

DATE ISSUED: May 28, 2003

REPORT NO. 03-097

ATTENTION: Honorable Mayor and City Council  
Docket of June 3, 2003

SUBJECT: Authorization of Collateral for HUD Section 108 Loans

### SUMMARY

#### Issues:

1. Should the City Manager be authorized to place encumbrances on the following City properties to satisfy collateral requirements for HUD Section 108 loans?
  - (a) The Central Police Station, 2501 Imperial Avenue, for the Section 108 loan related to its construction
  - (b) The Ocean Beach Library, 4801 Santa Monica Avenue, the adjacent property at 4817-23 Santa Monica which is to be purchased with Section 108 loan funds, and the improvements that are to be placed thereon for the Section 108 loan related to the proposed Ocean Beach Library expansion;
  - (c) The proposed new College Heights-Rolando Library to be built on the vacant lot that connects Montezuma Road and Reservoir Drive with Mohawk Street for the Section 108 loan related to its construction;
  - (d) The Cortez Hill Transitional Shelter, 1449 Ninth Avenue for the Section 108 loan related to the purchase and renovation of the Cortez Hill property;
  - (e) The Viet Nam Veterans Homeless Facility, 4141 Pacific Highway, for the Section 108 loan related to the City's purchase of that property.
  
2. Should the City Manager be authorized satisfy collateral requirements by executing loan contracts that, in the event of the future elimination of the CDBG program by the U.S. Congress, would allow HUD to use the City's final year of CDBG funding to pay off the outstanding balance of the following two loans?
  - (a) The Logan Heights Library
  - (b) District 4/SEDC loan

Manager=s Recommendations:

1. Authorize the City Manager to place encumbrances on the following City properties to satisfy collateral requirements for the respective HUD Section 108 loans:
  - (a) The Central Police Station, 2501 Imperial Avenue, for the Section 108 loan related to its construction
  - (b) The Ocean Beach Library, 4801 Santa Monica Avenue, the adjacent property at 4817-23 Santa Monica which is to be purchased with Section 108 loan funds, and the improvements to be placed thereon, for the Section 108 loan related to for the proposed Ocean Beach Library expansion;
  - (c) The proposed new College Heights-Rolando Library to be built on the vacant lot that connects Montezuma Road and Reservoir Drive with Mohawk Street for the Section 108 loan related to its construction;
  - (d) The Cortez Hill Transitional Shelter, 1449 Ninth Avenue, for the Section 108 loan related to the purchase and renovation of the Cortez Hill property;
  - (e) The Viet Nam Veterans Homeless Facility, 4141 Pacific Highway, for the Section 108 loan related to the City=s purchase of that property.
  
2. Authorize the City Manager to satisfy collateral requirements by executing loan contracts that, in the event of the future elimination of the CDBG program by the U.S. Congress, would allow HUD to use the City=s final year of CDBG funding to payoff the outstanding balance for these two loans:
  - (a) The Logan Heights Library loan
  - (b) District 4/SEDC loan

Other Recommendations: None

Fiscal Impact: Other than recording fees for the property encumbrances, estimated at \$200 or less, there is no significant direct cost. Encumbrances on the properties listed in Recommendation 1 will total \$14.8 million at the time of placement and, to the extent to which each is encumbered, these assets of the City will not be readily available to collateralize other long term debt issuances. However, HUD is flexible about accepting substitute collateral at a later date and about taking a junior position as long as their collateral requirements continue to be met. The value of these encumbrances will decrease as each annual principal payment is made. Granting HUD the right to attach our final year of CDBG funds (Recommendation 2), in the unlikely event that the CDBG program is abolished by Congress and we can not find any other source of funds to continue making scheduled payments on the loans, would reduce the final year allocation to the City by the amount of debt that is outstanding at that time. The Logan Heights Library loan has been approved by HUD for \$3,030,000. The Engineering and Capital Works Department is processing a Request for Council Action which would authorize the Manager to borrow \$353,500 more for the Logan Heights Library. If the Council

approves that request, the loan amount will be \$3,383,500. The Manager has requested a \$3,535,000 loan for the District 4/SEDC Projects pursuant to Council authorization to do so in September, 2002. The amount that would be pledged if Recommendation 2 is approved by the Council would therefore be at least \$6,565,000 and no more than \$6,918,500 (contingent on the final amount of the Logan Heights Library loan) in the first year and would decrease with each annual payment of principal.

## BACKGROUND

The City has made considerable use of the Section 108 Loan Program. We have 10 loans in our portfolio and current debt of \$25.9 million. In addition, four loans totaling \$9.2 million have been approved but not yet funded; HUD is reviewing applications for the District 3 Public Improvements and District 4/SEDC totaling \$6.6 million; and there are additional applications being discussed. The City has generally used the loan program to help finance public facilities, such as police stations, fire stations, and libraries as well as neighborhood facilities such as homeless shelters, although we have used it to support several economic development projects as well. We generally use our annual CDBG allocations as the source of repayment although in a few cases developer payments, tax increment revenue and sales tax revenue are used. Regardless of the repayment source(s), HUD also requires the pledge of future CDBG dollars to ensure that annual repayments are made in a timely manner. As an additional layer of security, HUD requires collateral which may be in the form of real estate, pledges of other revenue streams such as tax increment revenue or pledges of other assets which are acceptable to them. The City Council approved policies governing the encumbrance of City property and other assets in January of 2003. (See Attachment I – HUD Section 108 Guidelines.)

## DISCUSSION

Federal requirements regarding collateral for Section 108 loans have changed over time. While some of the earlier projects had no collateral requirements, HUD now requires collateralization for all loans. Real estate must be collateralized at 125% of the loan value. A recent review of our Section 108 loan portfolio (which includes funded loans, approved loan applications, and pending applications) revealed a number of funded loans for which the collateral process has not been formalized or may be unclear. In addition, there are some pending loans for which collateral has not been established. To be fully compliant with HUD regulations, collateral that is acceptable to HUD must be established for all loans. As indicated in the Manager's Report that accompanied the Section 108 Guidelines, the Manager is now returning to Council to formally establish collateral for a number of loans in a manner consistent with the new guidelines.

The Manager's recommendations contained in this report are consistent with the guidelines. The guidelines require that whenever possible, the real estate or revenue stream(s) related to the project that is being financed with the 108 loan be designated as the collateral. Recommendation #1 addresses 5 loans for which the collateral can be established in this manner. It should be noted that all of these loans were approved by HUD prior to FY '03 and that they accepted our standard offer of the facilities being financed with the loan to be used as collateral. Since late

last year, HUD has indicated that public facilities such as police stations, fires stations and libraries are no longer acceptable as collateral. This policy position may impact our ability to continue use of the 108 program to finance such public facilities; the Manager is currently negotiating with HUD regarding this change in policy.

The guidelines also recognize that it is not always possible to use the project related real estate and that there is often no project related revenue. They therefore provide other alternatives which may be considered to meet the collateral requirements (see Section I, Collateral, Paragraph 2 of the attached Guidelines). The Manager's recommendation regarding the Logan Heights Library and the District 4/SEDC loans reflects the alternative which best addresses the situation for these two projects. The Logan Heights Library is being built on School District property and cannot be offered as collateral. There is no associated revenue stream. The major component of the District 4 loan is a senior center which is being built on parkland which cannot be offered as collateral because of charter restrictions. The other two projects included in that loan are public improvements which cannot be collateralized. None of the projects has an associated revenue stream. The Manager has not been able to identify other assets in Districts 8 and 4 which are available to be encumbered as collateral and which would also be acceptable to HUD. Therefore, based on analysis of the alternatives, the Manager's second recommendation incorporates the alternative of authorizing HUD to use our final CDBG allocation to pay off the specified loans. Since we would be paying both loans with CDBG funds, this collateral would only be utilized in the event that Congress terminates the CDBG program in the future and the City cannot find other sources of repayment. This authorization would allow HUD to take enough money from the final year allocation to fully repay the designated loans. The amount that is committed by such a pledge (a "hard pledge" of CDBG) will decrease as each principal payment is made.

The "hard pledge" of CDBG funds would be in addition to the "soft" pledge that allows HUD to use the City's CDBG allocation to make an annual payment, in the event that the City cannot or will not make the payment. The Manager is seeking clarification from HUD regarding the extent to which the hard pledge can be used as collateral but it is assumed that such pledges could not exceed our annual CDBG allocation. Authorizing the use of the "hard" pledge of CDBG as collateral for these two loans would encumber \$6,565,000 (or \$6,918,500 if the loan increase for the Logan Heights Library is approved) which is substantially less than our annual allocation of \$18-19 million. HUD has already indicated its willingness to accept a hard pledge as collateral in these two cases.

## ALTERNATIVES

1. Do not authorize the encumbrance of City real estate for the 5 specified loans.

2. Do not authorize the Manager to agree to a hard pledge of CDBG funds for the two specified loans.

Respectfully submitted,

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Hank Cunningham, Director  
Community and Economic Development

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Will Griffith, Director  
Real Estate Assets Department

APPROVED: \_\_\_\_\_  
Bruce Herring, Deputy City Manager

CUNNINGHAM/FISCHLE-FAULK/BC

Attachment: [HUD Section 108 Loan Program Guidelines](#)

# HUD SECTION 108 LOAN PROGRAM GUIDELINES

(adopted January 13, 2003)

## 1. COLLATERALIZATION

(1). Whenever possible, the Manager will recommend to the Council that the loan related asset including leasehold interests and/or any revenue generated by the loan related project be used to collateralize the loan.

(2). When full collateralization of a loan is not possible using only the loan related asset or revenue stream, the Manager will consider the following options in terms of each project's situation and needs and recommend that one or more of the following be used:

a. **From within the same Council district only**, alternative real estate, revenue, or other assets including, but not necessarily limited to:

- Other 108 loan financed real estate which has uncollateralized value
- Any other appropriate City property
- Tax increment revenue (applicable only to projects in redevelopment areas)
- Assignment of leasehold interests, including the assignment of rights related to lease-leaseback agreements on property that could not otherwise be used as collateral, parkland in particular

b. Granting HUD the right to attach the City's final CDBG entitlement grant in the event that Congress terminates the CDBG program.

(3). Community and Economic Development staff will track collateral status for each loan and, in the case of those that are collateralized wholly or in part by alternatives contained in guideline #2, will take necessary steps to reduce the collateral to the loan related assets. These steps could include the release of encumbrances as loans are paid down and the substitution of one collateral source for another. HUD is generally receptive to substitution of collateral as long as the newly offered collateral still meets their 125% requirement.

## 2. LIMITS ON HUD SECTION 108 DEBT

Establish a limit on 108 debt to an amount no more than the 3.5 times the City's annual CDBG entitlement grant award.

### **3. ESTABLISHMENT OF AN ANNUAL APPLICATION PROCESS FOR 108 LOANS**

The Manager will utilize the annual Consolidated Plan process to provide a status report regarding use of Section 108 funds to the City Council. In addition, to the greatest extent possible, the Consolidated Plan process will be used to structure the consideration of projects to be assisted with 108 loan funds. This would require that a list of projects to be considered for 108 financing during the following year be submitted to the Manager prior to the Consolidated Plan public hearing process. These projects could then become part of the Consolidated Plan which is submitted to Council for review, usually in May of each year. The Council would subsequently have an opportunity to review the proposed projects, consider the merits and public benefit of each, assess the impact on the City's overall debt as well as on the CDBG program, and decide whether or not to utilize the City's 108 borrowing capacity to assist these projects.