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City and County Credit Support for Affordable Housing

Introduction

Cities and counties face a well-recognized challenge from the growing mismatch between the demand and supply of available housing and the consequent pressure on housing affordability. In a number of jurisdictions, rising costs are putting housing out of reach of a growing segment of the population and straining housing availability for vulnerable populations including people with disabilities or who are experiencing homelessness. Existing and new housing is increasingly unaffordable except to high-earning workers: the entry-level price for traditional single-family ownership is unattainable for many, and the lack of mobility from the rental market to home ownership has placed upward pressure on rents. Consequences to renters include excessive expenditures for shelter costs and/or long commutes to work from more-affordable areas. These consequences also negatively impact local economic development because businesses have difficulty recruiting and retaining employees due to the lack of affordable housing.

Prices for rental housing have long been constrained or mitigated by federal and state programs providing housing subsidies in partnership with housing authorities and affordable housing developers. The acceleration of housing prices, particularly in high-demand urban areas, and the inability or unwillingness of federal and state programs to keep up with the widening gap between market rents and affordable rents has exacerbated the issue to a crisis level. One side effect of this federal and state failure is that cities and counties now are being asked to do more to create affordability and sustain livability.

Cities and counties have a number of traditional means to help address this housing affordability challenge. Some of these means are regulatory methods of encouraging density and lowering pre-development and development costs, including up-zoning and inclusionary zoning, building code revisions, parking requirement revisions, adjusted impact fees and streamlined permitting processes. Financially, cities and certain counties may provide property-tax deferrals for affordable multifamily housing pursuant to Chapter 84.14 RCW and provide property or general funds to their housing authorities pursuant to Chapter 35.83 RCW. Cities and counties may also ask voters to approve a levy lid lift of regular property taxes for a specific purpose and term pursuant to RCW 84.55.050, an affordable housing levy of regular property taxes pursuant to RCW 84.52.105, or an additional local sales tax to fund affordable housing and related services pursuant to RCW 82.14.530. Cities can contract to provide funds to private for-profit or non-profit developers in consideration of covenants to set-aside units for persons and families making less than 80% of area median income under RCW 35.21.685 and RCW 36.32.415.

In addition, cities and counties may wish to encourage the development or preservation of affordable housing by pledging their credit to support these projects where the affordable housing benefit is significant and the potential financial risk to the city or county can be properly evaluated and minimized. This article examines the issues relevant to a city or county that is considering a program of credit support to promote affordable housing.

Credit Support

Although a traditional tool, the pledge of county and city credit is an often-overlooked source of financial support to encourage affordable housing. Cities and counties generally have the ability to borrow at relatively low interest rates because their sources of debt repayment include a variety of taxes and fees derived from a diverse economic base. The marketplace values the promise of a city or county to repay from these general fund sources at a much higher level than those of a housing authority or a non-profit or for-profit private developer whose sole source of payment is the rents it hopes to collect. In addition, cities and counties often have the legal capacity to incur indebtedness beyond their political and practical ability to raise taxes and fees to pay debt services, creating unused debt capacity. The challenge is to find a way to contribute the unused borrowing authority and provide the credit strength of a city or a county to an affordable housing developer to reduce the borrowing cost of the development without simply transferring the risk from the lender to the guarantor and credit enhancer.

A city or county has explicit statutory authority to loan funds to public and private developers to finance affordable housing. RCW 35.83.050; RCW 35.21.685; RCW 36.32.415. This explicit statutory authority necessarily implies the authority to promise to make such loans. In consideration for this obligation to make a loan, the developer must agree to set aside housing units for persons and families of "low income," which is statutorily defined as under 80% of area median income and generally considered to meet the "poor and infirm" exception to the state constitutional prohibition against gifts of public funds. Wash. Const. Art VIII, Section 7; RCW 35.21.685; RCW 36.32.415. Public funds can be used to provide publicly available affordable housing to eligible persons and families; any private benefit to the developer would be incidental to that purpose.

In the simplest form of such a pledge, a city or county could enter a contingent loan agreement ("CLA") with its housing authority or a non-profit or for-profit private developer (each, a "developer"). Under the CLA, the city or county agrees to loan money to the developer in the event the developer cannot pay debt service on its affordable housing debt, essentially guaranteeing payment of debt service for the project. This obligation continues as long as the developer's debt is outstanding. When funds become available to the developer, the developer repays the loan from funds remaining after resuming payment of debt service and providing for the maintenance and operation of the affordable housing. The developer's commitment in return for this guarantee (to provide housing for "low income" persons and families) is often set forth not only in the CLA, but also in a recorded deed restriction running with the property and assuring the set-asides will remain in place in an amount and for a term the city or county deems appropriate and adequate.

The CLA enhances the creditworthiness of the project in the eyes of the bank or other investor providing the debt. Absent such a guarantee or other reserves to pay debt service if the project runs into difficulty, the project's creditworthiness will be tested by reference to its projected cash flows, i.e., rents and costs. The lender relying solely on cash flows likely will demand a higher interest rate to reflect the risks of delay, vacancy, depreciation, etc. A higher interest rate increases the project's operating costs and adds pressure to increase rents to a level that is less affordable for potential tenants. But if the city or county will provide debt service coverage in the event the project is in trouble, the lender has a reduced risk of default and can accept a lower interest rate, driving down the pressure on rents.

The Washington State Supreme Court has determined that a CLA obligating a city to stand behind the debt of a special purpose entity was a debt for purposes of applying statutory and constitutional debt limits. *In re: the Bond Issuance of Greater Wenatchee Regional Events Center*, 175 Wn. 2d 788 (2012). The fact the obligation was contingent or limited in its scope was not persuasive to the divided court majority, and consequently a CLA as described in this discussion should be assumed to be debt. Because many cities and most counties have debt capacity, this is not necessarily a prohibitive factor though it needs to be carefully considered by the guarantor. If used prudently, CLAs can put some of this debt capacity to work for affordable housing.

We note as a threshold matter that the guarantor cannot assume that its obligation to provide funds under the CLA will never be used, and any use of a CLA should be carefully considered. On a few occasions in Washington, including recently, guarantors who have entered into CLAs have been called upon to advance significant amounts of funds. In some situations, cities or counties were required to spend general funds to support the debt of special purpose districts which was used to construct civic auditoriums when the special purpose district failed to achieve operations adequate to pay debt service on their bonds. In other situations, a city or county was required to spend general funds to support the debt of its housing authority which was used to construct market-rate condominiums as part of an urban renewal program.

In addition to underscoring the reality that CLAs can be called upon, these situations prompt additional consideration of which projects are best or least suited to benefit from this tool. Providing credit support to affordable housing may provide a different risk profile with less risk than many other types of projects. If the project pencils at affordable rental rates and market rents keep increasing, the demand for affordable rental units should increase. Although in the private market this would result in higher rents, in projects with limits on rental affordability enforceable by deed restrictions, this should result in greater affordability. In fact, some housing authorities and non-profit developers have acquired projects that at the time of acquisition had market rents, but due to their mission to provide affordability their willingness to limit rent increases have made them more and more affordable relative to the market over time.

To explore more fully the possibility of a city or county using credit enhancement as a means to creating more affordable housing units, it is useful to examine this type of transaction from the perspective of the developer, the governmental guarantor and the lender.

Developer Perspective

From the perspective of the developer, the advantage of a city or county guarantee in the form of a CLA is reduced borrowing costs for the project, which consequently gives the developer a greater ability to lower its costs and the project rents. The amount and impact of the interest cost savings will depend on a number of factors including the size of the project, the credit rating of the guarantor, the cost to the developer of securing the CLA (e.g., transaction costs and fees to the guarantor), and the savings relative to market rates. Clearly, if the advantages of a lower interest rate are marginal or unnecessarily entangling, the developer would have no reason to proceed. In almost every case where a project can benefit significantly from credit enhancement, however, obtaining such credit enhancement from a city or county will be less expensive than securing it through the private marketplace.

One of the critical reasons for this difference is the city or county focuses on creating affordable units instead of generating its own financial profit from the credit enhancement. The county or city guarantor will review the financing not from the perspective of making a profit but from the perspective of protecting itself from having to actually make payments pursuant to the CLA. For example, it may require reserves and that reserves at certain levels be liquid and available from the project or from the general balance sheet of the developer. It may further require covenants from the developer that the CLA will not be called upon until available reserves of the developer are spent. With respect to a private for-profit developer, the guarantor may desire to limit profits to assure the lowest possible rents and/or to subordinate developer fees below repayment of draws on the CLA.

In addition, the city or county often knows the developer (and, in the case of a housing authority, appoints its board), and can be more focused on the public benefits of affordable housing and the specific risk of default (as opposed the abstract or worst-case risk scenarios a private lender might use in its underwriting). In short, the developer is likely to find the public guarantor will be more pragmatic and mission driven in assessing the risk of default than the general marketplace, resulting in a willingness to support the debt at a lower cost.

County/City Perspective

The governmental guarantor will want a significant public policy benefit in the form of set-asides for affordability, and likely will want the deepest income restrictions for the longest period consistent with the realities of the financing. This tension between the goals of the guarantor and the developer with respect to such covenants will likely be greater with a for-profit developer than a non-profit or governmental developer, but does not preclude transactions with any type of developer. In many circumstances, the governmental guarantor may want or need private developers to provide affordable housing because these developers have the expertise and capacity to build and manage these projects more efficiently and sustainably than less experienced or more resource-challenged non-profit or public developers.

To better understand the strength of the project and ensure an appropriate return for taking on credit risk, the county or city providing credit support needs to underwrite the developer and the project much as a lender would. At the same time, because the government is "only" promising to spend money if the developer cannot pay debt service, it has a somewhat different perspective than a lender. The guarantor weighs the risk of having to provide money in the future, and not the return on a current cash outlay.

The guarantor should understand the project and its risks, evaluate the ability of the developer to perform, and consider whether the pro forma affordable rents are adequate (with other funding) to support project operations and debt service. The guarantor also will want to understand what reserves are available to pay debt service if unforeseen problems arise with the project and what financial covenants exist to make sure those reserves remain in place. The guarantor will want to understand who will monitor financial and other covenants and to reach agreement up front as to what will take place upon early warning of project problems, and who among the developer, guarantor and the project lender will control those actions. The guarantor will want to understand its authority to take possession or title to the property if necessary, and its authority to relet or otherwise address the performance of a troubled project.

As an example, already constructed and leased up projects do not pose the same construction and rent-up risks to the guarantor and guarantor requirements may differ with the type of project. In some cases, particularly with housing authority developers with significant successful development experience and a healthy balance sheet, the guarantor may be less concerned about the details of the project itself. In other cases where the project appears more likely to draw on the CLA, the guarantor may want to require a deed of trust and title insurance to secure the contingent loan. Having protected itself as a lender, it can share credit for helping to provide affordable housing without spending funds, albeit while taking on certain understandable risks.

In managing this process, one significant challenge to the city or county providing credit enhancement may be obtaining the appropriate expertise and experience to negotiate with the developer consistent with the credit enhancer's policy goals, to monitor project performance over time, and to enforce city and county remedies as and when necessary. Although not a traditional bank or lender, the guarantor still needs to limit its exposure to prudent risks and negotiate, monitor and undertake enforcement actions accordingly. Underwriting and being responsible for a transaction in this manner is not always a familiar role for government and may require the help of consultants as well as an understanding of the scope of and limits of the consultants' work. A robust procurement process, a clear statement of scope, and specificity in terms of opinions, feasibility reports and other deliverables may be helpful in this regard.

Lender Perspective

With a city or county's guarantee of a developer's debt, the lender or investor is in the enviable position of having a significantly stronger credit to assure repayment of its debt. In return, its lowered risk should result in a willingness to lend at a lower rate. The lender may be a party or a third-party beneficiary to the CLA so it is assured the credit enhancer will be obligated to make payment to it within defined time periods if the borrower itself cannot make payment. All parties will want early trip wires if credit problems arise so that payment by the credit enhancer, while obligated without qualification, can be avoided if possible. There may be ancillary benefits to these transactions as well, e.g., CRA credit if eligible, and public recognition.

Conclusion

Cities and counties have a host of tools to support the provision of affordable housing. While some involve regulatory action and others require the expenditure of limited public funds, the provision of credit guarantees to developers in exchange for affordable housing may provide genuine financial benefit without the expenditure of funds or a significant risk to future tax revenues otherwise required to support general government. As the affordable housing crisis worsens and interest rates rise, it is a response that in the right circumstances can be meaningful and available.

If you have any questions about this article or pertaining to state and municipal law and finance generally, please contact any of our public finance attorneys.

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Dated: April 11, 2017