OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Item Number: Council 203/RA 1

Community Development Block Grant Loan Repayment Agreement

OVERVIEW

In December 2008, the Office of the Inspector General (OIG) of the U.S. Department of Housing and Urban Development (HUD) issued an audit of the City of San Diego's Community Development Block Grant (CDBG) program, with a specific focus on CDBG funds loaned by the City to the Redevelopment Agency. The audit found that the City failed to properly administer CDBG funds provided to the Agency, and that the City did not execute loan agreements and failed to ensure repayment of outstanding CDBG loans. The OIG recommended that HUD require the City to execute loan agreements with the Agency and establish a repayment schedule for outstanding CDBG loans.

Over the past year, the City and Agency worked with HUD to develop a plan to address the OIG's findings and recommendations, and the parties have agreed upon a repayment plan. The terms of the proposed repayment plan were presented to the Council and Agency Board on February 23, 2010. At that meeting, the Council directed staff to prepare the loan repayment agreement, which is currently before the Council and Agency Board for consideration.

In addition, staff is recommending that the Council and Agency take several other actions, most prominently, the cessation of interest accrual on all Agency long-term debt to the City as of June 30, 2009, and the forgiveness of approximately $144.2 million in remaining CDBG and Section 108 debt, including principal and interest.

FISCAL/POLICY DISCUSSION

Under the terms of the CDBG Loan Repayment Agreement, the Agency will repay a total amount of $78,878,000 to the City over a 10-year period. In accordance with the Repayment Schedule included as Exhibit A to the Repayment Agreement, annual payments from the Agency to the City will increase over the 10-year period, from approximately $3.6 million in FY 2010 to $16.4 million in FY 2019.

A significant element of the Repayment Agreement is that all repayments from the Agency to the City shall be treated by the City as CDGB program income. As discussed in IBA Report 10-17, *Redevelopment Agency ERAF, CDBG Repayment, and Debt to the City*, this will result in significant additional funding for the City's CDBG program over the next 10 years, and it is critical that the City develop a plan for the use of these funds, and establish a process for how they will be allocated. Such a plan has not been yet been presented.

Other significant terms of the Repayment Agreement include the following:

- All repayments will first be applied to outstanding principal and then to accrued interest;
- The City will apply a sufficient portion of the repayments toward the defeasance of the Mercado del Barrio and Valencia Business Park HUD Section 108 loans;
- Agency, with City consent, has the right to make prepayments of all or a portion of the amounts listed in the Schedule of Annual Repayments;
- All repayments shall be subordinate to any bonded indebtedness which has or may be issued by the Agency;
- The City will allocate sufficient resources for administration and oversight of the CDBG program associated with the program income resulting from repayments.

As described in IBA Report 10-17, loan repayment amounts across the different project areas have been determined based largely on ability to pay, and are not proportional to outstanding CDBG debt. While this results in a certain degree of inequity among the project areas, requiring payments on a proportional basis would significantly impact the viability of certain project areas. It should also be noted that no project area is required to make payments in excess of the outstanding CDBG debt for that project area. An attachments to this report provides total outstanding CDBG and Section 108 debt, repayment amounts and debt forgiveness by project area.

<u>Cessation of Interest Accrual and CDBG Debt Forgiveness</u>

Two of the more significant recommended actions are the cessation of interest accrual on all Agency long-term debt to the City as of June 30, 2009, and the forgiveness of approximately $144.2 million in remaining CDBG and Section 108 Loan debt. As of June 30, 2009, the total outstanding CDBG and Section 108 Loan debt to the City was

$228.4 million, including principal and interest. As illustrated in the staff report, this debt would be extinguished as follows:

Total CDBG Debt as of 6/30/09	$ 228,432,499
Less: Loan Repayment Agreement	(78,787,000)
Less: Principal on NTC Section 108 Loan	(5,431,000)
Approximate Debt Forgiveness	**$ 144,214,499**

The IBA supports the recommend actions to extinguish the total outstanding CDBG and Section 108 Loan debt, including the cessation of interest accrual and the forgiveness of remaining CDBG debt.

As described in the staff report provided for the February 23 Council/Agency meeting (RA-10-11/RTC-10-015), in 1981 interest rates on Agency debt to the City were set at "the maximum rate allowed by law," which at the time was 10% per year. In FY 1983, the maximum rate was increased to 12%. In 1993, the basis for interest charges was changed to the Prime Rate plus 2%. These interest rates have been set significantly higher than standard government borrowing rates, and have greatly increased the level of Agency debt to the City. As reflected in the staff report, total outstanding principal as of June 30, 2009 was $118.5 million, while outstanding interest was $150.1 million.

The IBA also supports the forgiveness of all remaining CDBG and Section 108 Loan debt, estimated at $144.2 million as reflected above. Our support for this debt forgiveness is based on the following:

1. **The majority of the remaining CDBG debt is due to interest charges.** As described above, the interest rates charged on Agency debt to the City have been set at very high levels, and have resulted in a rather arbitrarily high level of debt. Of the $144.2 million estimated for forgiveness, approximately $96.6 million is due to interest charges imposed by the City.

2. **Requiring repayment would have significant impact on redevelopment efforts.** At a very minimum, requiring repayment of the remaining $144.2 million in CDBG and Section 108 Loan debt would result in a commensurate reduction in the capacity to implement redevelopment projects. In addition, it may result in several redevelopment project areas, such as Barrio Logan, Central Imperial, Gateway Center West, and Southcrest, no longer being viable. As indicated in the staff report, these project areas serve some of the communities that have the most need.

According to a March 8, 2010 report from the City Attorney, forgiveness of the CDBG debt owed by the Agency to the City may be legally permissible if the City Council determines that the forgiveness services a public interest. As summarized in the staff report, the public interest is served by the implementation of the redevelopment plans. Since tax increment funding is necessary to implement these plans, it would be appropriate and in the public interest to forgive the remaining CDBG and Section 108 Loan debt.

3. **Debt forgiveness would be a more efficient and effective use of resources.** If the remaining CDBG and Section 108 Loan debt is forgiven, then 100% of the remaining $144.2 million will be available for the benefit of the community through redevelopment activities. If the remaining debt is repaid, the City would be required to treat the payments as CDBG program income, and a portion of the funds would be used for administration and oversight. In addition, forgiving the remaining debt would be more efficient than trying to redirect loan repayment amounts back to the contributing project areas via the CDBG allocation process.

<u>Non-CDBG Long-Term Debt to City</u>

In addition to the $228.4 million in CDBG and Section 108 Loan debt, the Agency also holds approximately $40.2 million in other long-term debt to the City as of June 30, 2009, including principal and interest. As illustrated in the staff report, there are numerous different sources of this debt, including sales tax, capital outlay, water and sewer funds, TransNet Prop A, and General Fund allocations. Repayment of the debt in some of these categories may be used to benefit the General Fund.

It is proposed that the ability to make payments on these other debt categories be examined as part of the annual budget process and five-year financial projections for each project area. Essentially, we believe this means that non-CDBG debt will begin to be repaid immediately based on ability to pay. However, as the staff report cautions, the project areas that have higher levels of debt are those that have the least ability to pay. We recommend that the criteria and timeframe for non-CDBG debt repayment be discussed further, and that to the extent possible repayments be focused on those debt categories that may provide a benefit to the General Fund.

CONCLUSION

In accordance with the OIG recommendation in the December 2008 audit of the City's CDBG program, the City, Agency and HUD have reached an agreement regarding the repayment of CDBG funds recorded as debt from the Agency to the City. The terms of this agreement, memorialized in the CDBG Loan Repayment Agreement, include the repayment of $78.8 million from the Agency to the City over the next 10 years, and the treatment of all repayment funds by the City as CDBG program income. It is critical that the City develop a plan for the use of these funds, and establish a process for how they will be allocated.

In addition, staff is recommending the cessation of accrued interest on all Agency long-term debt to the City as of June 30, 2009, and the forgiveness of approximately $144.2 million in remaining CDBG and Section 108 Loan debt. The IBA supports these recommendations for a number of reasons, including the potential negative impact to redevelopment project areas and the more efficient and effective use of resources. In addition, we recommend further discussion of the criteria and timeframe for repayment of outstanding non-CDBG long-term debt.

[SIGNED]

Tom Haynes
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst

Attachment