

### REPORT TO COUNCIL

#### **SUBJECT**

Approve the Amended Request for Modification of 2003 CDBG Loan to Sunnyvale Community Services

#### **BACKGROUND**

In 2003, Sunnyvale Community Services (SCS) acquired the property at 725 Kifer Road, where its main facility and offices are located, with the assistance of two loans from the City. One loan was a bridge loan funded by the City's general fund, which was paid back in full shortly after the acquisition, and the second was a long-term mortgage of \$400,000 in CDBG funds.

The original 2003 loan terms included a thirty-five year term, 3 percent simple interest, and a fifteen-year deferral of all principal and interest payments (from 2003-2018). At the end of the fifteen-year deferral period, the loan became fully amortized for the remaining twenty years of the term. The required monthly amortized payment of principal and interest is approximately \$3,217 per month. Because the loan was funded with federal funds, a special federal requirement also applies, known as the "reversion of assets" requirement, discussed in greater detail below.

In early 2013, SCS wrote a letter to the City asking it to forgive the CDBG loan in full. That request was considered by Council on August 27, 2013 as part of RTC 13-206 (Attachment 1). The request was not approved on that date, however Council directed staff to develop a modified version of one of the alternatives presented in that report for consideration at a later date (see August 27, 2013 meeting minutes, provided in Attachment 2, page 6).

On December 17, 2013, Council considered an alternative loan modification proposal which was recommended by staff and agreed to by SCS, as part of RTC 13-274 (Attachment 2). That proposal included three possible loan modifications, as follows:

- *Option 1:* Defer all payments of principal and interest to the end of term (2038);
- *Option 2:* Forgive interest accrued to date and reduce interest rate to zero 0 percent going forward;
- *Option 3:* Forgive the loan balance at end of term.

At that meeting, Council approved Option 1 and referred the rest of the request (Options 2 and 3) to the Housing and Human Services Commission (HHSC) for consideration and a recommendation to Council. Council also asked the Commission to pay particular attention to several questions related to possible unintended consequences of approving the requested loan modifications, which are outlined in the Discussion section below. Minutes of the December 2013 meeting are included as Attachment 3.

In early July, SCS sent the City a letter with a revised request asking for City approval of Option 2 only (forgive/waive interest), with no reference to Option 3. That letter is provided as Attachment 4. Pursuant to Council direction, the HHSC considered this request and made a recommendation to Council at its meeting on July 23, 2014. Minutes of that meeting are provided in Attachment 5.

Staff has prepared this report so that Council may consider SCS' current request for approval of Option 2 with the benefit of the HHSC recommendation.

## **EXISTING POLICY**

### **Housing Element of the General Plan**

#### **Goal E, Policy 5.6:**

Support local service providers that offer facilities and support services to homeless individuals and families, and persons at risk of homelessness.

### **2010-2015 HUD Consolidated Plan**

#### **Goal C: Community Development**

*Objective:* Support provision of essential human services, particularly for special needs populations.

## **ENVIRONMENTAL REVIEW**

N/A

## **DISCUSSION**

At the December 2013 meeting, Council provided specific direction to the Commission on the issues it wished the Commission to address regarding the SCS request, as noted in the meeting minutes (bracketed text added for clarification):

Councilmember Moylan moved and Councilmember Davis seconded the motion to refer the proposed action on Options two and three on page 4 of the RTC to the Housing and Human Services Commission and to specifically [ask] staff and the commission to consider the precedent issue and the issue of whether this action would essentially evade our normal [competitive funding] process and take funds that would normally be available to all the other agencies and give them to one, and if it would also evade our [human services funding] policy on capping what fraction of these funds we can give to any one agency.

As noted above, the options referred to in that motion were:

Option 2: Forgive interest accrued to date and reduce interest rate to zero percent going forward.

Option 3: Forgive balance at end of term (2038).

### **The Current Request from SCS**

Based on its letter dated July 1, 2014, SCS is no longer requesting Council approval of Option 3, but is requesting approval of Option 2. That would result in all interest accrued to date being forgiven, no further interest would accrue, and SCS would be required to pay back only the original loan principal of \$400,000 in 2038, or upon sale/transfer of the property.

The December 17, 2013 RTC recommended Council approval of a draft agreement to amend the current SCS promissory note. That agreement included a clause to implement Option 2, among other

clauses. Part of the rationale for staff's recommendation to approve Option 2 was that the federal "reversion of assets" (ROA) requirement. That requirement essentially means that the City has a 17 percent equity share (investment) in the property, based on the CDBG loan's initial loan to value ratio of 17 percent at the time SCS acquired the property. The ROA payment is due and payable to the City upon sale, transfer, or change of use, and would equal 17 percent of the appraised market value of the property at the time of the sale or transfer. This ROA payment cannot be waived by the City under federal law. (Please see Attachment 1 for additional background on the ROA requirement.) The ROA requirement, if triggered during the term, would likely result in a payment to the City equal to or greater than the amount of interest owed plus the original principal.

If Option 2 were approved, the ROA requirement would still apply if SCS transfers the property before 2043. If Option 2 were not approved, any payment of interest due upon transfer would also be credited toward the ROA payment. In other words, payment in full of the City loan under its original terms would also satisfy the federal ROA requirement. Therefore the total amount received by the City if SCS transferred the property prior to 2043 would not likely be reduced due to approval of Option 2. The only scenario in which Option 2 would have a material fiscal impact to the City would be if SCS were to remain in its current property, continuing to provide CDBG-eligible services, until 2043, in which the ROA payment would never become due.

#### The Precedent Issue

Council directed staff to consider "the precedent issue", which refers to the concern that approval of a request to forgive part or all of any City borrower's outstanding loan balance and/or reduce interest rates could set a precedent that might motivate other City borrowers to seek similar loan modifications. The Housing Division currently manages a portfolio of approximately 20 loans similar in nature to the SCS loan, as well as many more loans on rental housing and on owner-occupied single family homes and mobile homes. The Division's long-term revenue projections, prepared by Finance in consultation with Housing staff, take into account historic rates of loan repayment revenues, trends, and to some extent, major balloon payments expected on particularly large loans.

If the SCS request is approved and starts a trend of loan modification requests, staff will evaluate each on a case-by-case basis. It should be noted that this request is intended to be a non-precedent setting action and staff does not suggest that the City embark on a wide practice of loan modifications. Any modifications would require that the Division's projections of future CDBG loan payment revenues would need to be revised, and the amount of funding projected to become available in future years (generally in the ten- to thirty-year time frame) would need to be adjusted downward, if approved by the City Council.

Approval of this particular request for a loan modification does not commit the City to approving any or all future requests for modifications from other borrowers. It should be acknowledged that the City may face difficulty with explaining to another borrower why they could not receive the same treatment as a prior borrower has received, the public record (RTC) outlining the conditions that exist that lead to staff recommending, and Council's final action whether approval or denial, must establish transparency for the City's actions.

Nonetheless, each loan and each project financed with CDBG assistance or other Housing funds has different characteristics, and differing abilities to generate revenues for loan repayment. Because of this variety in project particulars, the City can and has historically exercised a fair amount of

discretion in setting loan or grant terms for different projects, based on those project particulars and what is deemed reasonable and amenable to both parties in the loan transaction, and what will create the most effective use of the available funds for the community in the long term. Negotiating different loan terms for different projects as deemed prudent by the City, and as agreed to by the borrowers, is fully in compliance with the CDBG regulations and HUD guidance, as well as state and federal laws applicable to the use of these special revenue funds.

The concern about precedent has materialized to some extent in that another Housing borrower has approached staff informally several times in the past year, following the initial SCS hearing, to inquire about the possibility of modifying the terms on five City loans on a multi-family rental property funded by a variety of Housing funds, including CDBG, HOME, and Housing Mitigation funds. That borrower would like the interest rate on those loans, currently a mix of 3 percent and 5 percent among the five loans, reduced to at least 3 percent, if not 0 percent, and that all payments be deferred to the term or be payable only on a residual receipts basis.

That borrower has not yet submitted a formal letter request, as some additional information about the property's finances needs to be gathered before that can be done; however more borrowers may come forward with such requests in the future, depending on how Council responds to the SCS request. Staff explained to the borrower that requests regarding loans on rental property, which typically, but not always, generate some rental income that can be used to make loan payments, may be treated differently than those on public facilities that generate no rents or other revenues that can be used for debt service. When staff receives a formal request from this borrower in the next several months, it will be shared with the Commission and Council at that time.

Nonetheless, in setting loan terms, most public sector lenders, including cities lending out CDBG funds, typically distinguish between loans on affordable rental housing that generates net positive cash flow, such as many of the larger multi-family rental properties on which the City has loans, and loans on properties that essentially serve as public facilities, such as the SCS facility, which usually do not generate any rental income or other revenues derived from the secured property itself. Staff would not recommend forgiving accrued interest or reducing interest rates to zero on any properties with outstanding City loans that generate rental income, regardless of the final action taken in response to the SCS request. The City has one loan on a very similar facility that also has a three percent interest rate, which is a loan of \$25,000 for the Second Harvest Food Bank in San Jose, fully deferred and due in full in 2022. However, that facility is not focused on providing services to Sunnyvale residents, and is not located in Sunnyvale, so that might be a justification for retaining the interest requirement on that loan, in the event Second Harvest might make a request for loan modification following this hearing.

#### Issues Related to Human Services Funding

Council also directed the commission to consider two additional questions, as noted above:

- a) Whether this action would essentially evade our normal process and take funds that would normally be available to all the other agencies and give them to one; and
- b) if it would also evade our policy on capping what fraction of these funds we can give to any one agency.

Regarding Question a), one could interpret the potential forgiveness and/or reduction of CDBG interest otherwise due on the SCS loan as preventing those funds from eventually becoming available for other CDBG projects, some of which would be projects of other non-profit agencies.

That interpretation assumes the borrower would have funds available to make the otherwise-required interest payments when due, which is never guaranteed with any borrower.

However, any CDBG loan payments received by the City, including interest payments, are typically deposited into the CDBG Revolving Loan Fund (RLF), which can only be used for housing rehabilitation loans to home owners and/or to providers of affordable rental housing for rehabilitation projects. Because the RLF regularly receives program income ranging from \$50 to several hundred thousand dollars at a time, and because the funds may be re-used on an ongoing basis for both large and small rehabilitation loans, the link between one particular loan payment anticipated in 2038 (since the deferral was already approved) and the amount of CDBG funding available for human services in the near term (or the long term) is not that direct. In addition, most of the human services grantees are not involved in housing rehabilitation projects, and therefore would not be applying for housing rehabilitation loans from the RLF.

However, the federal cap on how much of the CDBG funds can be spent on public services (15 percent) is based on the sum of the CDBG “program income” (i.e., all loan payments received and other miscellaneous CDBG revenues) and the annual CDBG grants. Therefore, if the amount of program income were to decrease dramatically, the total amount available for human services would also decrease due to that cap. However, only 15 percent of any decrease would impact human services activities, due to the federal cap. The other 85 percent of the decrease would reduce funding available for CDBG capital projects, such as housing rehabilitation, housing site acquisition, ADA curb cuts, WorkFirst Sunnyvale (an SCS grant project), or other projects.

The amount of interest at issue with the SCS request, up to \$420,000 potentially receivable in year 2038 (deferred by Council’s prior approval of Option 1), would not have any impact on CDBG activities until 2038. If the City were to approve additional loan modifications for other borrowers, projected future CDBG revenues would be further reduced, which would impact the CDBG projects or programs, including human services programs, the City could fund in future years. This could be interpreted as resulting in the type of impact implied by Question a).

Although some may be concerned by the impact of forgiving or waiving the interest might have on the City’s ability to fund programs of other agencies, one could also consider the value of services the City’s needy residents are receiving from SCS as being of equal or greater value than the interest the City would receive, which is currently set at \$12,000 per year, and what other types of programs could be funded with that amount of funding. SCS noted in its earlier letters to the City that it could help approximately 12 households avoid becoming homeless with the \$12,000 it currently must set aside to cover the interest accrual on the CDBG loan. In addition, SCS leverages all of its funding with a large number of volunteers who provide critical services at no charge, so the true amount of service the City’s needy residents receive is actually much larger than that represented by SCS’ direct costs to provide services.

Regarding Question b) above, staff does not believe the requested action would have any direct impact on the City’s policy to limit the amount of funds provided to any one agency to 25 percent, because that policy only applies to human services funding, whereas the funds SCS is asking to be forgiven (interest due on an existing loan) are derived from CDBG capital project funds. Those funds were awarded to SCS in 2003 as a CDBG capital project (loan) award, and the human services funding policy does not apply to capital project awards.

However, Question b) suggests that SCS could use the savings from deferred or reduced interest payments for additional human services, assuming it would have the funds needed to make the CDBG loan payments. It is typically difficult for non-profits to raise new funds for existing debt service. The City might consider what positive financial impacts its decision to approve Option 1 (in December 2013), and/or its potential approval of Option 2, could have on SCS' overall financial standing when considering any future applications for funding from SCS. In particular, this factor may be relevant to Council during the next human services funding round which is scheduled to take place in early 2015.

### **FISCAL IMPACT**

Approval of Option 2 would reduce projected loan payment revenues to the CDBG Revolving Loan Fund (RLF) by approximately \$135,600 in interest accrued to date, plus an additional \$285,000 projected to accrue through the remainder of the loan term, assuming the loan remains outstanding for the entire term, for a total of \$420,000 in projected interest payments currently due in 2038. If the property were sold prior to that time, the payment would be due earlier, but the amount of interest accrued would be less, depending on when the sale occurs.

The above-described impact does not factor in possible unintended impacts that could occur if many additional borrowers are motivated to request loan modifications if the SCS request is approved. However, if any additional loan modification requests are received, the fiscal impacts of such requests would be considered and valid reasons may exist to deny some requests.

### **PUBLIC CONTACT**

Public contact was made by posting the Council agenda on the City's official-notice bulletin board outside City Hall, at the Sunnyvale Senior Center, Community Center and Department of Public Safety; and by making the agenda and report available at the Sunnyvale Public Library, the Office of the City Clerk, and on the City's website.

The Housing and Human Services Commission (HHSC) considered this request at its meeting on July 23, 2014.

### **ALTERNATIVES**

1. Approve the current SCS request ("Option 2") to revise the existing loan agreement to forgive the interest accrued to date and reduce interest rate to zero percent, and make a formal policy statement that this action shall not be seen as a precedent for other borrowers, and is made only due to the unique role of SCS in the Sunnyvale community.
2. Take some other action in response to this request.

### **BOARD/COMMISSION AND STAFF RECOMMENDATION**

Alternative 1: Approve the current SCS request ("Option 2") to revise the existing loan agreement to forgive the interest accrued to date and reduce interest rate to zero percent, and make a formal policy statement that this action shall not be seen as a precedent for other borrowers, and is made only due to the unique role of SCS in the Sunnyvale community.

Staff recommends this alternative because it was part of the previous staff recommendation included in RTC 13-274, and the estimated fiscal impact of this alternative would likely be offset in large part

by the reversion of assets payment if the property is sold before 2043. If SCS retains the property until 2043, the impact will not be offset by such a payment, however by that time the real value of the foregone interest will be significantly reduced due to inflation.

At that point in time, the potential fiscal impact to the City of the forgiven \$420,000 in CDBG loan interest payments could be considered a reasonable contribution by the City for the community services provided by SCS for the 35-year term of the loan. These services are of great benefit to the City by alleviating hunger, homelessness, and other hardships faced by its lower income residents, which, if not alleviated, can also have significant impacts on the entire community in the form of increased demand for City-provided emergency services, increased crime, or other types of impacts. In addition, staff does not believe that this action should set a precedent for other borrowers, as it is recommended only due to the unique role of SCS in the Sunnyvale community and the fact that the property does not generate any rental income or other revenues that could be used to make interest payments.

The Housing and Human Services Commission (HHSC) considered this request at its meeting on July 23, 2014, and recommended that Council approve Alternative 1. The vote was 4-2-1, with one commissioner absent. Minutes of that meeting are provided in Attachment 5.

Prepared by: Suzanne Isé, Housing Officer

Reviewed by: Hanson Hom, Director, Community Development Department

Reviewed by: Robert A. Walker, Assistant City Manager

Approved by: Deanna J. Santana, City Manager

## **ATTACHMENTS**

1. Report to Council 13-206 dated August 27, 2013
2. Report to Council 13-274 dated December 17, 2013 (includes August 27, 2013 minutes)
3. Minutes of December 17, 2013 Council Meeting
4. Letter from Sunnyvale Community Services Dated July 1, 2014.
5. Minutes of July 23, 2014 Housing and Human Services Commission Meeting
6. Letter from Sunnyvale Community Services dated October 22, 2014