

Achieving the Elusive Goal: Long-Term Sustainability of Subsidized Housing

Summary of a Focus Session Convened by the Joint Center for Housing Studies¹

Overview

On April 20, 2005, leaders in the rental preservation field gathered to discuss the long-term sustainability and preservation of subsidized rental properties. The discussion focused on tax credit properties and therefore did not focus on expiring contracts on housing with rents affordable to extremely low income households. The principal finding of the session is that there are a number of ways to create incentives *and* capacity to sustain properties for the long run. These are summarized below.

A list of the participants in the focus session and the agenda for the meeting are appended to this summary.

Premises

The session began with a discussion of premises to see whether there was agreement on them as a backdrop to a dialog on how to get incentives right for sustainability. The premises were culled from the literature. **The conversation revealed that the following premises were uncontroversial:**

- Real estate requires significant reinvestment at least every 15 to 20 years, but often sooner. Reinvestment is required to meet a number of purposes. These include: replacing worn out systems; repositioning properties so that they remain competitive; meeting the evolving needs of aging tenants; and undertaking structural modifications required by new regulations.
- If the rental income from a property has not generated sufficient reserves or it will not support a larger mortgage, or if there is insufficient equity to borrow against, the funds to preserve the project must come from outside it.
- Placing restrictions on rent increases and targeting aid to poor households with limited ability to pay rent makes it unlikely that property cash flows will be sufficient to cover capital improvements unless initial underwriting allows for cash flows large enough to adequately fund replacement reserves.

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- Unforeseen events can dramatically increase operating costs or rehabilitation costs relative to the initial *pro forma*. Designing programs with this in mind, and developing best practices that allocating agencies and property owners can follow to respond swiftly to such shocks when they arise is critical to long-run viability of subsidized housing.
- State and local administration allows for greater responsiveness to problems while increasing the importance of sharing best practices.
- Location decisions influence the long-term costs and viability of properties as well as the likelihood had that owners will opt out of programs when contracts expire.
- Insufficient attention is being given to long-term ownership and management incentives.

Most significantly, there was a strong theme running throughout the discussion that the tax credit marketplace is working quite well. The participants felt that the multiple stakeholders in tax credit transactions—from allocating agencies, to syndicators, to corporate investors, to lenders, to the IRS, to bond underwriters, to developer/owners with long track records, to attorneys, to providers of soft debt—have tended to make the market self-correcting over time. There are lots of eyes on the market with different expertise and perspectives. It was agreed that problem properties are generally identified early. There was some difference of opinion as to how much pressure is brought to bear to correct problems, but most felt that the multiple stakeholder create incentives to manage properties well and deal with problems when they become apparent. Nonetheless, there was also general recognition that there will always be some failures because of the risks associated with real estate generally and of agreeing to restricted rent covenants in particular. Further, there was widespread agreement that more could be done to help properties withstand operating shocks and to better capitalize replacement reserves.

The conversation also revealed that several widely accepted premises need revision or revisiting. The group felt that there was a tendency to assume incorrectly that development fees result in fully front-loading incentives. In fact, most participants agreed that developer fees fairly compensate developers for risk, are often conditioned on performance, and provide at least some incentive to manage properties well. In addition, the participants also generally felt that projects do not now have sufficient cash flow to fund replacement reserves. But they questioned the current thinking that the answer is capitalizing a large reserve amount up front. As discussed

below, underwriting and structuring developments so that they produce enough debt service coverage to cushion properties against normal market risks (higher than expected expenses or lower than expected rent revenues) and to make deposits to a replacement reserve was seen as a better approach.

Lastly, a concern was raised that modifications to existing programs intended to facilitate preservation of expiring use properties could have the unintended consequence of making it harder to preserve these properties. Entities seeking to preserve expiring use properties often compete against other firms that intend to convert the properties to market rate when the subsidy contract expires. If state agencies, lenders, or other key players impose additional underwriting rules it could make it even harder for these entities to compete against conversion purchasers who can raise capital from conventional sources and are not bound by the rules of subsidy programs. For example, requiring large replacement reserves to be funded upfront would increase the capital a preservation entity would have to deliver upfront. Hence, an alternative approach to facilitating preservation would be to consider ways to increase the competitiveness of preservation entities, either through more flexible underwriting or through facilitating access to lines of credit through credit enhancements or other mechanisms.

Existing Preservation Incentives

There was an extended discussion of developer fees, resulting in two points: (1) developer fees are not as high as some might think; and (2) a developer's desire to earn future developer fees is itself an incentive for long-term management.

- **Developer fees:** Several participants pointed out that most developers wish to continue to receive tax credit allocations to build new projects and recapitalize their existing properties. Therefore, they have a strong incentive to keep their properties from showing up on allocating agency and syndicator watch lists. This does not mean all will be successful, however, because real estate involves risks that will predictably cause some fraction of properties to fail. But it does mean that developers will go to lengths to keep properties from failing.
- **State conditions on developer fees:** Several states limit developer fees. As a result, in some cases these fees do not in and of themselves provide much return but instead defray risks that some projects will not get built or fail to meet leasing goals. In addition, many states only

allow the fee to be earned over time based on performance and the condition of the property. Hence, the extent to which developer fees front-load incentives is likely overstated.

The Politics of Sustainability

The group acknowledged that several aspects of the politics of long-term sustainability and preserving expiring use properties influence responses to these challenges.

- **Higher amounts of upfront public subsidy is required to build in preservation:** Building in the upfront capacity to preserve housing in the face of operating cost and capital improvement shocks through more generous underwriting implies higher amounts of public subsidy. The result is an inherent tension between the desire to maximize the number of units produced or rehabilitated with tax credits and other affordable housing production funds with the desire to minimize failures. From an economic and a political perspective the question is one of whether buying more insurance against failures with greater upfront subsidies is worth the costs it imposes.
- **Discomfort letting projects fail:** Several participants noted that there is a tendency not to let properties fail. White-knight buyers and new subsidy infusions will often be arranged at significant cost even though it might make more sense to use the subsidies for new projects. Some argued that project-based programs should be structured so that owners have financial flexibilities and incentives similar to owners not under subsidy contracts (higher initial debt service coverage ratios and a more generous back end if proper location and management decisions are made). If they fail in spite of these, there should not be an immediate presumption of a government bailout.

Creating Capacity to Sustain

It is not enough to create incentives for preservation: the financial capacity to sustain properties must also be built in. There are two primary approaches for financial sustainability. The first is adequate replacement reserves, so that a greater proportion of long-term capital needs can be funded from the property's resources. The second is adequate debt service coverage, so that properties can withstand reasonably foreseeable operating cost and rent revenue shocks.

Participants generally felt the time has come to embrace more realistic debt service coverage standards. The number that the discussion focused on was debt service coverage of

1.2x net operating income. Though not specifically discussed, the presumption is that net operating income in this context was meant to be also net of payments to capital reserve accounts. Hence, higher debt service coverage is not a substitute for also addressing the reserve account issue.

Regarding reserve funding, participants acknowledge that while the theoretically correct answer may be a large reserve deposit that is built into initial underwriting, as a practical matter, fund providers and developers alike face powerful temptations to sacrifice an adequate reserve deposit in order to enjoy more immediate benefits such as developing additional units, or enjoying higher developer fees. **Participants wondered whether a potential alternative to building cash flows for adequate capital replacement reserve accounts into initial underwriting is a funding system that provides public funds after year 10, in response to a property-specific capital needs assessment. Others maintained that funding capital replacement reserves upfront is a practical alternative. It was further argued that if it is accomplished without adding hard debt to the property, it can be a powerful tool for sustainability (especially in tandem with more generous debt service coverage ratios).**

- **Increase capital reserve allowances:** The participants raised several concerns about bulking up on capital reserves as the way to meet the long-term capital needs of aging properties. First, it was pointed out that larger reserves lower internal rates of return and can generate phantom income. Second, larger reserves often reduce the flexibility of the owners since uses of reserves are often restricted. Third, it is difficult to estimate capital needs in advance. Not all agreed that the first two concerns are valid or that third was a reason not to build in larger capital replacement reserves upfront. There was a general recognition that properties require some capital infusion to meet capital replacement needs every 10 to 15 years but that rent restrictions make it unlikely that the funds to meet these needs can be obtained through refinancing the mortgage. Therefore they capital reserves must either be built in as much as possible from the start, or the funds needed must be supplied later after a certified capital needs assessment is completed.
- **Periodically assess and fund capital needs:** Given the challenges of predicting what the capital needs of a project will be well in the future, several participants argued instead that subsidy programs should build in a full capital needs study every 5, 10, or 15 years. Upon completion of the study, additional public funds would be provided to ensure these capital

needs are met. The shorter timeframe was suggested as a way to give the allocating agency and the owner time to make necessary adjustments to sources and uses. One obvious drawback to this approach is that it might create a further incentive to economize on initial cost, at the expense of higher ongoing cost. Another is that an owner who will need new public funding every 10 to 15 years is not an “owner” in any economically meaningful sense.

- **Increase debt service coverage:** Many participants felt that the simplest way to build in the capacity to withstand unanticipated operating cost, capital needs, or other market shocks was to permit more generous debt service coverage ratios. This was seen as a more market-driven approach. The simplest fix would be to allow a debt service coverage ratio of 1.2. However, some felt that a triple test based on percent of rent, net operating income, and operating expenses would be even better. This would allow more fine-tuning to make sure that the cash flows are enough to withstand market shocks.
- **Use flexible soft seconds:** It was understood that since the tax credit is the principal method for financing projects and is tied to eligible basis, additional subsidies would be required to accommodate higher debt service coverage ratios. These often take the form of soft second mortgages. Arrangements could be made so that the soft second would only be repaid from surplus cash (after debt service and expenses) with surplus cash being shared between the owner and the soft second lender in a way that provides incentives for high quality long-term management. The cash compensation to owners could also be made contingent on performance goals. Potentially, funding replacement reserves on an ongoing basis could be part of such an agreement.
- **Sign creditor agreements:** With so many creditors involved in typical preservation deals and new developments, it was felt that confusion over agreed upon distributions of cash flows can arise. In some cases, owners enter into agreements believing that they have more generous debt service coverage ratios than they end up having. This is because soft-second creditors required repayment of loans that owners thought would only have to be repaid under special circumstances. To make higher debt service coverage ratios work, therefore, creditor agreements—clear letters stipulating the distribution of cash flows under different circumstances to the project, creditors, and owners—could be vital.
- **Other approaches:** Several additional ideas for dealing with unanticipated capital needs or operating costs shocks emerged including: 1) Allowing rents to change while staying within

set affordability ranges by setting them below required maximums to begin with and allowing them to increase if additional operating income is necessary; 2) Allowing rents to adjust higher if a tenant's income increases; 3) Withholding a portion of tax credit allocations to capitalize a state rainy day fund. But it was acknowledged that these would likely require a change in tax credit law and would need a long vetting process before making any decision to pursue them.

Improving Preservation Incentives

The participants agreed universally that incentives to reward responsible ownership and management of subsidized rental properties are not as strong or targeted as they could be. Several ideas for building in incentives for proper management were raised. Overall, there was a strong preference for approaches that would build upon market forces.

- **Allow a meaningful back end:** Some in the group felt strongly that the best incentives for owners to make the right decisions for sustainability from the start—from location to design to management—are those that let owners have as large a piece of a potential back-end profit as possible. It was duly noted that power of the back end as an incentive diminishes the longer the owners is bound to rent compliance for all units. One way to create a meaningful back end suggested at the meeting would be to allow owners to bring a certain fraction of units up to market at the end of a reasonably short compliance period (say 15 years) in return for agreeing to continue to leave the remainder under compliance in perpetuity (see also “debates” below). Of course, this approach necessarily would entail sacrificing some units in each property over time. Another approach mentioned was to go back to the practice of allowing owners to convert to market rate without restriction after a period of time with the implicit understanding that they will sustain properties.
- **Create flexibilities that allow cash to flow to owners for performance:** Once again, the idea surfaced that it would make sense to allow a higher debt service coverage ratio and allow owners to share in cash flows in return for meeting performance goals. This was seen as the most powerful incentive for properly managing properties. Hence, higher debt service coverage was seen as a means of both creating the capacity and providing the incentive to maintain subsidized properties.

- **Underwrite for proper management practices:** There was a sense that property owners that want to hire and reward quality management are not given points in tax credit allocation plans. Hence, there is a risk that they will crimp on management services unless underwriting rewards them. Managers should have the opportunity to earn incentive fees if pre-established performance goals are met.
- **Make failure to maintain standards a recapture event with a time-to-cure provision:** One change in the tax credit program that all agreed would be a powerful incentive to maintain properties is making failure to meet certain property standards a recapture event. Owners and syndicators work hard to make sure recapture events do not happen.

Detecting and Dealing with Problems

The group also discussed how to detect and deal with financial problems or erosion in property standards before they go too far. It was generally agreed that existing watch list procedures are effective in identifying properties in financial distress but not for identifying properties in physical distress. It was also posited that in many cases once a problem is identified and a property is placed on a watch list, there is a tendency to expect it to cure itself. As a result, the group suggested the possibility of the following to help detect and deal with problems.

- **Introduce a physical inspection system such as REAC:** The HUD REAC system was seen as one approach to measuring the physical condition of properties. However, there was some sense that the grading system used by REAC may be more or less rigorous than needed for detecting problem properties. There was a concern that project failures lead to political pressures to curb or shutdown housing programs and that the best way to avoid these is to identify those headed for trouble early on.
- **Share syndication reviews:** Syndicators already do extensive reviews of properties for their investors. It was suggested that perhaps syndicators could share these reviews with allocating agencies rather than create a costly parallel system for identifying troubled properties.
- **Commit to action:** It is not enough to spot a problem. Action is often required sooner rather than later, but that action is not always now forthcoming. Once on a watch list, the owner, syndicator, and allocating agency should meet to discuss what to do about it.

Reducing Costs

The group felt that chances for long-run success in sustaining properties would be increased by reducing program costs. The following were ideas advanced about how to accomplish this.

- **Reward use of operating-cost saving technology:** The group believed that some materials and building systems add to the upfront costs of development but conserve on operating expenses and capital replacement needs. Because the market often does not fully capitalize the value of these benefits into the price, these technologies can reduce overall long-run costs. Some felt that an effort to identify opportunities to achieve such costs savings and to reward developers for adopting cost-saving technologies in allocation plans is warranted. However, caution is warranted: in the past, cost-saving claims were made on behalf of products later found to be flawed, such as aluminum wiring and fire retardant plywood.
- **Match funding cycles:** While acknowledging the difficulties in matching funding cycles among the many subsidy sources that it often takes to build new housing and preserve expiring use properties, there was agreement that such efforts are worth making to reduce funding costs. California was used as an example of a state dedicated to trying to match these cycles but that has so far been unable to accomplish it.
- **Standardize documents:** Participants were more sanguine that documents used in funding expiring use and new developments could be standardized across states and funding sources.

Debating Preservation Goals

Most of the day focused on practical solutions to the challenges of preserving subsidized housing under the assumption that once housing is assisted there is an interest in maintaining all or most of the rentals as affordable for as long as possible. The key barriers to achieving this that implicitly guided the conversation were 1) the difficulty in withstanding operating shocks and meeting capital needs when rent increases are restricted and debt service coverage ratios trimmed to the bone; and 2) the lack of targeted incentives to reward long-term proper management.

There was, however, also a more open-ended discussion of the appropriate goals for preservation policy. Several goals were posited.

- **Preserve 100 percent of units “in perpetuity:”** Some felt the goal of preservation efforts should be to create rent restrictions that run with the full useful life of the property. Absent

this there is a concern that tenants will be displaced, well-located affordable rental housing will be lost, and affordable rental housing that is in distressed areas may be neglected even though it is critical to revitalization efforts. In addition, it is often the case that once rentals reach the end of even a 15-year compliance period the rents they charge are very close to market. Maintaining the property at restricted rents in such cases entails only creating the internal capacity to sustain the properties or funding the capital needs externally, as discussed above.

- **Preserve only a fraction of units in the 60 percent to 80 percent range “in perpetuity:”** Some felt that a system which allows owners to take a fraction of subsidized rentals in a property to market, should prevailing conditions make this a profitable choice, and allowing the benefits of market appreciation to fund the continuation of rent restrictions on a fraction of units, might be a useful approach. The right fraction was not discussed at length and there was a general agreement that this strategy would run counter to the politics of preservation discussed above. But by harnessing appreciation on some fraction of units to cross-subsidize rent restrictions on others, the approach is potentially cost effective. However, it was recognized that not all properties are located in areas where going to market provides a large enough benefit. Indeed, the number of markets where rents are likely to increase enough on older properties to make this a viable exit strategy is limited. Thus, it was acknowledged that such an approach would not work in all circumstances and that a one-size-fits-all approach would not apply.
- **Encourage community income mixing:** Some felt an avowed purpose of the tax credit program and of preserving expiring use properties ought to be to encourage the creation of mixed-income communities. This would imply, among other things, rewarding projects in allocation plans that are located in gentrifying or higher cost areas even it meant spreading subsidy dollars thinner. It might also imply giving less preference to preserving and building housing in already low-income areas. This was seen as controversial but on the table as an issue.
- **Anchor urban revitalization:** Others argued that it is important to use project-based rental assistance to stimulate the revival of distressed neighborhoods. While income mixing was not necessarily seen as an unimportant goal or an impossible goal to pursue even in poorer neighborhoods, the emphasis was on the importance of sustainable affordable housing in anchoring, stabilizing, or upgrading neighborhoods.

Participants

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Agenda

Overview

The Joint Center for Housing Studies of Harvard University is convening a focus session to discuss strategies for promoting long-term sustainability of subsidized housing. The focus session will bring together 18 leaders in the field for the following purposes:

- To see if there is general agreement on lessons learned from the past and the appropriate directions for future policy
- To discuss the proper set of incentives for long-run sustainability and preservation
- To examine possible incentives to foster income mixing

The results of the focus session will be summarized and possibly used as input for planning a larger symposium on the subject.

Background

Each year, hundreds of thousands of low-cost housing units are lost from the housing stock. While few would lament the loss of housing that was built to unsuitable standards in the first place, most lament the loss of quality affordable rentals either to rent increases or want of proper maintenance, repair, and replacement of worn-out systems.

Over the last decade there has been a growing consensus that losing subsidized and other low-cost housing squanders past investments in housing. Attention has therefore increasingly focused on how to achieve long-term rental housing affordability.

Creating low-income housing that lasts for the long run involves challenges at every stage of a property's lifecycle – from sponsor and site selection, to design and construction, to funding (it costs more to produce sustainable developments), to operation and management, to periodic but necessary upgrading (as health hazards are discovered and major systems require replacement). It extends even to having mechanisms in place to effectuate transfers of properties from non-performing owners to effective stewards of the subsidized housing stock.

Despite more than a half century of experience subsidizing low-income housing developments, it is becoming apparent that we have not yet figured out how to create the proper incentives to develop, own, and manage low-income subsidized housing that lasts for several decades. Figuring this out would be a major accomplishment.

As it stands, a great deal of experimentation is taking place, thanks both to the large number of contracts that are expiring on subsidized housing units and the shift from mostly centralized administration of HUD funds to decentralized administration of tax credits and HOME/CDBG dollars. Indeed, the preservation crisis created by the mass expiration of HUD contracts has been blunted to by the ingenuity of state and local housing finance agencies in using tax credits, tax exempt bond funds, Section 8, and HOME to recapitalize the projects that need it. Though up in 2004, by one estimate states preserved only about 36,000 units with federal and other funds so there is a long way to go before states use even half of tax credit allocations for preservation. HUD through its Mark-to-Market program is also helping preserve rental housing and its strategies have been viewed as more effective than past HUD-led efforts to address preservation of the HUD-assisted housing stock.

Introductions (9:00-9:30)

The focus session will begin with introductions of participants and an introduction to the purposes of the focus session.

Premises (9:30-10:30)

The premises underpinning the session will be discussed. The purpose of the discussion is to see if there are basic principals upon which people agree and that can serve as common assumptions throughout the rest of the day. Participants will be contacted in advance of the meeting to determine which premises they feel warrant further discussion at the meeting.

- Are the initial premises valid?
- How should they be modified?
- Should others be added?

Break (10:30-10:45)

Getting Development Incentives Right for Sustainability (10:45 – 12:15)

The following questions will guide the discussion:

- Do the powerful incentives to maximize eligible basis add or detract from long-run sustainability? In what ways?
- What can be done in at the sponsor selection, project selection, and underwriting stages to help ensure long-term sustainability?
- What role could income mixing within a property play (either when placed in service or when its compliance period ends) in promoting its long-term viability? What incentives would increase the use of tax credits for mixed-income developments?

The purposes of the discussion are to identify:

- Changes in program rules and administrative best practices that would lead to better sponsor selection, project selection, project underwriting, and development incentives for sustainability.
- Changes in program rules and administrative best practices that would permit and create incentives for mixed-income developments.

Lunch (12:15-1:30)

Getting Ownership and Management Incentives Right for Sustainability (1:30-3:30)

The following questions will guide the discussion:

- What incentives to properly maintain properties are built into the current Section 8 and tax credit programs?
- How do we get management incentives right for long-run sustainability?
- How should allocating agencies and property owners respond to market-wide shocks to the costs of operating rental housing?
- How should IRS and allocating agencies detect and respond to individual properties that are not generating sufficient cash flow to support adequate maintenance and fully fund replacement reserves?
- What incentives would maximize the likelihood of properties ending up in the hands of preservation entities with proven track records?

The purposes of the session are to identify:

- Incentives that would lead to better management for long-run sustainability
- Best practices for responding to market-wide operating cost shocks
- Incentives that would lead to strong preservation entities
- Methods for ensuring early detection and intervention of troubled properties

Wrap Up and Next Steps (3:30-4:00)