California Energy Commission

CONSULTANT REPORT

City of Richmond Social Impact Bond Manual (Abridged)

For the City of Richmond Advanced Energy Community
EPC-15-076

Subtask 2.2 Plan and Permit Large-Scale ZNE

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ABSTRACT

A large number of abandoned and blighted homes in the City of Richmond, California create significant problems for the city and its inhabitants. Funded through a Social Impact Bond, the Richmond Housing Renovation Program (the Program) remedies this problem by acquiring these properties, rehabilitating them and selling them to low-income families at fair market value. To increase local homeownership rates, SparkPoint graduates are given the first opportunity to purchase rehabilitated houses from the Program as preferred buyers. The rehabilitation of the houses is performed by local contractors. The contractors have agreed to hire from the City's Richmond Build Academy, a job training program for the building trades. The unique part of this program is its funding mechanism: Social Impact Bonds funded by private investors.

The City of Richmond Advanced Energy Community grant from the Energy Commission in 2016 and 2017 has funded the technical support for exploring the potential of adding Zero Net Energy technologies to the construction and renovation of the homes through this existing program. The incremental costs of the new technologies are covered by the Social Impact Bond, and in the case of solar, systems are funded in part by a statewide program, Grid Alternatives. This environmentally-driven layer adds to the social and economic sustainability approach of the Social Impact Bond, to create a full triple bottom line opportunity.

This document provides the background on the development and implementation of the first-of-its kind Social Impact Bond in Richmond, supplementing the financial model of administrative documents (found in the Appendix), to inform the creation of other similar Social Impact Bonds through the state of California, and the nation.

Keywords: California Energy Commission, Social Impact Bond, City of Richmond, Zero Net Energy, Homeownership, SparkPoint, The Richmond Housing Renovation Program, triple bottom line

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CHAPTER 1: Introduction

Background: The Challenges

When planning for the Richmond Housing Renovation Program began, the City of Richmond contained some 1,000 blighted properties, of which 150-200 are blighted single-family units that the city was maintaining. This blight placed at risk neighborhood-level economic, social, and environmental conditions; perpetuated low property values; and impeded private investment.

The tax delinquencies on these properties was eroding the city's tax base and the city was incurring significant police and code enforcement costs. Property taxes, assessments, parcel taxes, bond issues and solid waste disposal bills all go unpaid, costing the City, County, School District and special districts millions of dollars in revenue. Blight also prevents private investment in neighborhoods because it undermines the value of real estate. Blighted properties also cost the City of Richmond an average of $7,000 annually per house to maintain the homes in blighted condition, for cutting weeds, boarding up windows and removing items that are illegally dumped at the properties.

Blighted, abandoned, and vacant properties also pose significant risks to the welfare of residents. These properties depress property values, degrade neighborhoods, and attract squatters and drug dealers. According to the Richmond Police Department the types of crime that typically affect blighted neighborhoods in the city are burglary, drugs, prostitution, trespassing and vandalism. The department found that the number of responses to and incidents of each of these types of crimes is likely to increase due to the presence of blighted properties in the neighborhood. These types of crimes are consistent with those identified in Vacant Properties: The True Costs to Communities by the National Vacant Properties Campaign in 2005.

Background: The Opportunity

The Richmond Housing Renovation Program's intervention strives to reduce the incidence of vacant and blighted single-family houses in vulnerable low-income neighborhoods of Richmond, California. The program came about because of three intersecting events.

The first took place at the Richmond Community Foundation's (RCF) Annual Summit in 2015. The concept of social impact bonds and pay for success models was the focus of several sessions; and the concepts generated a lot of interest. Second, the City of Richmond's bi-annual survey lifted up housing blight as one of the most important issues impacting local residents. Third, SparkPoint Contra Costa, our local financial services collaborative, was experiencing significant challenges in helping its first-time homebuyers purchase a home. While SparkPoint buyers could qualify for the mortgage at the list prices, they could not compete with cash and other investment buyers who were bidding up the prices of the homes. Of the 100 qualified buyers graduate each year from the SparkPoint program, only 2% of graduates had been able to purchase homes in the current market.

The RCF and the City of Richmond, with the key support of John Knox, the city's bond attorney and partner with Orrick Herrington Sutcliff, brought together key stakeholders to create new strategies and financing mechanisms for dealing with blight. The result was the Richmond Housing Renovation Program which is operated by the RCF through the foundation's single member LLC. The City Council approved the Social Impact Bond ordinance, and approved the sale of the five year bonds on June 2, 2015.

Program Objectives

1. Identify, acquire, rehabilitate and sell dilapidated, abandoned housing stock
2. Provide relief to neighborhoods affected by them
3. Create clean, safe and decent housing – appropriate to the neighborhood
4. Stabilize neighborhoods
5. Provide opportunities for First Time Home Buyers
6. Create a Social Impact Bond Financing Model in order to revolve funding and maximize the number of housing units in the program.

CHAPTER 2:
Richmond's Social Impact Bond

Partners

The process for planning and implementing a Social Impact Bond involves many partners and many steps. See below in Figure 1 for a summary for a flow diagram and the accompanying Social Impact Bond model for the City of Richmond.

Through adoption of Social Impact Bond Ordinance, City of Richmond has issued a Social Impact Bond for five-year term for three million dollars. The City loaned the bond proceeds to the Richmond Community Foundation, a non-profit 501c(3) corporation. The City will not have any repayment obligation; the repayment of the bonds will come entirely from the success of the program. To make the properties pencil out financially, agreements have been negotiated with the City of Richmond to rebate code enforcement fees and penalties received once the properties are acquired through tax sale or other means.

The program is technically operated by a Limited Liability Company ("the LLC") of which RCFis the sole member, in order to insulate the Foundation from liability for possible claims of construction defects. The LLC hires developers, architects and construction teams to rehabilitate the properties. For the term of the Richmond Advanced Communities grant, the Zero Net Energy Alliance and their consultant, Energy Solutions, have provided technical support to incorporate advanced energy efficiency and renewable technology into the home design. Grid Alternatives have provided the solar installation.

Mechanics Bank in the City of Richmond purchased the entirety of the bonds. Mechanics Bank receives CRA credit for its innovative investment, and will demonstrate program feasibility and sustainability to future investors who may not have the same community focus on social impact and who may expect a market rate investment return.

Union Bank serves as Bond Trustee for the account, and handles the acceptance and disbursement of (bond) funds; the maintenance of Reserve funds; and the custody of investments.

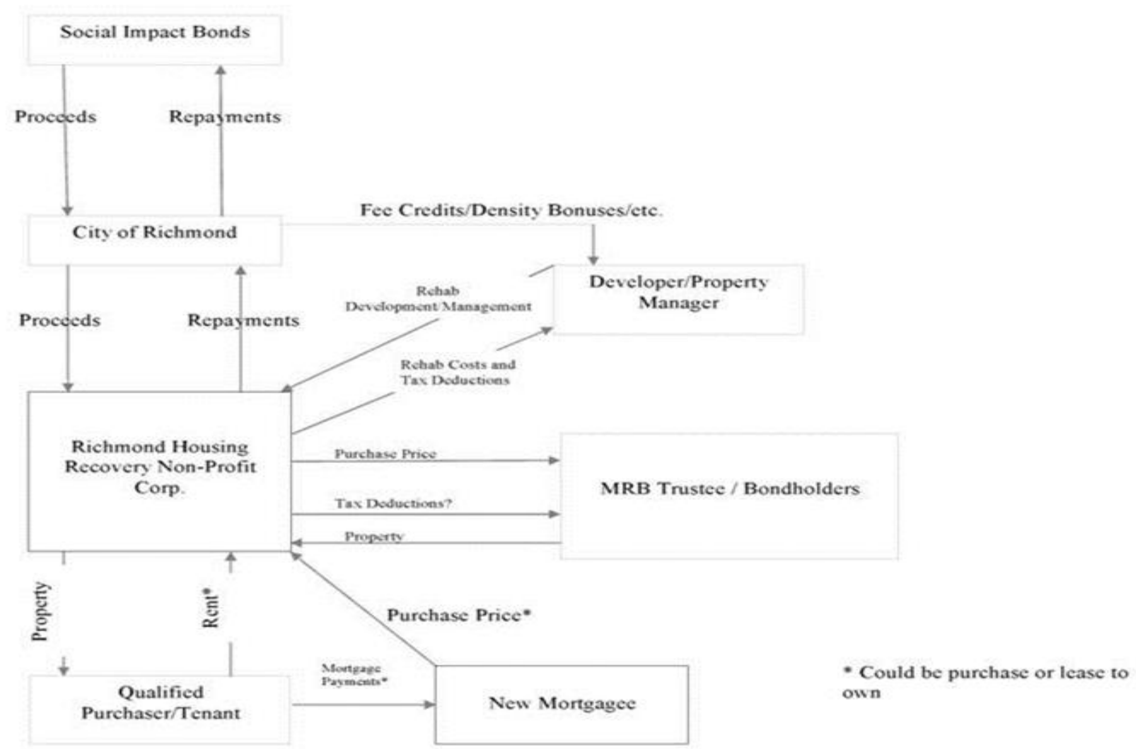

Figure 1: Social Impact Bond Structure in the City of Richmond

Bond Terms & Sequence

Below describes the terms and sequence of this Social Impact Bond. See the Appendix for the administrative documents for the bond.

- The proceeds of the bonds are deposited into a Program Fund, from which the LLC may withdraw funds to acquire, hold and rehabilitate properties. The Richmond Community Foundation receives $80,000 per year to cover its costs of administering the program.
- Once a house is rehabilitated and sold, the City reimburses the LLC all Code Enforcement Fines paid by the LLC to acquire the property.
- When a house is sold, the amount that had been withdrawn from the Program Fund (the costs of acquiring, holding and rehabilitating the property, are deposited into a Revolving Fund, and may be used by the LLC to again acquire, rehabilitate and sell properties.
- At the end of the bond term, the net profit on each property is divided between a fund from which the bondholders will be paid their return on investment, the "Supplemental Interest Fund", and the LLC. There will be, a maximum return on investment, after which, when reached, all of the profit would go to the LLC.

- After the fourth anniversary of the issuance of the bonds, the amounts from each property sale that would have been paid into the Revolving Fund shall, instead, be deposited into the Redemption Fund, from which the bondholders will be repaid their principal at the end of the fifth year of the program.
- Repayment of the bonds will be secured by all monies on hand in all accounts as well as by all properties while they are owned by the LLC.

Property Acquisition

Properties acquired by RCF fall into four types. Each presents a barrier for private investors from engaging in this activity and make it difficult to acquire the blighted properties. Below provides the type of condition, the barrier and the solution presented by this Social Impact Bond:

Type 1: Properties with delinquent taxes where the delinquent taxes exceed the value are acquired at tax sales. The county Treasurer Tax Collector can provide a discount to a nonprofit buyer.

> **Barrier:** They are already owned by the City, (in Richmond's case, these are left over from the Neighborhood Stabilization Program), or they need to be acquired at a public Tax Sale.
>
> **Solution:** The City agreed to sell to the program the properties it owns. Solution: Bid competitively at tax sales, and make up for any losses with the pay-for-success payments from the City. The City will rebate to the program any amount it collects in code enforcement fines as a result of a purchase of a property.

Type 2: Properties with deceased owners which need to go through probate in order to be acquired through a public sale.

> **Barrier:** The owners have died and the families of the deceased owners don't want to deal with the problem properties.
>
> **Solution:** Spend approximately $7,000 per house to bring the property through probate so that it can be brought to public sale and then purchase the property at the public sale.

Type 3: Properties with identified owners from whom we can purchase the properties.
Barrier: The owners have abandoned the properties but are still on record as the owners. Owners have an inflated sense of the value of the boarded up homes.

> **Solution:** Track down absentee owners and convince them to sell, or acquire the property as a donation from the bank or private owner.

Type 4: Properties where a mortgage holder has not foreclosed on the property; RCF works with the mortgage holder to foreclose so we can negotiate a purchase.

> **Barrier:** There are defaults in the payment of property taxes but the value of the property in its present condition is less than the total amount of the mortgage, property taxes, assessments, interest and penalties due.

Solution: RCF is exploring the use of Chapter 8 sales to acquire the properties from the county at a discount and working with lenders to acquire the properties.

Homeowners

RCF serves as co-Lead Partner for four SparkPoint sites, which serve as financial education centers that help struggling families restore their financial health. Graduates from the SparkPoint First Time Home Buyer (FTHB) program are eligible and able to purchase homes, but, as a practical matter, are often outbid by cash-bearing investors. SparkPoint FTHB graduates will be given the first opportunity to purchase rehabilitated houses from the Richmond Housing Renovation Program as Preferred Buyers. It is important to note, however, that this is not a subsidized or low-income housing program; the houses will be sold, whether to SparkPoint graduates or, if there are none interested or able to purchase a particular property, on the open market at fair market value.

Potential Benefits

The limited program budget requires efficient use of funds to meet the goal of 10 to 15 houses per year. The overall objective is to show the social return on investment materialized from RCF's efficient use of $3 million to provide the highest return given the capacity of renovating 10 to 15 houses per year. The impact on the community covers several areas:

- **Reduced costs for Code Enforcement:** Assuming that 40 houses are renovated during the five-year period, for a City savings associated with maintenance per house at $7,000 per year, the City will save $105,000 annually for each cohort of homes. With a discount rate at a five percent discount rate, the present value of the blight savings would be over $8 million after 40 years.
- **Reduced police services costs:** While the Richmond Police Department does not currently track calls for service by blighted properties, cities of comparable size and scope to Richmond estimate the combined incremental cost for annual calls at $6,400,296 for police service and $2,378,525 for fire service.
- **Return of taxes and bond fees:** A typical Richmond property would return an initial $20,000 in unpaid taxes and assessments, and add an estimated annual impact of $4,400 or more per year back to the tax roll.
- **Increase in neighborhood property values:** Since blighted properties across the country reduce property values in surrounding neighborhoods by 6 – 12% per year, the corollary is true; the values could increase by this much. The benefits are then seen by the city given the increase in the tax base and when applicable by the homeowners in the neighborhood upon the sale.
- **Local Workforce Development:** The rehabilitation of the houses will be performed by local contractors. The contractors partner with the City's

Richmond Build Academy, a job training program in the building trades, to hire workers.

- **Homeownership:** Homeownership as a value unto itself is particularly important to measure, since such physical and psychological health may transfer to increased personal interest on neighborhood conditions, which may also spread to and affect others on the block.
- **Emissions Reductions:** The implementation of energy efficiency and renewable technologies contributes to each homeowner's emissions footprint and the City's Climate Action plan targets.
- **Reduced Utility Costs:** The implementation of energy efficiency and renewable technologies has the potential to reduce energy costs for homeowners.

In terms of evaluating the potential benefits, RCF worked with students from the USC Sol Price School of Public Policy. RCF also has an established relationship with the Richmond Police Department's Code Enforcement Division and is using this relationship to collaboratively and routinely obtain block level crime data for evaluators to perform accurate and verifiable crime impact analysis without negatively impacting code enforcement and crime analysis operations.

Chapter 3: Social Impact Bonds – Challenges & Opportunities

Challenges

The three primary challenges of establishing a Social Impact Bond with large-scale impacts are:

1. **Finding proven, sustainable programs.** Private foundations and governments have for decades been funding experiments and start-up programs to prove whether social interventions work. The difficulty has always been to finance the on-going program once the seed money has dried up, but a Social Impact Bond could change that condition.

   Opportunity: The benefits of cleaning up blighted neighborhoods have been demonstrated in cities around the country, and because of the buying and selling of property as an asset, there is opportunity for an ongoing renewal of the funding stream until the bond expires.

2. **Producing a real return on investment**. Not all interventions, no matter how beneficial, can result in an actual financial return, but there are enough that there is an attractive menu of possibilities.

   Opportunity: In Richmond, both the County and the City will realize real financial benefits from reduced code and law enforcement costs and increased property tax revenues.

3. **Attracting investors.** The market for Social Impact Bonds is new, and the programs bear above-market risks. There are, however, investors willing to invest, some out of philanthropic motives, others because they are incentivized to do so. The former include private and family foundations willing to make "Program-Related Investments" (PRI) and socially-responsible mutual funds. The latter include banks that seek to meet their Community Reinvestment Act obligations.

   Opportunity: Right now, banks are willing to invest their CRA funds in Social Impact Bonds, and are content with modest returns. In the long run, however, the viability of Social Impact Bonds depends upon being able to deliver risk-adjusted market-rate returns.

Risk Factors

Key financial stakeholders of the RHRP are the RCF, City of Richmond, and Mechanics Bank. Yet each of these parties are under financial constraints that create an urgency for the program to demonstrate successes beyond those of financial concern. Many factors constrain RCF from successfully purchasing, rehabilitating, and selling blighted homes above the initial pro forma rate, which could limit the ROI to investors. The RCF can only renovate a small number of properties at any given time, so it will be important for the program to demonstrate its level of neighborhood impact to policymakers and future investors.

Risk factors include (City of Richmond, 2015):

- Construction and rehabilitation risk due to unforeseen material and labor cost increases;
- Resale risk as the result of RCF's ability to sell rehabilitated properties at or above the initial pro forma rate due to real estate market fluctuations;
- Risk of RCF not acquiring the number of properties expected annually due to variables such as title issues, probate issues, inability to obtain satisfactory prices, or the failure of mortgage holders to cooperate with foreclosures and/or short sales of properties;
- Risk of program management errors due to new systems and staff learning challenges;
- Risk of a lack of first loss guarantee, without protection by the City of Richmond or any other agency, where Mechanics Bank could lose its investment;
- Liquidity risk since the bonds are not liquid and lack a secondary market if the program fails;
- Risk of removing costly hazardous substances, such as asbestos or lead paint existing in older homes, and the incurred costs to abate them could be adverse to the budget and timeframes;
- Risk of casualty due to limits to the types of incidents that are insured on properties, such as insurance coverage for earthquake damage;
- Risk of future national economy downturn or regional housing market decline or crash is detrimental to Richmond and inaction will be even riskier as the current state of the housing market will remain stagnant;
- Risk of investors backing away from social investments that offer little to no return on investments may occur in a national economy downturn.

Opportunities

Despite potential risks, the RCF and its partners do not foresee obstacles to infringe upon the program's strength. While the risks should be discussed and understood within the collaborative, they should not deter from investment or partnership. Finance-related stakeholders work together throughout the project's life, and an effective communications strategy is required to provide a safe space for parties to discuss challenges, opportunities, threats, and solutions cooperatively and equitably.

This Social Impact Bond model offers program flexibility to operate under difficult constraints. For example, if the barriers to acquire a blighted home are too great, the RCF can turn its focus to another property. Flexibility helps the RCF to remain efficient in its use of finite organizational resources.

Another asset is RHRP's network of partners, pro bono advisors, and institutional stakeholders supporting it. Stakeholders share a strong sense of commitment to its success and the hope that an evaluation provides leverage for program scale-up and replication. Collective enthusiasm exemplifies a willingness to adjust the program model, if necessary, to improve its performance. Political support for the foundation and the program are substantial.

Finally, there are currently a significant number of blighted properties in Richmond to supply the program. As the program remediates blight and improves neighborhood conditions, profit-driven real estate investors may enter the market on neighborhood blocks that have not experienced such investment. Property values may increase, leading to increased sale prices that may constrain the program's budget and social mission.

Additional Considerations for Replicating this Social Impact Bond

Social Impact Bonds can be a viable strategy to address particular social needs in cities, but should be given careful consideration. Taking on blight through the untested social impact bond strategy could produce significant, scalable results, but without a way to take on all properties in a neighborhood, results might still lag behind the program's potential. The size of the bond would need to be big enough to prove the model, and the planning group decided that the value of the first bond would be $3,000,000.

Typically, social impact bonds are contracts, not bonds as investors think of them. If the group receiving the proceeds can improve a certain social condition, the investors are paid back with some interest; if it fails, the investors lose. The bonds have been used to reduce recidivism rates for criminals released from prison and to reduce teenage pregnancy rates. Although these bonds are issued by the City of Richmond, they are not secured by city revenues. The sole source of funds for debt service is proceeds from the sale of the rehabilitated properties. The bonds are intended for social impact investors less concerned with maximizing risk-adjusted returns than in using their capital for public benefit. The intent was that the Richmond bonds would most likely be sold via a private placement to a local bank endeavoring to meet its obligations under the Community Reinvestment Act.

Banks make these investments because they help fulfill the requirements of the Community Reinvestment Act of 1977, which requires them to meet a range of credit needs, "with the added bonus of qualifying for great P.R.," said Robert T. Esposito, a lawyer at Orrick, Herrington & Sutcliffe. "If you're a foundation, you can meet your 5 percent distribution" of assets as required by law, he said. "Or if you're an impact investor, you must be willing to trade off some returns."

The financial advisors believed that if all went well, the bonds will be fully repaid with up to 10 percent interest. Any extra proceeds will be retained by the Foundation. Due to the novelty of the program and the fact that it requires effective execution to be profitable, bond investors would taking on a significant risk of principal loss. While the bond issue is small, it is an example of increased investor interest in social impact projects, a niche that has long appealed to two types of investors: those who want to avoid companies that clash with their beliefs, and those with a desire to put a small portion of their wealth into an investment that could do some good, whatever the return. What has held social impact investing back is the perception that its returns are lower than those of investments without that social overlay.

APPENDIX A: Financial Model Documents for City of Richmond Social Impact Bond

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