United States General Accounting Office

GAO

Report to Congressional Requesters

July 1997

# HOUSING FINANCE

# Procedures and Costs for Developing San Diego Project Were Reasonable

GAO/RCED-97-190

GAO

**United States**
**General Accounting Office**
**Washington, D.C. 20548**

**Resources, Community, and**
**Economic Development Division**

B-277297

July 25, 1997

The Honorable Brian P. Bilbray
The Honorable Duncan Hunter
The Honorable Randy “Duke” Cunningham
House of Representatives

In response to allegations of mismanagement and excessive spending, you asked us to evaluate the San Diego Housing Commission’s role in developing Knox Glen Apartments, a 54-unit project consisting mainly of three- and four-bedroom town houses located on Logan Avenue in southeastern San Diego. The project, which replaced an abandoned, partially completed 116-unit complex, was financed with funds from a variety of sources, including the federal HOME and Low-Income Housing Tax Credit programs. Specifically, you asked us to evaluate (1) the process the Commission followed to develop the project, (2) the reasonableness of the project’s costs compared with the costs of other new and existing multifamily projects in the area, and (3) the impact of the project on the area’s rental housing market and supply of affordable housing. You also asked us to summarize the results of other governmental investigations of the Knox Glen project.

## Results in Brief

The process that the San Diego Housing Commission followed to develop Knox Glen Apartments was dictated, in large part, by its decision to revitalize the Logan Avenue site and by federal funding and local requirements. After purchasing the property and determining that the existing structures could not be salvaged, the Commission used HOME funds to demolish these structures and constructed new affordable housing on the site. From the start, the Commission met with neighborhood representatives, securing their approval of the project’s design and ensuring that this design met the requirements of the city and of the Low-Income Housing Tax Credit program. In addition, the Commission designated a nonprofit corporation to manage the project’s development and financing. The president of the nonprofit corporation is the Commission’s executive director, and the nonprofit corporation is staffed by Commission personnel on a cost-reimbursable basis.

Overall, the costs of developing Knox Glen Apartments were reasonable. The project’s site-specific costs were high but necessary to revitalize the Logan Avenue site. Because these costs (for acquiring the land, demolishing the existing structures, and complying with local design and zoning requirements) were high and because the project consisted mainly of large (three- and four-bedroom) units, the average per-unit cost was about $149,000. The project's per-square-foot costs above the foundation ($39.55) were about average for new construction in San Diego at the time, and the project's per-bedroom costs (about $40,300) were relatively low for the California projects that received tax credits at the same time.

The construction of Knox Glen Apartments increased the supply of affordable housing in the neighborhood without adversely affecting other rental properties in the area. All of the units at Knox Glen were rented within 2 weeks after the project was completed. An owner of three sizeable low-income properties in the area said that he lost about six families to Knox Glen, but his vacant units were quickly filled. Also, since Knox Glen was completed, a private developer began to construct 23 single-family homes for first-time home buyers across the street. According to the developer, he would not have built the project, and his bank would probably not have lent him the money for its construction, if the structures that formerly stood on the Knox Glen site had not been demolished.

Investigations by a San Diego County Grand Jury, a Select Committee of the San Diego City Council, and the Department of Housing and Urban Development's Inspector General found no abnormalities, malfeasance, or incompetence in the financing or construction of Knox Glen as a low-income housing project.

## Background

The HOME program, created under title II of the National Affordable Housing Act of 1990, makes funding available to state and local governments to develop and support affordable housing for low- and very low income households.[1] Eligible activities include assistance to qualified tenants, home buyers, and homeowners; property acquisition; new construction; rehabilitation; demolition; loan guarantees; and other expenses related to the development of nonluxury housing. The program's funding—an account with a line of credit—is allocated by formula to participating jurisdictions.

The Low-Income Housing Tax Credit program, created under the Tax Reform Act of 1986, substituted tax credits for existing tax incentives for the construction of low-income housing, such as accelerated depreciation.

[1]"Low-income" is generally defined as 80 percent or less of the median income for the area. "Very low income" is defined as 50 percent or less of the area's median income, adjusted for family size.

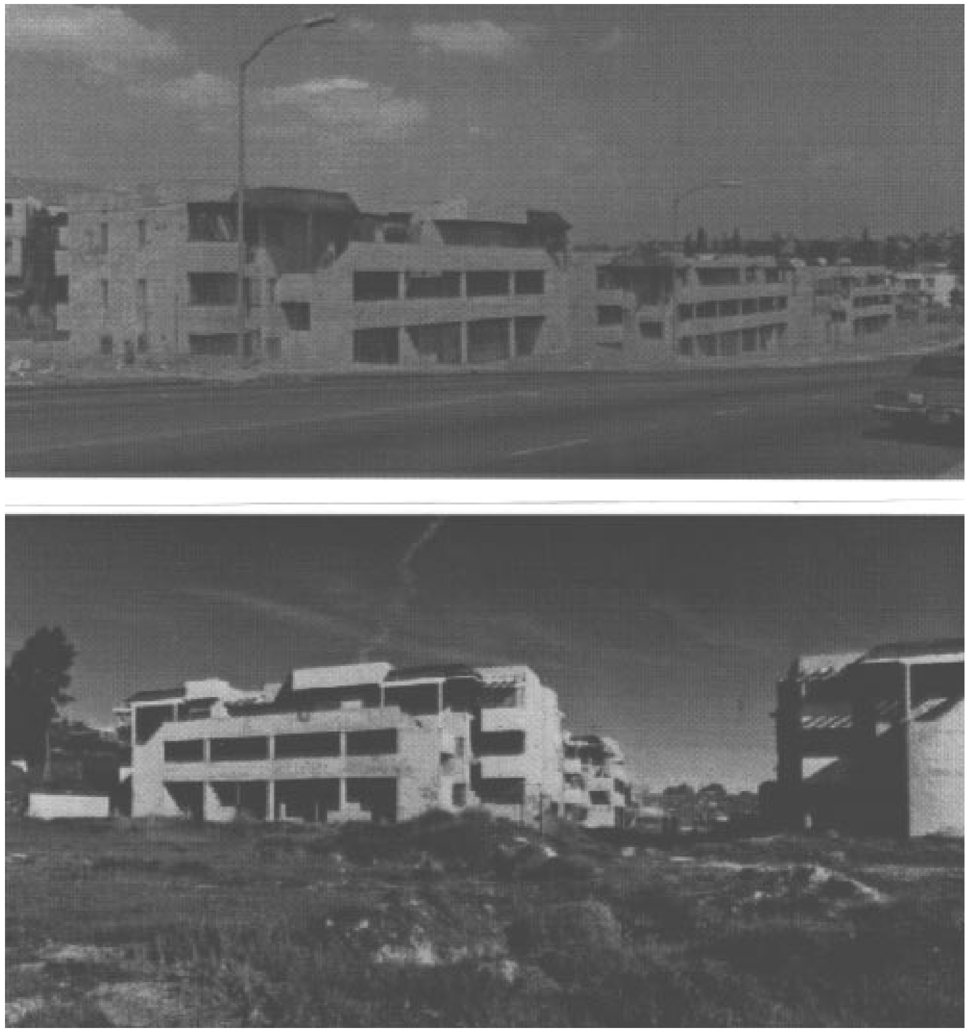
Under this program, an agency in each state administers the state's tax credit allocation, and for-profit or nonprofit developers build affordable housing projects. The California Tax Credit Allocation Committee administers California's tax credit allocation.

The Internal Revenue Code requires each state tax credit allocating agency to evaluate proposed projects against a qualified allocation plan that establishes a procedure for ranking the projects on the basis of how well they meet the state's identified housing priorities and are appropriate to local conditions. The Code further directs each state agency to consider the reasonableness of a project's development and operating costs.

The San Diego Housing Commission (Commission) is an independent, tax-exempt public organization created by the San Diego City Council in 1979 to advise the city on housing issues and to administer affordable housing programs. The City Council, which serves as the city's Housing Authority, reviews and approves all of the Commission's activities and programs. In 1990, the Commission created the San Diego Housing Development Corporation (Corporation), a nonprofit organization authorized to act as the general partner for tax credit projects. The executive director of the Commission is the president of the Corporation, and the same general counsel served both entities through the project's construction. The Commission provides staff and services to the Corporation on a cost-reimbursable basis.

The Commission became involved in the Knox Glen project in late 1992, after the mayor and a city council member asked the Commission to purchase the abandoned property on Logan Avenue known as Greentree Plaza. This 3.2-acre property included 116 apartment units in six buildings that were 65 percent complete when the builder declared bankruptcy in 1987. In 1988, the Federal Deposit Insurance Corporation (FDIC) took over the property, boarded up the abandoned buildings, constructed security fences, and periodically provided security guards. Despite these precautions, the property became an "eyesore" and a hangout for gangs, and was plagued with arson, trespassing, and vandalism. (See fig. 1.)

Figure 1: Greentree Plaza



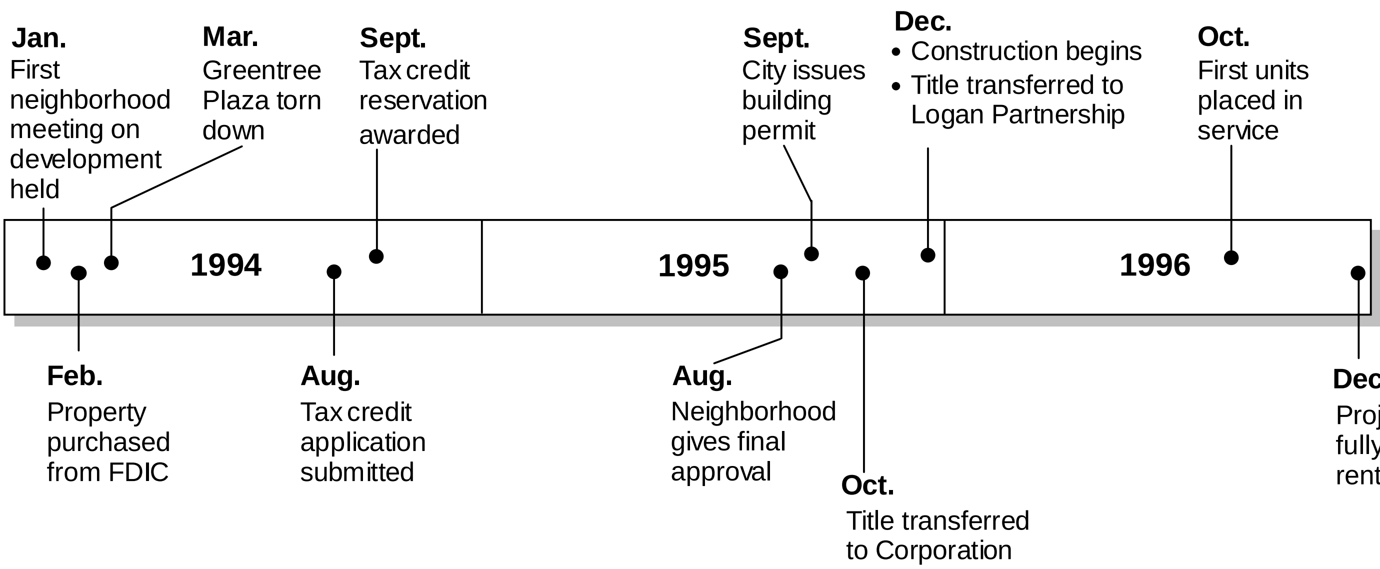
Greentree Plaza was located in the Lincoln Park section of southeastern San Diego, which an appraiser described in August 1995 as one of the "least desirable neighborhoods in the city." The average household income in the neighborhood is two-thirds of the citywide average, and the rate of violent crime is nearly twice the citywide rate. The Lincoln Park neighborhood is also the most densely populated in southeastern San Diego, averaging about 17 dwelling units per acre.

The neighborhood had opposed Greentree Plaza from the start, because of its density and appearance. After the developer declared bankruptcy, the city responded to these concerns by issuing new zoning and design regulations for an area that it designated at this time as the Southeast San Diego Planned District. The new zoning regulations, adopted in July 1987, lowered the allowable number of units per acre for the property from 29.04 to 17.42. The new design regulations, which applied to everything from parking to facade design, set standards for constructing or altering residential, commercial, and industrial property in the planned district. Added in August 1987, the new design regulations increased the San Diego municipal code by 42 pages.

## Development Process Was Reasonable Given Commission's Decisions

The process that the Commission followed to develop Knox Glen Apartments was largely dictated by its decision to revitalize the Logan Avenue site and by federal funding and local planning requirements. The Commission's involvement in the process consisted primarily of meeting with neighborhood representatives to develop a plan for the project and using the nonprofit Corporation to manage the project. Figure 2 identifies the principal steps in the development process.

**Figure 2: Stages in Knox Glen's Development**




## Commission Designed Project With Neighborhood Input

The Commission first met with neighborhood representatives after the Mayor's June 1992 press conference to discuss whether Greentree Plaza should be completed or demolished. The meetings confirmed the neighborhood's opposition to completing the development.

According to the Commission's executive director, FDIC had maintained that Greentree Plaza could be completed and rented and was asking $2.45 million for the property. However, several developers had inspected the development and concluded that it was beyond repair. Eventually, the Commission negotiated a purchase price of $700,000 with FDIC and bought the property in February 1994. The Commission first met with neighborhood representatives to discuss the development of a new project in January 1994.

In March 1994, the Commission demolished Greentree Plaza. To do so, it used HOME funds, the only funds available for demolition, according to the Commission. Because the HOME program provides funding only for activities related to the development of nonluxury housing, the Commission's use of HOME funds for demolition was consistent with its commitment to construct new affordable housing at the site.

Through additional meetings with community groups and in-house discussions, the Commission produced a development plan for the Logan Avenue site. This plan served as the basis of the application for tax credits. The plan provided for 55 units, primarily with three or four bedrooms to accommodate larger households. (See app. I, tables I.1 and I.2.) The plan also included recreation areas, space for community activities, and other amenities desired by the neighborhood.

To finance the project, the development plan proposed to combine tax credits with HOME funds, a low-interest community development loan, a commercial loan, and a deferred loan from the developer (see app. I, table I.3). On August 1, 1994, the Commission submitted its application for tax credits to the California Tax Credit Allocation Committee. The Committee evaluated this application against the Low-Income Housing Tax Credit program's criteria, determined that the project was eligible for tax credits, and awarded points for specific features. In total, the project received 105 points—ultimately the cut-off score required to qualify it for tax credits at the time. The project received 35 points for targeting lower-income households (see app. I, table I.4), 25 points for agreeing to serve these households for 55 years, 15 points for serving large families, 25 points for the amount of equity invested by owners in the project, and 5 points for providing special amenities, including a community center. In September 1994, the California Tax Credit Allocation Committee approved the Commission's application for tax credits and reserved tax credits for the project.

After receiving the tax credit reservation, the Commission continued to meet with neighborhood representatives to secure their approval of the project's design. The city of San Diego requires proof of the neighborhood's approval before it will issue a permit for a project's development. In addition, the Low-Income Housing Tax Credit program requires certification that a project has obtained all necessary state and local approvals before construction can begin. In August 1995, a task force of volunteers representing key neighborhood organizations approved the project's design, and in September 1995, the city approved a permit for the project's development.

The meetings with neighborhood representatives to obtain their approval took about 4 months longer than planned. These meetings were time-consuming because the Lincoln Park neighborhood did not want a repeat of its experiences with the Greentree Plaza development. For the new development, the neighborhood wanted the least dense, most aesthetically pleasing complex possible. For example, the neighborhood held the Commission to a strict interpretation of the 1987 zoning limits, negotiating a 1-unit reduction in the original plan for 55 units. At times, the neighborhood also emphasized aesthetics over costs. For example, the neighborhood insisted that barrel-vaulted roofs be designed into the structure in order to vary the roof lines. Community leaders believed that such a visually pleasing design would make the development stand out as well as eliminate any reference in appearance to Greentree Plaza.

## Commission Chose to Designate the Project's Developer

In October 1995, the Commission transferred the title to the Logan Avenue property, along with the tax credit allocation and the project's debt, to the San Diego Housing Development Corporation. To create the legal entity necessary to develop the project and obtain the necessary financing, the Corporation created the Logan Development Limited Partnership (Partnership) and transferred the project's title to the Partnership on December 1, 1995. The Corporation acts as the general partner and holds a 1-percent ownership share. Under this arrangement, the Corporation retains control of the project, and the other partners provide the equity funds to develop the project.

Instead of transferring the project's title to the Corporation and creating the Partnership, the Commission could have solicited proposals from existing nonprofit developers and awarded the project to the most qualified bidder. According to the agendas for the Commission's August and September 1995 meetings, the Commission considered this alternative. However, according to the agendas, a solicitation could have caused a delay that could have resulted in the loss of tax credits and required a reapplication in December 1995.

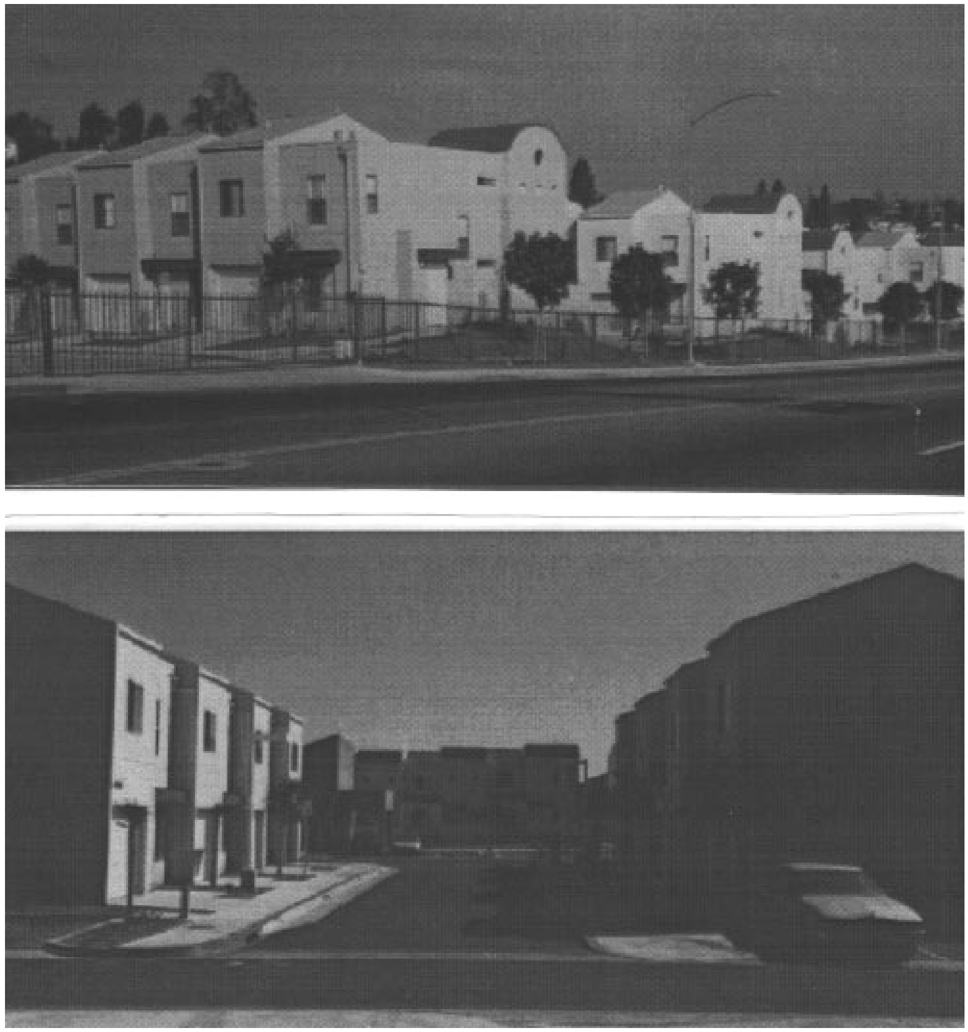
The directors of two San Diego community development corporations with experience in developing tax credit projects agreed that a delay could have resulted from soliciting bids in August 1995. They added, however, that the Commission could have solicited bids before the tax credits were awarded, and the chosen developer would then have negotiated the project's design with the neighborhood and finalized the development plan. According to both directors and the executive director of the San Diego County Apartment Association, the underlying issue is one of policy—whether a corporation established by a government entity with ties to that entity should be in the development business and whether such a corporation can build as efficiently as the private sector.[2]

The directors of the two San Diego community development corporations also expressed concern about the organizational links between the Commission and the Corporation. The directors noted that if the Commission were to solicit bids in the future, their organizations would have difficulty competing with the Corporation because the Corporation has direct ties to the Commission.

The first residents moved to Knox Glen in late October 1996, and all of the units were rented before the end of the year. (See fig. 3.) Forty percent of the residents moved from within 2 miles of the project, and the average distance moved was 4 miles. As of March 1997, 88 adults, 123 minors, and a resident manager were living in the 54 units, paying monthly rents ranging from $486 to $753 (see app. I, table I.5).

[2]A reference to the San Diego Housing Development Corporation's role in the project's development, appearing in the agenda for the Commission's July 18, 1994, meeting, seems to confirm the directors' position that the Corporation's participation was more a matter of policy than an action required to avoid delays. According to the agenda, the development plan recommended as the basis for the application for tax credits provides for ownership of the project "by a limited partnership, of which the San Diego Housing Development Corporation (SDHDC) would serve as general partner, . . . with development by the Commission on behalf of SDHDC."

Figure 3: Knox Glen



## Costs of Project Were Reasonable, Given Its Location

The costs of developing Knox Glen Apartments were reasonable, given the Commission's decision to revitalize the Logan Avenue site. This decision entailed high site-specific costs; however, when these costs are excluded, the project's costs are reasonable compared with those of other San Diego properties constructed at the time and of other California properties that received tax credits at the time. The Commission could have saved money by building new housing or rehabilitating existing housing elsewhere in the city, but it could not then have revitalized the Logan Avenue site.

## Site-Specific Requirements Increased Project's Costs

A project's development costs are usually closely linked to the project's location. Knox Glen's location—in an area affected by a community plan and a planned district ordinance with strict controls over the design of amenities—contributed substantially to its costs. Moreover, the costs of construction in San Diego are among the highest in California, and the costs of construction in California are among the highest in the nation.

Knox Glen incurred site-specific costs that accounted for over 25 percent of its total development costs of about $149,000 per unit. These included the costs of acquiring land and demolishing Greentree Plaza, of meeting the planned district's special design requirements, and of complying with the municipal building code and other city requirements. For example, the planned district requires covered off-street parking for at least 50 percent of a project's parking spaces and at least 200 square feet of exterior usable open space for each unit. For aesthetic reasons, the district also requires that structures be built with offsetting variations in a minimum of three vertical or horizontal planes. These requirements added substantially to Knox Glen's costs, as table 1 indicates.

**Table 1: Knox Glen's Site-Specific Costs**

| | Site-specific costs | | |
|---|---|---|---|
| **Cost category** | **Total** | **Per unit** | **Per bedroom** |
| Land acquisition | $807,800 | $14,960 | $4,840 |
| Demolition | $155,600 | $2,880 | $930 |
| Off-street parking and access[a] | $793,800 | $14,700 | $4,750 |
| Exterior usable open areas[a] | $38,850 | $720 | $230 |
| Offsetting planes requirement[a] | $154,000 | $2,850 | $920 |
| Off-site work[c] | $69,900 | $1,290 | $420 |
| Fire protection[b] | $65,650 | $1,220 | $390 |
| One-time school fee[d] | $109,520 | $2,030 | $660 |
| **Total** | **$2,195,120** | **$40,650** | **$13,140** |

[a]San Diego Municipal Code requirement for planned district.

[b]Uniform Fire Code and the City of San Diego Fire Department requirements and ordinances

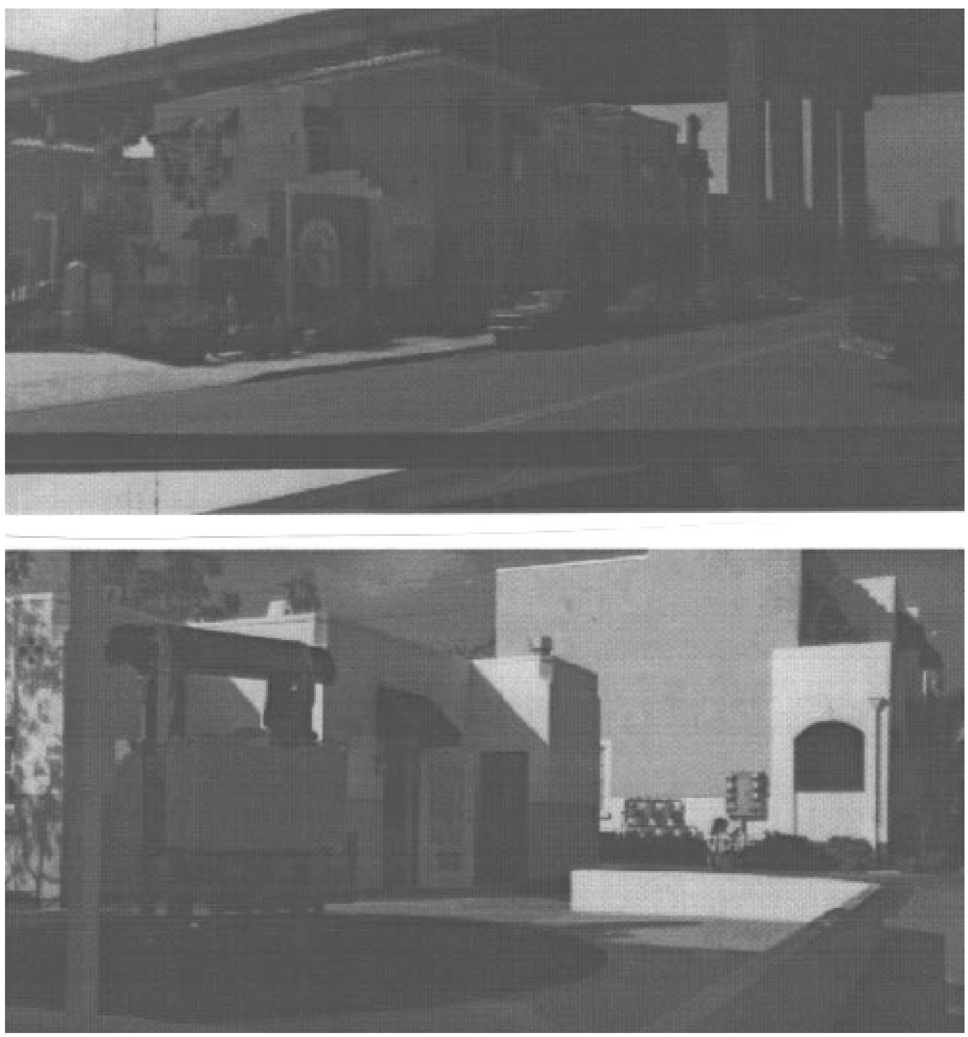
[c]San Diego Uniform Building Code, Uniform Fire Code, City of San Diego Municipal Code, Metropolitan Transit District Board Requirements, and Southeast Planned District Ordinance.

[d]San Diego school district assessment.

Source: San Diego Housing Commission.

We compared Knox Glen's site-specific costs with those of the Mercado Apartments, another family-oriented San Diego tax credit project that opened in June 1994, about 2-1/2 years before Knox Glen. This project—consisting of 18 one-bedroom, 60 two-bedroom, and 66 three-bedroom apartments; a community room; and a playground area—won a number of awards and has been cited as the tax credit project with the lowest per-unit costs in the city (about $92,000 per unit). (See fig. 4.)

**Figure 4: The Mercado Apartments**



Although the Mercado incurred substantial site-specific costs, it was generally subject to less restrictive and less costly requirements than Knox Glen. Located in a different section of San Diego, the Mercado's site was zoned to allow denser, less costly development. Additionally, the Mercado did not have to comply with the planned district's special design requirements. And because the Mercado is situated close to a trolley line, it did not have to provide covered parking spaces or as many parking spaces per unit as Knox Glen. However, the Mercado incurred its own costs for off-site improvements and for environmental remediation, which alone amounted to about $200,000. Overall, Knox Glen's site-specific costs were higher than the Mercado's—a difference that accounts for a significant portion of the difference in the two projects' per-unit costs.

## Construction Costs Were About Average

Because the costs of development often vary from site to site, much as the costs of developing Knox Glen and the Mercado varied, developers do not consider projects' total development costs comparable. Instead, they compare the per-square-foot costs of construction above the foundation. The specialist assigned by the Commission to oversee Knox Glen's construction for the Corporation surveyed a number of San Diego real estate developers in August 1996 to compare Knox Glen's estimated costs with those of other multifamily housing projects under construction at the same time. His survey revealed that Knox Glen's above-foundation construction cost of $39.55 per square foot was just below the average for nine projects, whose above-foundation construction costs ranged from $34 to $45 per square foot. (See table 2.)

**Table 2: Above-Foundation Costs Per Square Foot for Attached Multifamily Housing in San Diego, August 1996**

| Location of development | Number of units | Cost per square foot (above foundation) |
|---|---:|---:|
| South County | 230 | $45.00 |
| Poway | 249 | $42.50 |
| Rancho San Diego | [a] | $41.00 |
| Chula Vista | 135 | $40.00 |
| Middletown | 36 | $40.00 |
| Southeast San Diego | 15 | $40.00 |
| East County | 15 | $40.00 |
| Knox Glen | 54 | $39.55 |
| North County | 344 | $34.00 |

[a]Not available.

Source: San Diego Housing Commission.

The Mercado's above-foundation cost of about $37 per square foot is not significantly lower than Knox Glen's, given that the Mercado was constructed about 2-1/2 years earlier. In 1997, the same community development corporation that built the Mercado proposed a new 138-unit tax credit project, to be designed along the same lines as the Mercado. The estimated cost of this project is about $39.50 per square foot above the foundation.

## California's Costs Are Among the Highest in the Nation

High land and construction costs, stringent seismic standards, and other factors make California's tax credit projects among the costliest in the nation. In addition, in 1994, when the Commission applied for tax credits, the California Tax Credit Allocation Committee had not yet adopted the per-unit cost limits established by the Department of Housing and Urban Development (HUD) for nonluxury multifamily housing projects participating in its 221(d)(3) mortgage insurance program.[3] Before the Committee adopted HUD's 221(d)(3) limits in 1996, the costs for construction financing and various fees had escalated throughout the state. After the Committee adopted HUD's limits, these costs reportedly declined by 12 percent. Knox Glen received tax credits 2 years before the Committee adopted HUD's limits.

Compared with the costs of the other California properties that received tax credits at the same time, Knox Glen's costs were reasonable. Of the 30 projects—most of which were located in San Francisco, Los Angeles, or Sacramento—Knox Glen was the tenth lowest in eligible costs per bedroom. Eligible costs, computed on the eligible basis for tax credit projects, include the costs of new construction, the developer's costs, and various fees; they exclude the costs of land, permanent financing, rent reserves, syndication, and marketing (see app. I, table I.6). Knox Glen's eligible costs per bedroom were about $40,300.

## Commission Implemented Some but Not All Cost-Saving Measures

While reasonable, Knox Glen's costs were not as low as they might have been. As noted, the project's design included certain features desired by the neighborhood, and the Commission retained these features to secure

[3]This program is designed to establish maximum per-unit cost limits equivalent to the costs of constructing nonluxury multifamily housing projects for different areas within each state. Initially set by the Congress in legislation, the limits are adjusted annually by HUD to reflect changes in construction costs. The limits also reflect differences in housing characteristics, such as the presence or absence of elevators.

the neighborhood's approval of the project's design. In addition, the project included some amenities that were not required to satisfy code requirements but were necessary to enable the project to compete for tax credits.

To accommodate the neighborhood's preference for a low-density development, the Commission did not take advantage of a density waiver for affordable housing that would have allowed 69 units to be built on the property.[4] The waiver would have reduced the project's per-unit costs by spreading some general costs over more units, but it would not have permitted the construction of the town houses desired by the neighborhood.

Before starting to construct the project, the Corporation, architect, and contractor performed a value engineering study, which recommended a number of design changes to control costs. The Corporation chose to implement most of the study's recommendations. For example, the Corporation deleted skylights and glass from garage doors and installed less expensive doors, door hinges, drainage systems, and landscaping. The Corporation did not, however, substitute lower-cost roof facades or traditional pitched roofs with asphalt shingles for the barrel-vaulted roofs preferred by the neighborhood.

According to the project's construction specialist, the Corporation would have saved over $1,000 per unit if it had chosen the traditional pitched roofs with asphalt shingles, but the community insisted on "a design that would be more reflective of a single-family home with an evident quality of design." He said that the community chose the barrel-vaulted design to make the development stand out visually and aesthetically, as well as to eliminate any reference in appearance to Greentree Plaza. He added, however, that the final barrel-vaulted design represented a compromise with the local housing groups, which had originally advocated even larger and costlier vaulted roofs. In addition, he noted that the barrel-vaulted roofs are expected to last for the full 55 years that California tax credit projects are required to operate under restricted rents to serve low-income residents, whereas traditional shingle roofs require replacement every 10 to 12 years, making the ultimate cost differential negligible.

Another design feature that was not required by the tax credit program's or by state or local regulations but was requested by the neighborhood for

[4]The city of San Diego had already maintained that the new zoning limit of 17.42 units per acre should be rounded down to 17 before being multiplied by the project's acreage (3.2 acres)—an interpretation of the zoning ordinance that limited the project to 54.4 units rather than 55.7 units.

security reasons was a gated enclosure, which added almost $1,300 per unit to the project's costs. In addition, according to the project's construction specialist, the project received upgraded plumbing fixtures and flooring material to reduce its long-term maintenance costs.

The inclusion of a community center (see fig. 5) added to the project's costs. However, according to Commission officials, the project would not have qualified for tax credits without the points awarded for the center, and without tax credits, the project could not have been built.

**Figure 5: Knox Glen Neighborhood Center**

## Other Options Might Have Lowered Costs but Not Revitalized Neighborhood

Purchasing an existing apartment complex would likely have been cheaper than building Knox Glen Apartments. Other apartment complexes were available in the San Diego area when the Knox Glen project was being planned. Because many owners of multifamily properties were unable to refinance mortgage loans with high interest rates or to increase rents to cover costs, a number of properties were liquidated at very low prices. According to the San Diego County Apartment Association, some sold for as little as 40 to 70 percent of their replacement costs. But few of these apartment complexes consisted primarily of three- and four-bedroom units. Converting these properties would have increased the city's supply of affordable housing at less cost per unit than constructing Knox Glen; however, it would have provided fewer three- and four-bedroom units, and it would not have helped to revitalize the Lincoln Park neighborhood.

## Project Has Had a Positive Impact

Since it was placed in service, Knox Glen has not adversely affected other rental properties in the area, and it has stimulated new development.

The demand for affordable rental housing in San Diego is so great that new construction in almost any neighborhood is unlikely to harm existing rental properties. According to the city's consolidated plan for fiscal year 1997,[5] San Diego will need approximately 17,520 new housing units for additional low-income households during the next 5 years. Because the city's housing costs have increased much more rapidly than incomes, the report says, San Diego is now among the least affordable cities in the nation. Nearly 107,000 households with very low and low incomes pay 30 percent or more of their incomes for rent, and over 31,000 families are on the Commission's waiting list for rental assistance.

Given these figures, it is not surprising that Knox Glen's units were rented within days after they were completed. According to the property's rental agent, over 950 applications were received and about half of the applicants met the project's income guidelines. At the time of our visit, over 200 families were on the waiting list to apply for apartments that might become vacant.

We asked the owner of three sizeable low-income properties in the area whether he was concerned about the impact of Knox Glen on his business. He said he lost about six families to Knox Glen because it is new, has garages, and has somewhat lower rents. He added that he is not concerned because he had no difficulty replacing the families he lost.

Knox Glen's construction has already stimulated new development. Directly across the street, a private subdivision of 23 single-family detached homes is being built. According to the developer, the project's goal is to help revitalize the neighborhood by building affordable homes for first-time home buyers. The developer emphasized that he would not have built the project—and his bank would probably not have lent him the money for its construction—if the partially completed property that once stood on Knox Glen's site had not been removed.

[5]The consolidated plan is produced annually by an interagency working committee led by the San Diego Housing Commission. The plan replaces HUD's prior planning and application requirements with a single submission and satisfies the regulatory requirements for HUD's four formula programs: Community Development Block Grants (CDBG), HOME Investment Partnership (HOME), Emergency Shelter Grant, and Housing Opportunities for Persons With AIDS. Developing the plan gives the city an opportunity to shape its publicly supported programs into a coordinated housing and community development strategy.

## Prior Studies Did Not Find Serious Problems at Knox Glen

A 1994-95 grand jury investigation, a 1996 report by a housing subcommittee of the Select Committee on Government Efficiency and Fiscal Reform, and a 1997 report by HUD's Inspector General examined different aspects of the Commission's affordable housing portfolio. None of these reports found any abnormalities, malfeasance, or incompetence in the financing or construction of Knox Glen as a low-income housing project.

After examining the Commission's management and lending practices, the grand jury reported 18 findings and recommendations in 1995. It did not mention Knox Glen specifically in the report, although two of the management recommendations address issues raised by critics of Knox Glen's development.

The first recommendation called for a "total project" feasibility study to be submitted with the request to approve the funding for a housing project's development or rehabilitation. The Low-Income Housing Tax Credit program already requires three feasibility analyses for most tax credit projects—the first at the time of the preliminary reservation, the second if a carryover allocation is made, and the third when the project is placed in service. These three feasibility analyses were performed for Knox Glen.

The second recommendation called for the Commission to amend its underwriting criteria so that the allocation of funds or financing does not exceed a total of 90 percent of a property's appraised or market value. Under such amended criteria, the Commission would not have been able to fund Knox Glen—or to participate in most low-income housing tax credit deals. Under the Low-Income Housing Tax Credit program, the appraisal calculates the market value of a property using the restricted rents required for low-income households; therefore, the appraised value will typically be lower than the cost of construction.

The housing subcommittee followed up on the grand jury's work and examined Knox Glen as a case study. The subcommittee's report, released in October 1996, did not include the Knox Glen case study. Our review of the unpublished case study showed that the cost figures obtained by the subcommittee were very similar to the project's preliminary cost estimates.

In January 1997, HUD's Inspector General investigated allegations of possible noncompliance with HUD's regulations as well as excessive costs in developing Knox Glen. The Inspector General found no evidence of illegal acts or violations of HUD's regulations. Furthermore, the Inspector General concluded that the reasons for the project's costs appeared to be valid.

## Agency Comments

We provided copies of a draft of this report to the San Diego Housing Commission for its review and comment. We spoke with Commission officials, including the assistant to the executive director, the senior housing construction specialist, and the financial specialist for the Knox Glen project. The Commission commented that the draft was a well-researched and balanced presentation of the facts, and it agreed with the overall conclusions.

The Commission also further clarified its decision not to solicit bids from existing nonprofit developers. The Commission commented that the qualified nonprofit organizations were fully occupied with other projects in early 1994 when the property was purchased from FDIC and the negotiations with community groups began. According to the Commission, this factor weighed heavily in its decision to have the Corporation act as the general partner in the development of Knox Glen Apartments. We agree that the qualified nonprofit organizations were busy completing tax credit projects at the time the property was purchased. However, the question whether a nonprofit corporation established by a government entity with ties to that entity should be in the development business remains an open issue. The Commission also provided technical comments to improve the accuracy of the report, which we incorporated where appropriate.

## Scope and Methodology

We met with officials of the California Tax Credit Allocation Committee, the San Diego Housing Commission, the San Diego Housing Development Corporation, and the County Apartment Association. We also interviewed officials from HUD's San Diego office and from local community development corporations, as well as private developers and interested members of the public. In addition, we reviewed federal, state, and local program regulations and ordinances; files on the Knox Glen project; and reports of the grand jury, the San Diego housing subcommittee, and HUD's Inspector General. We conducted our review from March through June 1997 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the appropriate congressional committees; the Executive Director, San Diego Housing Commission; the Director, Office of Management and Budget; and other interested parties. We will make copies available to others upon request.

Please call me at (202) 512-7632 if you or your staff have any questions. Major contributors to this report are listed in appendix II.

Judy A. England-Joseph
Director, Housing and Community
Development Issues

# Contents



**Abbreviations**

| | |
|---|---|
| FDIC | Federal Deposit Insurance Corporation |
| SDHDC | San Diego Housing Development Corporation |
| HUD | Department of Housing and Urban Development |
| CDBG | Community Development Block Grants |

# Project's Characteristics and Funding

Knox Glen is a 54-unit complex consisting mainly of two-story town houses. It includes 9 two-bedroom units, 31 three-bedroom units, and 14 four-bedroom units. The average number of bedrooms is three. (see table I.1.)

**Table I.1: Size of Knox Glen's Units, by Number of Bedrooms**

| Size of unit, by number of bedrooms | Number of units | Total number of bedrooms |
|---|---|---|
| Two-bedroom | 9 | 18 |
| Three-bedroom | 31 | 93 |
| Four-bedroom | 14 | 56 |
| **Total** | **54** | **167** |

Source: Rent roll for Knox Glen Apartments, dated Mar. 7, 1997.

In addition to three- and four-bedroom town house units, Knox Glen contains 12 apartment flats. The six ground floor units are fully accessible for persons with impaired physical mobility. The size of the units varies from 678 square feet for a two-bedroom apartment flat to 1,383 square feet for a four-bedroom town house. (See table I.2.)

**Table I.2: Characteristics of Knox Glen's Units, by Number of Bedrooms, Type of Unit, and Square Footage**

| Size of unit, by number of bedrooms | Type of unit | Number of units | Number of square feet per unit | Total square footage |
|---|---|---|---|---|
| **Two-bedroom** | | | | |
| | Flat | 4 | 678 | 2,712 |
| | Flat | 5 | 711 | 3,555 |
| **Three-bedroom** | | | | |
| | Flat | 3 | 855 | 2,565 |
| | Town house | 14 | 1,197 | 16,758 |
| | Town house | 14 | 1,214 | 16,996 |
| **Four-bedroom** | | | | |
| | Town house | 14 | 1,383 | 19,362 |
| | | | | |
| **Total** | | **54** | | **61,948** |

Source: Rent roll for Knox Glen Apartments, dated Mar. 7, 1997, and Independent Auditor's Report, Dec. 23, 1996.

Knox Glen's development was financed with funds from a number of private and public sources. The first mortgage accounted for less than 25 percent of the total funding, while the proceeds from the syndication of the tax credits accounted for approximately 50 percent of the total funding. The public subsidies enable the development to charge rents that are comparatively affordable to low-income tenants. (See table I.3.)

**Table I.3: Sources of Funds Used to Finance Knox Glen's Development**

| Source of funds | Amount of funds |
|---|---|
| Tax credit proceeds | $4,066,907 |
| HUD-HOME funds | 1,399,000 |
| Community Redevelopment Agency of San Diego | 150,000 |
| American Savings Bank, including a $250,000 Affordable Housing Program award[a] | 1,795,000 |
| Developer fee note | 619,059 |
| **Total** | **$8,029,966** |

[a]The project received this award after the tax credit award.

Source: California Tax Credit Allocation Committee, final cost certification, Dec. 23, 1996.

All of Knox Glen's units are targeted to low-income households: 22 units are targeted to households with incomes at or below 50 percent of the area's median income (AMI), adjusted for household size, and 32 units are targeted to households with incomes at or below 60 percent of AMI, adjusted for household size. (See table I.4.)

**Table I.4: Household Income Levels Targeted at Knox Glen**

| Size of unit, by number of bedrooms | Household income level targeted, by number of units | | Total number of units |
|---|---|---|---|
| | 50 percent of AMI[a] | 60 percent of AMI[a] | |
| Two-bedroom | 9 | 0 | 9 |
| Three-bedroom | 7 | 24 | 31 |
| Four-bedroom | 6 | 8 | 14 |
| **Total** | **22** | **32** | **54** |

[a]Area median income, adjusted by household size.

Source: Rent roll for Knox Glen Apartments, dated Mar. 7, 1997.

Knox Glen's rents are lower than the maximum rents allowed under the section 8 rental assistance program, another program used by Department of Housing and Urban Development (HUD) to make rents more affordable to lower-income households. The primary reasons that Knox Glen can charge lower rents is the funding provided by the Low-Income Housing Tax Credit, as well as the other public and private subsidized financing provided to the Knox Glen development. (See table I.5.)

**Table I.5: Comparison of Knox Glen's Rents With the Maximum Rents Allowed Under HUD's Section 8 Program**

| Size of unit, by number of bedrooms | Number of units[a] | Monthly rent charged | Fair market rent ceiling for section 8 rental assistance[b] |
|---|---|---|---|
| Two-bedroom | | | |
| | 9 | 486 | 682 |
| Three-bedroom | | | |
| | 7 | 558[c] | |
| | 23 | 678[d] | 947 |
| Four-bedroom | | | |
| | 6 | 618[c] | |
| | 8 | 753[d] | 1,118 |

[a]Because no rent is charged for the three-bedroom unit occupied by the resident manager, only 53 units are included in this table.

[b]Figures obtained from a San Diego Housing Commission letter dated Mar. 18, 1997.

[c]Rents charged to households with incomes at or below 50 percent of the area's median income.

[d]Rents charged to households with incomes at or below 60 percent of the area's median income.

Source: Rent roll for Knox Glen Apartments, dated Mar. 7, 1997.

Table I.6 identifies Knox Glen's total development costs, by major cost category. It also indicates which of these costs are counted as part of the eligible basis for the Low-Income Housing Tax Credit program. Because of its location in a low-income neighborhood, Knox Glen was eligible to increase its tax credit eligible basis by 30 percent.

**Table I.6: Total Development Costs and Tax Credit Eligible Basis for Knox Glen Apartments, by Major Cost Categories**

| Cost category | Development cost | Tax credit eligible basis |
|---|---:|---:|
| Land | $970,585 | $0 |
| New construction | 5,019,186 | 5,019,186 |
| Architectural fees | 250,914 | 250,914 |
| Construction interest and fees | 115,179 | 115,179 |
| Permanent financing | 36,763 | 0 |
| Legal fees | 9,625 | 9,625 |
| Reserves | 234,000 | 0 |
| Other | 485,456 | 424,733 |
| Developer's costs[a] | 908,258 | 908,258 |
| **Total uses of funds** | **$8,029,966** | **$6,727,895** |

[a]Includes the developer's overhead and profit, as well as fees for consultants and processing.

Source: California Tax Credit Allocation Committee, final cost certification, Dec. 23, 1996.

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