ISSUE: ADOPT SUSTAINABILITY AND AFFORDABILITY PRINCIPLES?

Issue: Should the Commission recommend that future subsidized rental housing transactions be structured so that there is a very low likelihood that a future government "bail-out" will be required?

Why This Is An Issue: For the most part, subsidized rental housing has been underwritten to standards appropriate for market rate apartments but that, for a variety of reasons, produce a very high risk of downstream financial failure when applied to subsidized apartments. Adverse side effects include:

- Too many properties in physical and financial distress.
- Perception that subsidized rental housing has been a failure and will always be a failure.
- Constant focus on solving the problems of the past, with the result that current and potential future opportunities are starved of time, legislative attention, and funding.

Background: See the Sustainability and Affordability background paper for a full discussion of the topics summarized in this Policy Option Paper. In general, for properties with rents at or very near the levels needed to support new construction, traditional underwriting and financing approaches are appropriate. These rents are only achieved if they start at and are allowed to rise with the market. Market rents on existing properties generally reflect replacement costs and so when it comes time to refinance them, owners can use equity generated over time to fund the necessary capital improvements to their properties. However, in subsidized rentals, rents are not permitted to rise with market and thus traditional underwriting and financing approaches become much less workable, and sustainability principles become more and more necessary. Examples of sustainability modifications to traditional underwriting and financing practices include:

- Use more conservative allowances for rent loss and operating expenses (to allow the property to weather moderate stresses without failing).
- Increase the Replacement Reserve so it can fund more of the long-term capital needs (because, as affordability deepens, the property's ability to use cash flow and refinancing to fund capital needs decreases dramatically).
- Shorten the first mortgage term, to increase the ability to refinance later.

Adopting sustainability principles will, however, require more up-front government subsidies for each affordable housing transaction. For this and other reasons, if sustainability principles are adopted, a much longer term-affordability restriction is a logical *quid pro quo*. In addition, Sustainability is one of the Commission's five principles for housing resource delivery.

Options:

1. The Commission could recommend that subsidized rental housing be structured for long-term sustainability, without the need for additional government funding for an extended period such as fifty years.
   a. The Commission could also recommend that, together with sustainability, affordable housing be structured for long-term affordability as well.
2. Alternatively, the Commission could ratify the existing system, which implies additional funding (and risk that affordability will be discontinued) for many or perhaps most

properties in 15-25 years. Under this option, the Commission would make clear that the need to use available housing subsidies and tax incentives to fund improvements to properties after major systems run down does not reflect a failure of the properties. Instead, it is a deliberate decision by government to defer these costs rather than underwriting properties so that they can be self-supporting.

Options 1 and 1a are recommended.

Recommendations: The Task Forces make the following recommendations, for adoption by the Commission:

1. **Adopt Sustainability.** The Task Forces recommend adoption of sustainability principles.
   - 1.1. **Term Sheet.** Attached is a term sheet illustrating the sustainability principles recommended by the Task Forces.
   - 1.2. **Adopt a Comprehensive Policy Approach For Replacement Reserves.** For future affordable housing transactions, the Task Forces recommend a sophisticated and flexible approach that is consistent with Sustainability principles. HUD, RHS, State HFAs, and other providers of affordable housing subsidies and mortgage loans should require developers to submit an acceptable long term projection of capital needs. The approved underwriting would then be required to demonstrate that the long term capital needs of the property could be met, without jeopardizing affordability, over an extended term such as fifty years. The underwriting would utilize any appropriate combination of initial Reserve deposit, annual Reserve deposits, increased deposits over time, cash flow, and refinancing proceeds.

2. **Adopt Longer-Term Affordability.** The Task Forces recommend that future affordable housing transactions be structured with a long-term affordable housing use agreement:
   - 2.1. **Covenant Running With The Land.** The availability of the property for long-term affordable housing use is assured through a binding covenant running with the land. The long-term affordability of the property is not dependent on the identity or motivations of the sponsor, and is assured even if the property fails financially and undergoes a workout or a foreclosure.
   - 2.2. **Length.** The length of the use agreement term and the level of affordability it requires are appropriate for the property, its target resident population, and the subsidies with which it is financed.
     - 2.2.1. The length of the use agreement should be at least as long as the capital needs analysis period. A fifty year capital needs analysis period would suggest an affordability term of at least fifty years.
     - 2.2.2. [Do the Task Forces want to make a specific recommendation regarding term of the use agreement, or leave it up to State / local decision makers?]
   - 2.3. **Flexibility Increasing With Time.** The use agreement provides increasing flexibility (in particular, in income mixes, and ability to redevelop) over the term.

Why These Solutions And Not Others? The recommended term sheet, and the recommended long-term affordability structure, were developed by the Commission's consulting team, based on consultation with the Task Forces, MHC staff, and an advisory committee representing a wide range of expertise and viewpoints. We believe these recommendations form sound guiding principles for the implementation of sustainability and affordability, while providing flexibility to tailor solutions to property-specific circumstances.

Factors in Favor of Long Term Sustainability / Affordability: See the background paper for additional detail. In general, adopting sustainability principles for future transactions (including restructuring / recapitalization / preservation of the existing stock) could reverse the side effects noted above and thereby create an environment in which subsidized rental housing could be more successful in all respects:

- The percentage of governmental subsidies needed to shore up existing subsidized rental housing would drop steadily from its current high level.
- Affordable housing would have a much more market-like financial structure in which market discipline and market forces would be much more powerfully engaged than is now the case.
- The economic rationale for developing and owning subsidized rental housing would shift from the current focus on up-front fees to a balance between up-front fees and longer-term economics driven by asset management fees and distributable cash flow.
- A new category of investor – the provider of true real estate equity capital, whose return is realized from distributed cash flow – would appear, bringing increased financial discipline to properties and their owners and managers.
- Residents would be much more likely to receive the quality of housing that is intended.
- There would be far fewer incidences of troubled properties.
- Properties that were troubled would rapidly be resolved.
- Public attitudes toward subsidized rental housing would become progressively more and more positive as the incidence of troubled properties declined.

Factors Against: Arguments against creating a sustainable model include:

- Switching to a sustainable model will require more subsidy per new transaction. The Background Paper estimates that the additional subsidy will be at least 10% but not more than 25% per transaction.
- For many years to come, much of the annual funding for subsidized rental housing will continue to be needed for the recapitalization / preservation of the existing stock.
- In general, the most powerful benefits of sustainability will not be enjoyed for several years to come, whereas the negative impacts on production will be felt up front.
- Some argue that, notwithstanding sustainability flaws, past and current programs have produced nearly two million units, most of which are in acceptable condition (even though not sustainable over the long term) and thus there is no need to change approaches.
- Some argue that LIHTC is not as prone to sustainability problems as earlier programs. In particular, under LIHTC, private debt and equity providers bear most of the risk of downstream financial failure.

Attachments:

Sustainability Term Sheet
Sustainable Underwriting Principles

ATTACHMENT 1: "TERM SHEET" FOR LONG TERM SUSTAINABILITY AND AFFORDABILITY

THE DEVELOPMENT CONCEPT

Professional Ownership. The ownership entity is led by a "preserving entity" that combines a commitment to affordable housing, strong real estate and business skills, and the organizational capability to conceptualize, package, develop, stabilize, and operate affordable housing.

Professional Management. The property management firm is committed to the management of affordable rental housing as a major line of business. The firm features top quality staff, an effective business and policy framework, and a commitment to continuous learning.

Sustainable Design. Design is compatible with other buildings in the neighborhood. Scale is consistent with the neighborhood. The property is physically and socially integrated into the surrounding area. The property is inherently crime-resistant, using "defensible space" approaches or equivalent.

Cost-Efficient. The property is cost-efficient in every way: in its design, development costs, energy consumption, operating costs, and long term capital needs. The exterior design is low-maintenance. When selecting materials and construction approaches, developers consider not only the up-front cost but also longer-term factors such as durability, quality of warranty, ease of maintenance, maintenance costs, expected useful life, curb appeal, resident comfort, and energy consumption.

Target Market. The development concept is firmly grounded in the demonstrated housing needs of a clearly defined target market that is adequate to support the property and that has housing needs severe enough to justify the public funding required.

Use Agreement. The availability of the property for long-term affordable housing use is assured through a binding covenant running with the land. The long-term affordability of the property is not dependent on the identity or motivations of the sponsor, and is assured even if the property fails financially and undergoes a workout or a foreclosure. The length of the use agreement term and the level of affordability it requires are appropriate for the property, its target resident population, and the subsidies with which it is financed. Long use agreements provide increasing flexibility (for example, in income mixes) over the term.

Community Building. The development plan makes appropriate provisions for creating a community in which residents know each other, residents and management and neighbors interact regularly and productively, and in which community governance is responsive to the evolving needs of residents and neighborhood.

Non-Housing Services. The development plan identifies any services that are appropriate and necessary in order to serve the target market. Any such services are fully funded for a reasonable period of time. If such services are needed but are not fully funded on a long-term basis, the property is capable of continuing as affordable and sustainable in the event the services must be discontinued.

UNDERWRITING AND FINANCING

First Principle: Financial Flexibility to Absorb Unanticipated Costs. A primary goal of sustainable underwriting and financing is to give reasonable assurance that the property can survive unanticipated financial "shocks" such as temporary market weakness, fluctuations in utility rates, local decisions to dramatically increase real estate taxes, fluctuations in the property insurance markets, and operating costs that escalate more rapidly than the allowable rents. This is achieved through some combination of allowance for vacancy loss, conservative projections for operating expenses, and adequate debt service coverage ratio. A possible additional resource is additional flexibility to increase rents (while still maintaining affordability).

Second Principle: Ability to Self-Fund Long-Term Capital Needs. The second primary goal of sustainable underwriting is to give reasonable assurance that additional governmental subsidies will not be needed to meet the property's long-term capital needs for an extended period such as fifty years. The capital needs would be funded through a combination of initial reserves, future reserve deposits, future refinancing, and future cash flow not needed to provide an equity return.

Affordable Rents. Affordable to the target market and below comparable market levels.

Modest Annual Rent Increases. The owner may increase rents modestly in accordance with an inflation indicator, without needing approval from government. The projected annual rent increases are expected to be affordable to the target market.

Adequate Allowance for Rent Loss. If the property's intended rents are at or only marginally below market levels, the rent loss allowance will reflect an average-of-cycle condition for otherwise similar market rate properties, typically 7% to 9%. If the rents are materially below market levels, the rent loss allowance can be lower, but no less than 5%.

Adequate Operating Expenses. Operating expenses are underwritten based on typical expenses for similar affordable properties in the same market area with good (not necessarily outstanding) management and that are at least five years old. Underwritten expenses reflect typical results under typical (less than ideal) conditions.

Asset Management Fee. The operating budget includes a fee designed to cover the owner's reasonable costs of asset management. The size of the fee is reasonable in light of the ownership tasks required and in light of any performance-based requirements for payment of the fee (e.g., if the fee is expected to be earned only some of the time, the fee amount should be higher so that, on a portfolio basis, a performing owner would generate sufficient funds to cover costs and risk).

Adequate Reserves. The property's reserve deposit is based on a property-specific long-term capital needs projection. The underwriting will demonstrate the property's ability to self-finance its capital needs (not necessarily solely from reserves) over a period of at least fifty years.

Reasonable Debt Service Coverage. The underwriting, when viewed in its entirety, gives reasonable confidence that the property can withstand moderate shocks without failing financially. For typical underwriting, a DSCR in the 1.20+ range, with a projected operating cash flow of at least 3% of EGI, would be reasonable.

Reasonable First Mortgage Debt. Typically, the first mortgage should have a fixed interest rate and be self-amortizing through constant level monthly payments, over a loan term not to exceed thirty years[1]. Departure from the typical characteristics would be accompanied by other features of the transaction providing additional financial robustness, for example: rents that are at least 10% below comparable market levels, and / or a reserve deposit that is designed to fund 100% of long term capital needs, and / or a higher DSCR. If the financing is tax-exempt, the loan amount is not more than the amount that could be achieved with conventional (non-tax-exempt) financing[2].

Owner / Developer Incentives. In general, the developer makes more money when the property is sustainable and makes less money when the property is not sustainable. The most powerful incentive is the fact that development proposals must be based on sustainability principles in order to be approved. Another example is the asset management fee discussed above. Another potential developer incentive is to escrow a portion of the developer fee that is now paid in cash upon completion (or lease-up, or other traditional trigger point) until the property achieves targeted sustainability-related results, for example:

- Adequate Reserves. The existing reserve balance, plus projected deposits, is determined adequate in accordance with a third party professional capital needs assessment, acceptable to and approved by government, with an appropriately long time horizon.
- Net Cash. The property has cash in excess of accounts payable ("positive Surplus Cash" in HUD terminology).
- Cash Flow. The property's actual cash flow meets or exceeds levels originally determined to be consistent with sustainability.

Governmental Incentives. The governmental agency (ies) that provided the subsidies also have incentives and disincentives that are aligned with the property's sustainability. For example:

- Future Allocations. Each year's allocation formula (by state for LIHTCs, by participating jurisdiction for HOME funds, by HUD Hub or Program Center for §202 and §811 funds) could reward allocators whose previously funded properties are meeting sustainability targets, by directing additional subsidies to them for allocation to developer / sponsors.
- Requirement to Cure Failing Properties. Agencies could be required to set aside significant amounts of otherwise discretionary funds to cure properties that are actually failing (for example, have accounts payable in excess of cash, or negative cash flow, or physical deficiencies), with additional consequences if the property is still failing after a reasonable period of time such as two years. This would provide a powerful incentive to agencies to achieve property success while giving agencies flexibility to negotiate workout / restructuring / transfer / refinancing transactions that respond to individual property needs and that share the costs of restructuring appropriately between agency, owner and other stakeholders.
- Requirement to Fund Sustainability. With respect to properties that are not failing but that have not achieved sustainability, agencies could be required to set aside otherwise discretionary funds, with additional consequences if the property is still not sustainable after a reasonable period of time such as two years. As with the previous example, this creates

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[1] Although 40 year terms (FHA and some tax-exempt bond transactions) and 50 year terms (RHS) are traditional, such loans amortize so slowly that there is little or no ability to refinance to help meet the property's first wave of heavy capital needs at years 15-25. For example, an 8% / 40 year loan amortizes less than 20% in its first 20 years.

[2] Else, the property would be over-leveraged, the "owner" would have inadequate equity, and the bondholders would be the actual "owners" of the property if anything went wrong.

powerful incentives in favor of sustainability without tying the agency's hands in terms of achieving a resolution that makes sense for each individual property.

- Choice Among Alternative Allocators. If a particular allocating agency has a particularly poor track record in terms of achieving success and/or sustainability, Congress could provide that future funding and authority be transferred to an alternative allocating agency.

SUSTAINABILITY IN VERY-LOW-MARKET-RENT NEIGHBORHOODS

Some subsidized rental housing is located in neighborhoods with comparable market rents that are too low to cover operating costs, reserves and vacancy loss, even if the property has no required debt service payments. This pattern most commonly occurs in distressed inner city neighborhoods and rural areas. The problem is exacerbated whenever operating expenses are abnormally high (for example, because of high maintenance costs in the inner city, or because of the higher operating costs of elevator buildings for the elderly).

For such properties, it is not possible to achieve sustainability until neighborhood market rents rise significantly. Policymakers may nonetheless determine that developing affordable housing in such an area is appropriate. In such situations, the property should be structured to be as close to sustainable as possible, in particular:

1. Zero debt. Total development costs should be funded by grants, as in the §202 and §811 programs.

2. 100% project based deep subsidy. Again, this mirrors practice in the §202 and §811 programs.

3. Adequate reserves. Because there is no ability to refinance, the reserve for replacement must be adequate to fund 100% of capital needs for an extended period such as fifty years.

4. Adequate operating margin. The rents must include an amount over and above anticipated costs of operation, so that the property can weather moderate "shocks" without failing.

ATTACHMENT 2: SUSTAINABLE UNDERWRITING PRINCIPLES

OVERVIEW

An affordable housing transaction has sustainable financing and structure if each of the following sustainability tests are met:

1. Long Term Capital Needs can be 100% supported from reserves, or from a combination of reserves and reasonably predictable refinancing.
2. Stabilized NOI is very likely to be achieved as projected.
3. DSCR is adequate to withstand moderately large adverse circumstances.
4. Financing is reasonable.
5. Trending assumptions are reasonable.

The determination that these tests have been satisfied requires real estate judgment based on good data and experience. Accordingly, the tests are described below in general terms and not in terms of specific percentages and ratios.

1. LONG TERM CAPITAL NEEDS CAN BE 100% FINANCED

Capital Needs Assessment. There is a property-specific long term capital needs assessment that estimates the annual capital expenditures necessary to maintain the major building systems over the long term. The original capital needs assessment, prepared at the time of original structuring and approval, must be for a period of time long enough to encompass at least the first replacement of the major building systems (roof, siding, windows, parking lot resurfacing, HVAC, …).

Reserves. The combination of any up front reserve funds, the initial monthly reserve deposits, and planned future deposits (increased at the rate of inflation, or perhaps more rapidly than inflation) is sufficient to fund at least a significant portion of the long term capital needs.

Refinancing. Any of the long term capital needs that cannot be funded from the reserve can be funded from future refinancing that is reasonably predictable, taking into account any affordability restrictions in the long term use agreement, and taking into account uncertainty about future property value and future mortgage market conditions.

2. STABILIZED NOI IS REASONABLE AND ACHIEVABLE

Rents. Projected rents are very likely to be achieved, taking into account location, design, other property characteristics, and the long term use agreement. In particular, because occupancy is restricted by income level, the achievable rents for an affordable property are below the market comparable level that a non-income-restricted property could achieve.

Vacancy / Rent Loss. The rent loss allowance is reasonable considering the range of vacancy and bad debt loss the property is likely to incur over a typical real estate cycle.

Operating Expenses. The property is very likely to meet or beat is projected operating expense budget. The projected operating expenses are based on actual operating costs of typical comparable properties that are at least five years old.

Reserve for Replacement. The projected reserve deposit is consistent with principle #1 above.

3. Debt Service Coverage is Adequate

Rent Variance. If the rents that are actually achieved are modestly lower than the projected rents, the property will still be able to cover its required mortgage payments. If the actual rents are, say, 3% below projected levels, that should not throw the property into negative cash flow.

Expense Variance. Various components of operating expenses are subject to large variances. Examples include utility costs, real estate taxes, property insurance, and security costs. If the actual operating expenses are, say, 10% higher than projected, that should not throw the property into negative cash flow.

4. Financing is Reasonable

Original Financing. The projected financing is either firmly committed or very likely to be obtained.

Non Traditional Financing. If the first mortgage is not fixed-rate, or is not self-amortizing, there is additional debt service coverage (or other financial protection) sufficient to give a very high degree of assurance that the property will be able to pay debt service over the long term.

Subordinate Financing. If the property includes “soft” junior financing, the terms of that financing are consistent with the property’s long term sustainability. For example, the subordinate lender should not have a right to repayment until expenses are paid, the property is maintained, and the reserves are adequately funded.

5. Trending is Reasonable

Revenue Trending. The rate at which income is projected to grow in the future is consistent with restrictions in the long term use agreement and is less than the rate at which expenses are projected to grow in the future.

Operating Expense Trending. The rate at which expenses are projected to grow is consistent with reasonable long term projections of inflation.