous Changes in Program H-36 Provisions for Incorporation into BMR Ordinance

In-Lieu Fees for Fractional Units: In-lieu fees are currently permitted for very small projects that owe less than one full BMR unit and for fractional units owed for projects of less than 30 units unless the developer agrees to an adjustment in the type or size of the BMR units to cover the fractional unit. Staff recommends that the BMR ordinance clarify that for large projects, a fractional unit of less than 0.5 shall be covered by adjusting the type or size of the BMR units to eliminate the need to pay in-lieu fees.

Subdivisions and Parcel Maps of Three or More Lots Intended for Construction of Single Family Homes: Program H-36 currently states that the BMR requirement for single family land divisions must be met with the dedication of buildable parcels to the City or the construction of BMR units within the subdivision, unless this is infeasible. Also, while past practice has been to require in-lieu BMR fees on the future homes built on these lots, Program H-36 does not clearly state this is a requirement. Due to the extremely high values of single family lots and new, detached homes, requiring BMR in-lieu fees is the most practical alternative for meeting the BMR obligation in most situations. Staff recommends that the BMR ordinance should state that the preferred alternative for single family homes and land subdivisions is the payment of in-lieu fees. The in-lieu fees would be based on the appraised value of the lots as ready to build, fully improved lots and on the value of the future homes, to be paid when the homes are constructed and sold.

Open Space (OS) District Projects: Staff recommends that the ordinance clarify that affordable housing construction is not considered feasible in the OS district and thus the payment of in-lieu fees will be required in all cases for projects located with the OS zoning district, including land subdivisions subject to the BMR requirement.

Policy # 1K: BMR Rental Program: Establish More Specific Standards for Affordable Rents and Occupancy in the Proposed BMR Ordinance but Authorize the Director to Determine Initial BMR Rents Annually

Affordability Standards for BMR Rentals: The consultants' recommendations focused entirely on the BMR home ownership program. However, the proposed BMR ordinance will also need to set overall policy for the BMR rental program. The current text of Program H-36 is not specific about the affordability of BMR rental units. Due to the volatile nature of the rental market, more flexibility is needed for the Director to set initial affordability levels for BMR rents. The ordinance should implement current staff procedures which require all initial BMR rents to be at least 25

percent below market rents for comparable units and locations and that 20 to 30 percent of total BMR rental units in a project be at the very low income affordability level.

Goal #2: Policy Changes to Strengthen the BMR Requirement to Increase Overall Affordable Housing Production

Staff recommends that Council direct staff to continue to analyze the following policies (2A – 2C) and return to Council with recommendations or additional policies to either incorporate later into the proposed BMR ordinance or into the next Housing Element revision.

Policy # 2A: Allow Substitution of Smaller Units Only If More BMR Units Are Provided by the Developer; Otherwise BMR Units Must Meet City Comparability Standards

Since the program's inception, there has been a policy that BMR units should be comparable to the market rate units, but that policy has not been consistently enforced. Written standards for both owner and rental BMR units were put in place about ten years ago by staff and since then, they have been more consistently applied. As a result, BMR units in projects presently in the pipeline are provided in proportion and comparability in type, size, number of bedrooms and location to the market rate units. The consultants' report includes a set of formulae to calculate equivalence between different unit types of for-sale housing. If a developer proposes an alternative for consideration, then a customized analysis should be required of the developer to determine that at least an equivalent BMR contribution is obtained by the City. At times, there may be good reasons for a larger variety of units for the BMR market than are produced by developers in their projects. Staff recommends that a policy be developed allowing the substitution of different unit types and sizes for the BMR units, provided adjustments are made in the number of BMR units provided, with the standards for the equivalence included in the Policies and Procedures Manual.

[See Section 6.3 of the KMA / AA report]

Policy #2B: Require Land Dedication as the Default Option on Larger Sites of Three or More Acres

The purpose of this policy is for the City to obtain land to then provide to non-profit housing developers willing to build subsidized rental housing. Palo Alto's BMR program has always allowed and encouraged voluntary offers of land, instead of inclusionary, on-site units. However, developers have only rarely been willing to provide land or even to construct rental units on their own land either on or off site. Any land dedication to meet the BMR requirements must be provided with appropriate zoning in place and must be a buildable, legal parcel free of environmental impediments. All impact fees and other exactions must be paid. The site must be adequate in all respects for, at a minimum, the construction of the number of rental housing units, equivalent in size to the required inclusionary BMR units. While land dedication is more likely to be practical on sites of five or more acres, some sites as small as three acres could provide a half acre parcel, which would be sufficient for a small rental development. If land dedication was infeasible or undesirable for a particular project, then the developer could contribute an equivalent piece of land at another location or the BMR agreement would revert to the standard inclusionary type of agreement. If Council supports this policy, staff recommends that further refinement and study be completed and the program framework brought back to Council for approval as part of the next Housing Element revision. This will avoid delaying the adoption of the BMR ordinance.

[See Section 6.5.3 & 6.6.3 of the KMA /AA report]

Policy #2C: Base the Minimum Number of BMR Units on the Site's Size and Zoning Capacity

Currently, the number of BMR units provided is a function of the total number of units actually built by the developer. Almost all residential projects are built at much less than the zoned density of the land due to the greater profitability of larger homes and the strong market for for-sale homes or townhomes on separate lots. By fixing the minimum number of BMR units in advance on a parcel basis using an objective, mathematical calculation, the City could be assured of a more predictable level of affordable housing production. Land owners, developers, and potential buyers would know with certainty the affordable housing requirement for any residentially zoned site. Some small discount could be made from the theoretical maximum density to account for the effect of development standards on unit yield. Further study would be needed regarding the application of this policy to mixed use projects and to projects under Planned Community zoning. Since this policy would encourage development of sites at the high end of the density range, staff recommends that further analysis and refinement of this concept be included in the work program for the upcoming Housing Element revision. [See Section 6.4.4 of the KMA / AA report]

BOARD AND COMMISSION REVIEW

Human Relations Commission (HRC): On December 14, 2006, the HRC discussed the recommendations in the consultants' report with Planning staff in a study session format. A representative of PAHC also attended. The HRC members expressed a broad range of widely differing opinions about the fundamental objectives of the BMR ownership program. Generally, the HRC was supportive of the consultants' recommendations; but did not specifically act on the report or on any particular policy recommendations. The HRC is primarily concerned about the BMR ownership program from the standpoint of the individual owner, especially owners who have financial problems or other unique situations. A few BMR owners have appealed at various times to the HRC about the hardship of monthly HOA dues and the low level of appreciation under the one-third of CPI formula.

Planning and Transportation Commission (PTC): The PTC will review any proposed BMR ordinance and make recommendations to Council on its adoption.

RESOURCE IMPACT

Funds are available and budgeted in FY 2007-08 in the Residential Housing Fund for the cost of contract legal services to assist staff with the preparation of both a BMR ordinance and with the development of new BMR ownership deed restrictions and related enforcement documents.

Implementation of the portion of Policy # 1C: "Create a Renovation Loan Program for Very Low Income BMR Owners" will require both additional financial and staff resources. The financial resources could come from a higher and more predictable revenue stream from expanded application of BMR in-lieu fees and possibly from CDBG funds for the loans. Further analysis of alternatives for administering the loan program will be conducted during the BMR in-lieu fee analysis, if Council supports the program in concept.

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 mundane 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 as well as adoption of a new BMR ordinance would more clearly support these two guiding principles of the BMR Program.

TIMELINE

The timeline for Council review and action on the policy changes to the BMR Program are dependent upon the time required to prepare the BMR ordinance following Council direction. Concurrently with the drafting of a new ordinance, Planning and legal staff will need to work on the proposed changes to the deed restrictions and Policies and Procedures Manual. The existing language in the BMR Program H-36 of the Housing Element will also need to be modified and an amendment to the Housing Element adopted by Council concurrent with the adoption of the BMR ordinance.

A tentative schedule is proposed as follows:

September 11 th	Action by Policy and Services Committee on Proposed Changes
Sept. – Dec. 2007	Preparation of Ordinance & Environmental Review Process
January 2008	PTC Review of the BMR Ordinance and Related Changes to Program H-36 of the Housing Element
March 2008	City Council Adopts BMR Ordinance, including policy changes and related Housing Element Amendments
May 2008	City Attorney Completes New Legal Documents (deed restrictions, deed of trust) & Revisions Completed by Planning & PAHC to Policy and Procedures Manual

ENVIRONMENTAL REVIEW

The administration of the BMR housing program is categorically exempt under Section 15326 of the California Environmental Quality Act (CEQA). However, the adoption of an ordinance to implement the BMR program will require CEQA review.

PREPARED BY: _____

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DEPARTMENT HEAD REVIEW: _____
STEVE EMSLIE
Director of Planning and Community Environment

CITY MANAGER APPROVAL: _____
EMILY HARRISON
Assistant City Manager

ATTACHMENTS

- A. Below Market Rate Housing Program Economic / Policy Analysis and Recommendations Prepared by Keyser Marston Associates, Inc. and Anderson & Associates (includes Appendix C: Summary and Analysis of Homeowners Survey) [Hard copies to Council and CDs to public]
- B. Summary List of Staff Recommended Actions for Council Approval
- C. Inventory of BMR Units [Completed and Occupied Units and Pipeline]
- D. Description of Appreciation Formula Recommended by KMA

CC: Palo Alto Housing Corporation, Marlene Prendergast, Executive Director
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