MILLENNIAL HOUSING COMMISSION
PRESERVATION TASK FORCE
BACKGROUND PAPER: PRESERVATION OF EXISTING AFFORDABLE HOUSING

OVERVIEW

There is widespread agreement that it is good policy to preserve for the long term the existing stock of rental housing that serves low-income households with good quality housing at rents they can afford. See Part II for a discussion of why preservation is considered good policy. However, each portion of the stock presents different preservation challenges and requires largely different preservation approaches.

Part I of this paper briefly discusses the three large portfolios that now provide apartment housing that is affordable to low-income households: assisted housing (HUD-assisted, RHS-assisted, and LIHTC), public housing, and unregulated affordable apartments. Each portfolio's preservation risks are assessed, and preservation strategies are suggested.

Part II discusses the case for and against preserving assisted housing, public housing and modest market rate apartments, to the extent not addressed in Part I.

Part III proposes a practical framework for making the preservation decision.

Part IV discusses how the Commission's long-term-sustainable "term sheet" could be applied to the preservation of existing affordable housing.

Part V presents a summary of potential recommendations the Commission could make to facilitate preservation of this stock.

Appendix 1 presents a list of questions to be answered when making preservation decisions

Appendix 2 presents an outline of a property assessment process that is adequate for making preservation decisions.

Appendix 3 repeats the "term sheet" from the Committee's background paper on Sustainability.

PART I. THE PRESERVATION UNIVERSE

Preservation discussions always involve assisted housing, sometimes involve public housing, and sometimes involve modest market-rate apartments as well.

ASSISTED HOUSING

The Portfolios That Comprise Assisted Housing. There is universal agreement in the affordable housing community that preservation efforts should encompass properties that are already receiving federal subsidies and that are already occupied by low-income households. This encompasses the following portfolios of privately owned assisted housing:

HUD Older Assisted	4,200	properties	450,000	units
HUD Newer Assisted Insured	3,500	properties	325,000	units
HUD Newer Assisted Non Insured	3,500	properties	325,000	units
HUD §202 and §811	4,600	properties	250,000	units
RHS §515 Direct Loans	16,700	properties	450,000	units
RHS §514 Farm Labor Housing	1,000	properties	10,000	units
LIHTC	16,700	properties	1,000,000	units
Total	50,200	properties	2,810,000	units

Estimates for the HUD-assisted portfolio are by The Compass Group, LLC (see the Commission's Historical Context background paper for further discussion). Data for the RHS-assisted portfolio are from the Rural Housing Service. Data for the LIHTC portfolio are estimates by The Compass Group, LLC, based on information from the National Council of State Housing Finance Agencies.

PRESERVATION RISKS IN ASSISTED HOUSING

There are a few over-arching preservation issues affecting the entire assisted housing portfolio.

Barriers to Transfer of Ownership. Preservation will often – but not always – require a transfer of ownership. See the Commission's background papers on Barriers to Acquisition, and Preservation Tax Incentive, for a full discussion of the various barriers faced by preserving entities who seek to acquire and preserve existing assisted housing.

Capital Needs Risks. Most properties are in good physical condition today. However, most will have difficulty meeting their ongoing capital needs (for major repair and replacement of major building systems as they age). Some properties could meet their long-term needs through prudent financial planning, but others will need significant new governmental subsidies. On-Site Insight, a prominent capital needs assessment firm, estimates that 70% of assisted properties will have unmet capital needs in time and are therefore at risk. OSI further estimates that 60% of those at-risk properties could meet their twenty-year capital needs if reserve deposits are increased now by $10 to $20 per unit per month[1]. Typical assisted properties are accruing capital needs at the rate of $600 per unit per year, ranging however from under $300 per unit per year to over $1,000 per unit per year (underscoring the need for property-specific evaluation). By contrast, the median annual Replacement Reserve deposit is $329 per unit per year[2].

Debt Restructuring. Some assisted properties cannot be made sustainable and viable without significant reductions in their existing mortgage debt. HUD's Mark to Market program has accepted roughly 1000 properties with §8 rents above market levels and needing debt restructuring in order to be sustainable at market rents. Results thus far indicate that at least 15%

[1] More detailed information is available at www.on-site-insight.com.
[2] From On-Site Insight's compilation of 102 recent capital needs assessments.

of the HUD-assisted stock requires debt restructuring[3] in order to be sustainable.

The following is a general discussion of each portfolio. These discussions are abbreviated and describe conditions applicable to most of the portfolio. As there are exceptions to practically every blanket statement that can be made about these portfolios, any property-specific work should be based on an analysis of that particular property and its governing documents. *Preservation risks are assessed in italics.*

- **HUD Older Assisted.** In general, affordability was provided through a below market interest rate mortgage loan, rents limited to those needed to support operations, and in many cases project-based assistance (some of which was added after the properties were developed). Affordability was assured generally through twenty years, after which time the mortgage loan could be prepaid and the properties converted to market rate use. The twenty-year period has passed for the entire portfolio[4]. *The prime preservation risk is that the properties can be taken out of the affordable inventory whenever doing so is economically feasible. A secondary preservation risk is that many of these properties face large capital needs that cannot be financed internally (i.e., without further injections of subsidies) while maintaining affordability.*

- **HUD Newer Assisted Insured.** Affordability was provided through twenty-year project-based §8 contracts, most of which have expired, and the remainder of which will expire between now and the end of 2004. The FHA-insured mortgages carry market interest rates. At the expiration of the §8 Housing Assistance Payments (HAP) Contract, the owner can convert to market rate operations with or without prepaying the insured loan. *The prime preservation risk is expiration of the affordability requirement. Most, but by no means all, of these properties are in good physical condition. However, given their age, these properties face large capital needs in the next few years, creating a secondary preservation risk that those capital needs cannot be met without new government subsidies.*

- **HUD Newer Assisted Non-Insured.** These were financed with State or local tax-exempt bonds, and project-based §8 contracts generally coterminous with the bonds (usually 30 or 40 years)[5]. These HAPs expire beginning in the late 2000s and continuing through early 2020s. *These properties are not at immediate preservation risk. However, when the HAPs expire, these properties generally will be debt free and thus will present significant preservation risks whenever their highest and best use is something other than*

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[3] Through August 2001, owners of 1075 properties have applied for debt restructuring. This represents roughly 15% of the properties eligible to be considered for debt restructuring (having project-based §8, rents above market, and an FHA-insured mortgage loan). HUD's Mark to Market office believes that the number of properties needing debt restructuring is somewhat larger than the number whose owners have applied thus far.

[4] Some older assisted properties are still under affordability restrictions. Some were originally developed by nonprofits and had forty-year restrictions. Others were financed through State HFAs who imposed restrictions longer than twenty years. Others have local restrictions, for example associated with redevelopment parcels, zoning variances, and real estate tax abatements.

[5] Some early properties had, instead of a single 30 or 40 year HAP, a series of five year HAPs, with an opportunity for the owner (but not for HUD) to opt out at the end of each five-year period. The affected HFAs generally were successful in creating HFA-specific preservation initiatives that assured the preservation of these properties through the term of the bonds.

continued affordable housing.

- **HUD §202 and §811.** These properties were all developed by nonprofits under HUD requirements that generally prohibit conversion to market rate housing. There are three important sub-portfolios, each with different physical preservation implications.
  - **Early §202s.** Starting in 1959, these had direct loans from HUD and generally some project-based assistance (often less than 100%). *It is virtually certain that some of these properties, especially those without 100% §8, have capital needs problems and are at risk. Those with 100% §8 simply need increased reserve deposits (and rents), probably for the most part in the $10 to $20 per unit per month range noted earlier in this paper. Those with less than 100% §8 may need either above-market rents (to fund increased reserves) or restructured debt (to permit increased reserves within market rents).*
  - **Middle §202s.** From 1974 to late 1991, §202s (§811 was created in late 1991) had direct loans from HUD and 100% project based assistance. *These properties do not present physical preservation risks unless their owners and HUD have failed to increase the originally inadequate reserve deposits*[6] *(and rents) to levels adequate to cover long-term capital needs.*
  - **New §202s and §811s.** Since late 1991, these properties were developed with 100% capital grants and thus carry quite low rents (the level needed to support operations and reserves only). *These properties do not present physical preservation risks unless their owners and HUD have failed to increase the originally inadequate reserve deposits (and rents) to levels adequate to cover long-term capital needs.*

- **RHS §515 Direct Loans.** These properties are programmatically similar to the HUD Older Assisted stock: below market interest rate loans (here, directly from RHS rather than privately-held and government-insured), a twenty-year affordability commitment (expired for most properties), and partial to full project-based assistance (here, mostly RHS Rental Assistance rather than HUD §8, although some properties have §8). §515 was enacted in 1962 but did not generate significant volume until the 1970s. §515 properties are still being developed. *Preservation issues are similar: risk of escape when market conditions permit, and problems funding long-term capital needs as properties age. However, due to the relative weakness of most rural real estate markets, the capital needs risk is by far the most serious. The prevalence of capital needs risks is likely to be similar to the HUD Older Assisted stock.*

- **RHS §514 Farm Labor Housing.** Most units are in "off farm" properties operated by nonprofits or public bodies. The remaining units are in "on farm" properties, typically single family dwellings. *Preservation issues are mostly limited to physical preservation risks.*

- **LIHTC.** Properties developed **[1987 through 1992?]** had at least fifteen-year affordability commitments that begin expiring in 2002. Properties developed later have

[6] For all its programs, HUD sets initial reserve deposits according to a formula designed for market rate apartments, generally adequate to cover between one-third and one-half of long term capital needs. See the further discussion later in this paper.

at least thirty-year affordability commitments[7]. *Accordingly, the expiring-use risk is relatively limited in this portfolio.* However, anecdotally there is a concern that original underwriting for many properties was far from consistent with sustainability principles[8], indicating a likelihood that many properties are facing financial problems as they age. Most were financed with market-rate-style (small) reserve deposits, implicitly assuming that other capital needs would be funded through refinancing or from conversion to market rate housing at higher rents. Thus, some LIHTC properties have a built-in financial crisis similar to those we have seen in the HUD-assisted and RHS-assisted portfolios. See the Commission's background papers on Historical Context, and Sustainability, for additional discussion of this issue. *For the LIHTC portfolio, the prime preservation risk has to do with funding escalating long-term capital needs while preserving affordability. Most likely, State allocating agencies will devote a portion of their annual LIHTC allocations to the preservation of existing at-risk LIHTC stock.* Finally, it should be emphasized that the LIHTC program itself is a prime vehicle for the preservation of the HUD- and RHS-assisted stock; a small but material number of those properties have been recapitalized and preserved using LIHTCs.

POTENTIAL PRESERVATION APPROACHES, IN ASSISTED HOUSING

Reducing Barriers to Acquisition. See the background papers on Reducing Barriers to Acquisition, and on Preservation Tax Incentive, for approaches to facilitate the long-term preservation of assisted housing.

Approaches to Reduce Conversion Risk. This risk is most significant in portions of the HUD-assisted portfolio, although it affects some RHS-assisted housing and a few LIHTC properties. The appropriate policy response is to continue to provide funding (through LIHTC, HOME, CDBG and otherwise, for example through HUD's Mark to Market and Mark Up To Market programs) that can be used for preservation as deemed appropriate by State and local allocating agencies. *The amount of funding needed depends on the property's market value over and above existing mortgage debt, and the costs of acquisition and preservation*[9]. *For properties with value below their governmentally-based mortgage debt, additional funding will be needed to support debt restructuring*[10].

Approaches To Reduce Capital Needs Risk. This risk is significant throughout the portfolio. The appropriate policy responses include proactively increasing Reserve funding throughout the portfolio (see below), and continuing to provide funding that can be used for recapitalization when appropriate. *For some properties, increasing the Reserve deposits to appropriate levels cannot be done without restructuring the existing mortgage debt. For other properties,*

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[7] State allocating agencies have the option of negotiating longer affordability commitments, above and beyond the federally required minimums. Many, perhaps most, agencies do so for many or most of their properties.

[8] This was partially a result of developer and lender and investor adherence to rules of thumb developed for market-rate apartments. Another factor was pressure from State allocating agencies to make proposals more competitive. In response to that pressure, some developers reduced the apparent cost of their proposals by shifting capital needs problems into the future, to be dealt with via market conversion when the LIHTC affordability agreement expires.

[9] Typical preservation transactions involve roughly $15,000 to $30,000 per unit in government subsidies. See the Historical Context background paper.

[10] In HUD's Mark to Market program, when debt restructuring is needed, the existing mortgage debt must be written down heavily (on average, roughly 70%), in order to achieve sustainability once rents are reduced to market levels.

increasing the Reserve deposits is readily feasible but, if not pursued now, will inevitably lead to serious problems later. Using the On-Site Insight estimates discussed earlier, and using plausible additional assumptions, the up-front cost to government to convert to adequate Reserves can be roughly estimated as follows:

30% of properties have adequate reserves now			$0	cost per unit
42% need a $10-$20 PUPM increase in deposits				
6% need to reduce debt service	$20	PUPM	$2,900	cost per unit
36% could accommodate the increase			$0	cost per unit
28% of properties need a greater increase				
8% need to reduce debt service	$40	PUPM	$5,300	cost per unit
8% need to reduce debt service	$20	PUPM	$2,900	cost per unit
12% could accommodate the increase			$0	cost per unit
Average cost to government, per unit			$830	cost per unit
Total assisted universe			1,810,000	units
Estimated total cost to government			$1.5	biillion

The calculations above utilize the following assumptions:

60%	with inadequate reserves need a small increase in deposits
15%	needing a small reserve increase need debt relief
30%	needing a large reserve increase need debt relief for the full amount
30%	needing large increase need debt relief for half the full amount
$10	Debt reduction per dollar of debt service relief
$500	Per unit government overhead, to restructure debt

Answering Questions of Preservation-Worthiness. A small but material number of properties have failed. They do not constitute community resources but instead are community problems. The appropriate policy response is property-specific assessment (see Appendices 1 and 2) to determine whether the property can be made successful and, if not, how best to remove it from the stock and relocate residents. *If properties are not preservation-worthy, experience suggests that the costs for demolition, relocation of residents, and redevelopment will exceed normal new construction costs; 150% of new construction cost would be a reasonable estimate.*

Open Questions for the Commission, Regarding Preservation of Assisted Housing.

- **Level of Funding.** The Commission could consider whether the existing level of funding for preservation and recapitalization is adequate.

- **Replacement Reserve Funding for Existing Properties.** The Commission could recommend that HUD and RHS systematically obtain professional capital needs assessments, and increase Reserve funding to the level needed to fund ongoing capital needs, perhaps in conjunction with an extended affordability commitment from the property owner[11].

- **Underwriting and Financing.** As discussed in the Commission's background paper on Sustainability, the Commission could recommend the adoption of underwriting and financing principles for affordable housing, based on the principles of long-term sustainability and affordability outlined in the background paper. In particular, the Commission could recommend that HUD and RHS modify their approaches for setting Replacement Reserve deposits for future affordable housing originations, as discussed below[12].

- **Preservation Decisions.** The Commission could recommend systematic, property-specific assessments of all troubled assisted housing, to determine whether it should be preserved, and if so how (see Appendices 1 and 2).

ALIGNING REPLACEMENT RESERVES WITH PRESERVATION PRINCIPLES

As noted earlier, assisted properties are generally in good physical condition now but face increasingly severe problems in funding future major repairs and replacements.

Why Reserves Are So Often Inadequate. HUD[13] sets initial reserve deposits according to a formula designed for market rate apartments, generally adequate to cover between one-third and one-half of long term capital needs, implicitly assuming that the remaining capital needs will be covered through refinancing or cash flow. Although this approach is reasonable for market-rate apartments (indeed, it closely tracks practices in the non-governmental financing markets), it is not reasonable for affordable housing that, by design, will not have equivalent ability to refinance and/or generate cash flow. Moreover, FHA exacerbates this problem by using 40-year mortgage loans as its standard financing product; because 40-year loans amortize so slowly[14], generally properties so financed are unable to refinance to fund capital needs without significantly increasing rents. Similarly, programs that limit the owner's cash flow exacerbate the problem. Some HUD programs accelerate the onset of the problem by not requiring annual adjustments to the Reserve deposit to offset inflation. Potential solutions include:

- **Larger Deposits Sufficient to Fund 100% of Long Term Capital Needs.** Develop a new formula designed to cover up to 100%[15] of long-term capital needs, to be used for affordable housing that is intended to retain its affordability over the long term. A pure

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[11] If increasing Reserve deposits to the necessary level is not feasible while staying within market rents, the property should undergo debt restructuring, in Mark to Market or otherwise, so that it can be viable in the future.

[12] The need to modify underwriting standards is specific to affordable housing. For market rate housing, it is reasonable to continue to rely on some combination of cash flow and future refinancing to cover a portion of long term capital needs.

[13] This discussion reflects HUD practice, but RHS practice, and State HFA practice, are similar in many material respects.

[14] At an 8% interest rate, a 40-year loan amortizes less than 20% in the first twenty years. By comparison, an 8% / 30 year loan amortizes 40% in the first twenty years.

[15] A 100% formula would be appropriate whenever it was not prudent to rely on downstream cash flow or downstream ability to refinance. Conversely, for affordable properties with some ability to refinance, the reserve formula could cover less than 100% of estimated capital needs (but more than the one-third or so that traditional reserve formulas will cover).

100%-funding formula would call for significantly higher reserve deposits than are suggested by rules of thumb developed for market rate apartments. Economic analysis by The Compass Group for the Commission, for a typical newly constructed garden apartment property in a several different market areas, suggests that:

- Typical rule-of-thumb reserve deposits ($200 to $300 PUPA), although not adequate to fund 100% of expected capital needs for the property's first 20 years, are reasonable for market-rate properties that have high debt service coverage ratios, low operating expense ratios, strong potential for future refinancing, and the expectation of refinancing after the first 10-15 years.
- Reserve deposits in the $350 to $525 PUPA range (varying with local cost levels) are needed in order to fully fund the property's 20 year capital needs (i.e., with reserve deposits below this level, a refinance will be required prior to the 20th year). These amounts are below the rate at which capital needs accrue – benefiting from the fact that reserves can build up, and earn interest, for several years before the first replacements will be needed.
- Reserve deposits in the $575 to $975 PUPA range will be needed in order to fully fund the property's 50-60 year capital needs. These higher amounts are driven by the need to replace siding, windows and other very long-lived components, and are consistent with the rate at which capital needs accrue.
- Affordable properties serving households at higher incomes are likely to have relatively low expense ratios and relatively strong ability to refinance in the future and thus can afford to use reserve deposits that fund less than 100% of long-term capital needs. A few such properties can afford reserve deposits as low as those used in market-rate properties.
- Affordable properties serving households at lower incomes are unlikely to be able to rely on future refinancing and thus are more likely to need the highest levels of reserve deposits.

- **Alternatives to a 100% Funding Formula.** Variations on this theme include:
  - **Vary By Affordability.** The amount of the first year reserve deposit could vary from the current approach (for market rate housing) up to three times the current approach (for affordable housing that is not expected to have refinancing potential and is not expected to generate significant cash flow), depending on the cash flow and refinancing potential suggested by the long term economic projections for the property[16].
  - **Vary By Loan Term.** Retain the current approach for loans with terms of 10-12 years or less (i.e., 40 year amortization with 7 or 10 or 12 year terms)[17]. Require

[16] For example, economic analysis by The Compass Group for the Commission, for a typical garden apartment property in Atlanta, suggests that a $350 PUPA Reserve deposit is adequate to fully fund the property's 20 year needs. The $350 deposit level, plus future refinancing, will fund the property's 50-60 year needs when the housing is targeted for households at or above 55% of AMI. However, at 45% of AMI, the future refinancing capability declines significantly, requiring reserve deposits of $450 PUPA. At 40% of AMI, there is little or no likelihood of future refinancing, and a $575 PUPA reserve deposit (adequate to support 100% of long term needs) is needed. Results would, of course, vary for other structure types and other market assumptions.

[17] As a practical matter a 7-10-12 year "bullet" loan will have to carry a significantly greater debt service coverage ratio than FHA's formula 1.11:1, to provide reasonable assurance of the ability to refinance. On that basis, the existing (small) Reserve deposit formula would be viable because there would be significantly more cash flow. If, conversely, FHA continued its 1.11:1 DSCR standard with shorter terms, it would be unsound to continue with the

a larger initial deposit for self-amortizing loans (i.e., 40 year amortization and 40 year term). Similarly, the current approach (or perhaps less) might be reasonable for loans with 30 (vs. 40) year amortization, because of the relatively faster amortization and consequently greater potential for refinancing (40% vs. less than 20% amortization in twenty years, at an 8% interest rate).

- **Trend Faster Than Inflation.** A relatively modest first year deposit that is increased at a rate faster than inflation might be a workable approach for properties that are expected to have cash flow growth over time.

- **Larger Initial Balances.** If the Reserve started with a significant balance at the time of development, the annual deposit needed would be reduced.

A Comprehensive Policy Approach For Reserves. The Commission could recommend a more sophisticated and flexible approach that is consistent with Sustainability principles. HUD, RHS, State HFAs, and other providers of affordable housing subsidies and mortgage loans could 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[18]. The underwriting would utilize any appropriate combination of initial Reserve deposit, annual Reserve deposits, increased deposits over time, cash flow, and refinancing proceeds.

PUBLIC HOUSING

PRESERVATION RISKS IN PUBLIC HOUSING

Overview. Preservation of public housing is a worthwhile effort but – as discussed below -- one that presents quite different issues from those presented by the assisted housing universe.

Little or No Market Conversion Risk. Like §202 and §811 housing, public housing is not at risk of conversion to market-rate use. Like "new" §202 and §811 housing, public housing was developed with the equivalent of 100% capital grants[19]; ongoing revenues need only support the costs of operation and capital expenditures.

Risks of Reduction in Stock. A number of initiatives are permitted that would have the effect of reducing the total number of units in the PHA's portfolio. This reflects a political judgment by Congress that curing the worst properties was more important than maintaining a fixed number

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existing (small) Reserve deposit formula unless the amortization period were shortened to, say, 25 to 30 years.

[18] A capital needs analysis period of fifty years is an example of a period long enough to encompass at least the first replacement of most major building systems, and long enough to encompass most of the period during which the property is likely to be useful in its original configuration. A longer period would risk encompassing the time at which a redevelopment / demolition / reconstruction decision is likely to be needed. A shorter period would risk ignoring some important and expensive major systems (e.g., elevators, in-ground and in-wall utility pipes, sidewalks, siding, windows, masonry tuckpointing, …). Of course, the length of the affordability commitment could be longer than the term of the capital needs analysis (but probably should not be shorter).

[19] The federal government pays directly the debt service costs for the bonds that financed the development of most public housing. Recently developed public housing was funded with capital grants.

of units without regard to their quality. Whether this judgment was appropriate is a continuing subject of debate. In particular, these mechanisms could lead to reduction in stock:

- As large troubled public housing properties are redeveloped (under HOPE VI or otherwise), there is almost always a reduction in the total number of units on that site. Typically, some -- but not all -- of this shortfall is recouped via new development on other sites.
- Some public housing is being demolished with no immediate plans for replacement. In general, if the PHA's overall stock assessment concludes that replacing the units is not in concert with local housing needs, demolition without replacement is permitted or encouraged.
- PHAs are allowed to pursue homeownership conversions of some of their inventory, which would result in a decrease in the affordable rental stock but an increase in the affordable homeownership stock.

Significant Capital Needs Risk. However, because public housing was developed primarily between 1937 and 1970, and because many public housing authorities (PHAs) have not been able to fund their properties' long-term capital needs, much public housing is at risk. The most commonly cited study estimates the capital needs backlog in public housing at $24.6 billion, an average of $20,390 per unit[20]. The same study estimates that, if the backlog were eliminated, the ongoing capital needs would average $1,679 per unit annually. *The prime preservation risk has to do with long-term capital needs that exceed the PHA's capital needs funding[21]. The extent of the capital needs backlog, and the adequacy of existing funding levels, are the subject of intense debate[22].*

Questions of Preservation-Worthiness. *Secondarily, to a much greater extent than with the more recently developed portfolios discussed above, some public housing properties may not be worthy of preservation[23].*

PRESERVATION APPROACHES IN PUBLIC HOUSING

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[20] Abt Associates, *Formula Capital Study: Capital Needs of the Public Housing Stock in 1998*, prepared for HUD and dated March 2000.

[21] PHAs receive annual Capital Fund appropriations, averaging $2300 to $2400 per unit in recent years. In a sense, this is analogous to an annual Replacement Reserve deposit, but one that is expected to be spent rather than saved. Moreover, PHAs are permitted to use some Capital Fund amounts for operations and for systems, and most PHAs do so. To that extent, the full amount is not available to meet the capital needs of the portfolio.

[22] Some of the debate is methodological. Should a system that is functional but that is past its theoretical useful life be considered a "backlog" (the Abt study includes these items in its backlog estimate). Should a 20-year roof that is functional but 10 years old be defined as a current "backlog" (the Abt study excludes such costs)? Should the capital needs estimate reflect bringing the property into market-competitive condition, "housing of last resort" condition, or something in between (the Abt study includes a small amount, rather less than one percent, for marketability improvements)? Should the unit prices reflect private market benchmarks, historical PHA costs, or something in between? Should the unit prices include an allowance for architecture and engineering, and/or an allowance for oversight and supervision? Thus, by some estimates, current capital funding falls far short of amounts needed to fund ongoing needs; by other estimates, current capital funding would be adequate if spent in the manner favored by the estimator.

[23] The prime examples are the high-rise properties for families that, starting in the mid 1990s, are systematically being redeveloped under the HOPE VI program, primarily as townhome and garden-style properties at considerably lower density. Other public housing presents other preservation issues having to do with unit sizes and features and density that, although considered reasonable at the time of development, are not consistent with current standards.

Preservation issues in public housing are limited to capital needs risk and questions of preservation-worthiness.

Difficulties in Addressing Capital Needs Risk in Public Housing. Despite several rigorous studies performed at different times, there is much disagreement over the extent of the capital needs backlog in public housing. There is even more disagreement regarding how best to address the backlog. Part of the difficulty is that there is no consensus about the standards to which public housing should be held: market-compatible standards, below-market standards, or "housing of last resort" standards. An illustration of this is the perennial unresolved debate over whether public housing should continue with its present subsidies (analogous to project-based §8) or should be brought closer to a market model. In the meantime, much of public housing is not prepared to compete in the open market, and PHAs are uncertain whether to make the investments necessary to make their properties market-competitive. Another difficulty is that PHAs have less certainty regarding future funding levels than owners and operators of either market or assisted housing, leading to a reluctance to embark on capital programs that will take several years to complete. Another is that PHAs, as government entities[24], are not organized primarily for economic efficiency[25] and consequently are not able to utilize their funds as efficiently as are private owners and managers. Finally, some PHAs have become unduly politicized, to the point that funds are prioritized away from maintaining the properties and toward expenditures that benefit local politicians and branches of local government other than the PHA.

Approaches to Reduce Capital Needs Risk. An obvious approach is to propose additional funding, if the current public housing system is judged to be a good approach for the long term. If the current public housing system is judged deficient in some respects, the following are examples of reforms that Commission could suggest, to improve the utilization of existing funding:

- **Clarity Regarding Standards.** As it seems unlikely that the overall shift toward more market-like approaches in affordable housing will reverse itself, or that it should exclude public housing, Congress could direct that public housing be brought into market-competitive condition over a specified time period. PHAs that could not produce a credible plan, or who failed to make acceptable progress, could be placed in receivership or otherwise put under new management.

- **Allow Properties to Convert to Alternative Subsidy Systems.** Congress could create opportunities for at least some public housing properties to convert to alternative forms of subsidy delivery. One example is to give tenants vouchers while requiring the property to meet reasonable standards and to continue to house voucher holders. Another is conversion to project-based §8, perhaps for some but not all units, instead of public

[24] Enabled by state and local law, but with broad powers usually used independently of state and local government.

[25] An example is procurement practices. Oversimplifying somewhat, governmental procurement practices are designed primarily to avoid scandal, secondarily to achieve best value, and almost without regard to timeliness. Conversely, in the private sector, procurement practices are almost solely focused on optimizing economic results. This is not to say that government has it wrong -- each approach is appropriate in its context and carries its own advantages and disadvantages – but instead to point out the difficulty of carrying out a fundamentally economic activity (housing) through a system that is not optimized for economic results.

housing Operating Fund and Capital Fund. *Whether this would reduce or increase cost to government would depend on the relationship between comparable market rents for public housing properties (i.e., the rents to be reflected in the §8 contract) and the existing level of public housing funding (Operating Fund and Capital Fund, plus other smaller funding streams). That said, the aggregate average appropriated funding for public housing is roughly $6000 per unit per year, which is comparable to the average appropriated funding for §8 units.*

- **Allow Properties to Privatize.** Congress could create opportunities for the transfer of public housing properties to preserving entities, with appropriate use agreements providing for very long term affordable housing use.

- **Allow Mortgage Financing For Renovations.** Congress could create the ability for at least some PHAs to convert their stock to a more market-like system and could provide those PHAs with the ability to borrow (perhaps with FHA credit enhancement) against the market value of their portfolio[26].

- **Allow Conversion to a New PHA Governance System.** Congress could create opportunities for at least some PHAs to convert to private not-for-profit status, with Board members who are not appointed through the political system.

Each of the foregoing approaches would be amendable to targeting based on resident profile, property performance, and PHA performance. Similarly, an approach could be required in some situations, optional in others, and not available in others. Finally, each of these approaches would be enhanced by incentives to achieve the desired results, and disincentives for failure to do so.

Approaches for Answering Questions of Preservation-Worthiness. The recently enacted public housing reform legislation requires PHAs to self-identify properties that should not continue in their current condition. This is a worthy initiative that should continue. The Commission could suggest that, in addition, HUD identify particular public housing properties that fail to meet appropriate standards and independently conduct a review of preservation-worthiness (see Appendices 1 and 2).

UNREGULATED AFFORDABLE APARTMENTS

PRESERVATION RISKS IN UNREGULATED AFFORDABLE APARTMENTS

Much of the nation's affordable rental stock is not government-subsidized at all, but instead is market-rate rental stock with rents that are affordable to low-income households. One reasonable definition is properties with rents at or below 30% of 60% of area median income.

[26] QWHRA permits mortgage financing in some circumstances. QWHRA also permits PHAs to borrow against future Capital Fund appropriations (which runs counter to the Commission's guiding principle on recognizing the full cost up front).

"Filtering Up" (Gentrification). Much of today's affordable stock will "filter up" (in economics jargon) to serve higher income households in the future.

"Filtering Down" (Disinvestment and Abandonment). Similarly, much of today's affordable stock is located in neighborhoods whose market rents are too low to support the expenditures necessary to maintain it and meet its long-term capital needs.

REDUCING PRESERVATION RISKS IN UNREGULATED AFFORDABLE APARTMENTS

Preserve or Not? Some argue that preservation efforts should also address market rate apartments with rents that are affordable to low-income households, especially if such housing is actually occupied by low-income households. Others argue that preserving such housing should be a lower priority, because doing so creates no immediate rent bargain, whereas preserving or creating assisted housing provides (or preserves) housing opportunities at below-market rents.

Reducing "Filtering Up" Risks. At-risk properties can be acquired by preserving entities and retained for affordable housing use. This seems attractive in theory but is difficult in practice. The preserving entity has to identify neighborhoods that are likely to gentrify, a task at which numerous private real estate speculators make their living. As a practical matter, the likelihood that a preserving entity will "beat them at their own game" is small. There is, in fact, a considerable risk that the preserving entity will end up buying at the top of the market, buying in a neighborhood that private speculators have concluded will not gentrify any time soon. However, if preserving entities are patient and have good access to capital, they can wait for periodic downturns in their local markets and purchase properties that – although fundamentally sound – are being distress-sold.

Reducing "Filtering Down" Risks. This also seems simple in theory. Preserving entities could invest in down-at-the-heel neighborhoods that the markets have overlooked, thereby help stem the tide of economic downturn, and benefit from the future rise in value. It should be noted, however, that local governments have attempted this for decades, in the name of community development, and failed frequently. Oversimplifying somewhat, when there is a failure, the usual result is that investments are made prematurely in response to political pressure from residents, before values have declined to the point that private investors are willing to invest. This premature intervention merely delays the inevitable. If, conversely, government, and preserving entities, waited until private investment begins to come in to a neighborhood, they could be part of the solution instead of part of the problem.

Fund Preservation of Market Rate or Assisted Housing? In summary, it seems best not to channel public funds into the "preservation" of unregulated affordable apartments, not because it is not worth doing, but instead because there is every reason to believe that the funds could be put to more effective use preserving assisted or public housing. This is not to say that localities should not support modest owner-occupied rehab programs and other efforts to help residents maintain their communities physically, but rather to point out that when government attempts to out-think the market, the market usually ends up with the better end of the bargain.

Potential Local Government Approach. That said, it could well be good local government policy to create modest incentives (such as partial real estate tax abatements) for the acquisition of unregulated affordable apartments by preserving entities. It is useful to contrast the federal and local government situations. The federal government clearly has many opportunities to invest in preservation and – if the past is any indication -- too few resources to address even the regulated stock, let alone the unregulated stock. For local government or geographically based preserving entities, however, an unregulated property may be critically linked to other community concerns. Market and ownership cycles may present good buying opportunities and small-scale local incentives may be very cost effective tools.

PART II. WHY PRESERVE?

Preservation is in response to preservation risks in the existing affordable stock (as discussed in Part I) and to the shortage of adequate quality housing that is affordable to, and occupied by, very-low-income households.

THE AFFORDABLE HOUSING SHORTAGE

There is a shortage of rental housing, of acceptable quality, with rents affordable to very-low-income households[27]. According to *State of the Nation's Housing 2001*[28]:

- One in eight renter households pay more than 50% of their incomes for rent and utilities.
  - Of renter households with incomes between 30% and 50% of AMI, one in five has a housing cost burden of 50% or higher.
  - Of renter households with incomes below 30% of AMI, two-thirds have housing cost burdens of 50% or higher.

- Three in ten renter households pay more than 30% of their incomes for housing.
  - At 30% to 50% AMI, two-thirds of renters have 30%+ housing cost burdens.
  - Below 30% AMI, over 80% of renters have 30%+ housing cost burdens.

- Households with two workers, both earning minimum wage, cannot afford a typical two-bedroom apartment.

- The federal government provides rental assistance to roughly 4.6 million households with incomes at or below 50% AMI[29]. Another 4.8 million households at or below 50% AMI have "worst case" housing needs[30].

PRESERVATION PROGRAM DESIGN ISSUES

This section will review issues that are commonly raised for and against particular preservation approaches, and that have not already been addressed.

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[27] "Very low income" is a defined term, signifying households with incomes at or below 50% of area median income, adjusted for household size ("AMI").
[28] Published by the Harvard Joint Center for Housing Studies and available at www.gsd.harvard.edu/jcenter . See especially the chapter on Housing Needs.
[29] 1.3 million in public housing, 1.9 million in private assisted housing, and 1.4 million with vouchers.
[30] Severe cost burden, quality problems, and/or overcrowding.

"REAL" (PROJECT BASED) VERSUS "VIRTUAL" (TENANT BASED) UNITS

Advocates for production and preservation of affordable housing, and advocates for tenant-based solutions, have argued heatedly over the relative merits of supply-side (production, preservation) and demand-side (vouchers, earned income tax credit, welfare to work …) approaches. At this point, there is general agreement that both approaches are needed, depending on the housing needs of individual communities and target populations.

At the same time, it is troubling that the §8 voucher program is not better received by private landlords[31]. As long as this continues, preserving existing assisted and public housing will be particularly worthwhile as these are properties explicitly available to low-income households. The same can be said in favor of the production (or acquisition, by preserving entities) of otherwise market rate apartments, with a portion of the units explicitly available to voucher holders.

MISLEADING CLAIMS OF LOSS OF AFFORDABLE HOUSING

When an assisted housing property opts out of the project-based §8 program, or prepays its below-market mortgage loan, that property is commonly said to have left the affordable housing stock, and advocates commonly speak of the loss of affordable housing. This is sometimes true – if the property's rents increase to the point that voucher holders cannot live there, there has indeed been a loss of affordable housing (although, under current law, low-income residents at the time of conversion have a continued right of occupancy through enhanced vouchers).

Conversely, if the property's new market rents are within the rents affordable to voucher holders, the property has not left the affordable stock but merely transferred from the regulated to the unregulated affordable portfolio. That is, whether a unit is "affordable" has to do with its rent level; whether it can be expected to remain affordable has to do with whether it is subject to a long-term use agreement. The expiration of a long-term use agreement is not necessarily a problem unless it is accompanied by an increase in rents beyond the "affordable" level.

It is true, of course, that once a property has converted to market rate (but at affordable rents), there is every reason to expect that it will leave the affordable stock if neighborhood market rents escalate to the point that they are no longer affordable to low-income households.

LANDLORD RELUCTANCE TO HOUSE LOW-INCOME HOUSEHOLDS

To the extent that private landlords generally are reluctant to house low-income households with vouchers, supply-side solutions become particularly important. Conversely, as landlords continue to adopt increasingly progressive fair housing approaches, tenant-based solutions become more feasible.

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[31] Why this is so is beyond the scope of this paper and is being considered by the Commission's Tenant Based Approaches Committee. Recent research confirms several flaws in the design and implementation of the voucher program. Once those are cured, one can hope that vouchers, and the households that hold them, will be much more widely accepted by private landlords.

Often, these discussions center on race and disability, and indeed fair housing problems in these areas are far from resolved. However, a number of affordable housing experts are coming to the view that discrimination (whether illegal or not) based on economic status is perhaps as important to the world of affordable housing. According to this line of thinking, the problem is not so much that voucher holders are more likely to be African American, or persons with disabilities, as that they are likely to have much lower incomes than the other households in a market rate property. If this view is correct, the success of mixed-income approaches becomes particularly important; for more information, see the Commission's separate background paper on this topic.

ROLE OF RESIDENTS

Based on experience over the past several years, affordable housing experts generally agree that residents should have a meaningful role in a preservation transaction. Residents are an excellent source of information on the property's strengths and weaknesses, and concerning resident relationships with the current owner and manager. Residents are likely to have useful information concerning neighborhood conditions and concerning the availability (or non-availability) of other affordable housing options.

"NOT THE WORST"

Some argue that preservation efforts should exclude the least desirable of existing assisted and public housing properties. To the extent that the property cannot cost-effectively be made into a community resource (instead of a community problem), this view is correct. However, it is important not to conclude that because a property has been unsuccessful so far, it cannot be successful in the future. If the problems are due to inadequate management, or to physical flaws that can readily be corrected, or to external factors that are no longer present or that can be corrected, preservation of the property should not be foreclosed. For this reason, the Commission may wish to recommend a comprehensive assessment of distressed properties, along the lines of the assessment discussed in Appendices 1 and 2.

"NOT THE BEST"

Particularly high-value (or high-cost) properties present a preservation dilemma. They may represent the only affordable housing in an area otherwise unavailable to low-income households (and with rents beyond the reach of voucher holders). Yet, preserving one unit at this property may cost as much as preserving two or more units in another neighborhood. This seems to be an example of a decision that is best made close to the action, for example through the devolved decision-making under the LIHTC, HOME and CDBG programs. In creating any new preservation program, however, the Commission should be careful to consider this issue, if only because a number of past programs have been severely criticized in this way.

PART III. MAKING THE PRESERVATION DECISION

ASSESSING PRESERVATION-WORTHINESS

The overall task is to determine the extent to which the property is (or can be) a positive resource to the community. Generally, properties that are already physically viable, financially viable, under adequate management, and well regarded by the community can be presumed to be good candidates for preservation. However, when properties fall short of those standards, it is important to make a thorough assessment of the problems and what would be required to solve them.

A formal property assessment protocol, such as the one referenced in Appendix 2, is an essential step in making this determination. A number of entities, public and private, have recently gained experience with such a protocol in HUD's Mark to Market program.

A second essential step is a "reality check" designed to determine whether the property has outlived its usefulness. For this purpose, the series of questions in Appendix 1 provide an example of the sort of "reality check" that would be appropriate. Unless the assessment team formally confronts these sorts of questions, it is all too easy to fall into the trap of assuming that every property, once developed, should continue in its current configuration.

PART IV. USING THE SUSTAINABILITY "TERM SHEET"

Appendix 3 repeats the term sheet from the Commission's concept paper on Long Term Sustainability and Affordability. This term sheet outlines the standards that are appropriate for developing and preserving affordable housing that will continue to be affordable and viable over an extended period, such as fifty years, without requiring periodic injections of government subsidy.

In preservation situations, sometimes it will be necessary to restructure the existing mortgage debt in order to provide for the long-term sustainability of the property. When preservation occurs in the context of HUD's Mark to Market program, debt restructuring is available when appropriate. However, the Commission could recommend that Mark to Market principles be adopted by RHS and State HFAs when making preservation decisions for existing RHS and LIHTC properties.

As one experienced observer noted, the Sustainability approach would have the effect of converting affordable housing from a business focused on up-front fees to one focused on longer-term cash flow. It seems self-evident that such a conversion would lead to better results over the long term.

PART V. POTENTIAL COMMISSION RECOMMENDATIONS

The preceding discussion suggests the following as potential Commission recommendations:

1. **Level of Funding.** The Commission could consider whether the existing level of funding for preservation and recapitalization is adequate.

2. **Comprehensive Assessment of Troubled Properties.** A small but material number of

assisted and public housing properties have failed. They do not constitute community resources but instead are community problems. The Commission could recommend that each such property receive a property-specific assessment, by an entity that is independent of the immediate stakeholders but accountable to government, to determine whether the property can be made successful and, if not, how best to remove it from the stock and relocate residents.

3. **Adequate Replacement Reserve Funding for Existing Properties.** The Commission could recommend that HUD and RHS systematically obtain professional capital needs assessments, and increase Reserve funding to the level needed to fund ongoing capital needs, perhaps in conjunction with an extended affordability commitment from the property owner. If increasing Reserve deposits to the necessary level is not feasible while staying within market rents, the property should undergo debt restructuring, in Mark to Market or otherwise, so that it can be viable in the future

4. **A Comprehensive Policy Approach For Reserves.** The Commission could recommend a more sophisticated and flexible approach that is consistent with Sustainability principles. HUD, RHS, State HFAs, and other providers of affordable housing subsidies and mortgage loans could 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.

5. **Funding For Public Housing Capital Needs.** The Commission could propose additional funding under the Public Housing Capital Fund, if the current public housing system is judged to be a good approach for the long term.

6. **Fundamental Change in Public Housing.** If the current public housing system is judged deficient in some respects, the following are examples of reforms that Commission could suggest, to improve the utilization of existing funding. Each of these approaches would be amendable to targeting based on resident profile, property performance, and PHA performance. Similarly, an approach could be required in some situations, optional in others, and not available in others. Finally, each of these approaches would be enhanced by incentives to achieve the desired results, and disincentives for failure to do so.

   6.1. **Clarity Regarding Public Housing Standards.** The Commission could recommend that public housing be brought into market-competitive condition over a specified time period. PHAs that could not produce a credible plan, or that failed to make acceptable progress, could be placed in receivership or otherwise put under new management.

   6.2. **Allow Public Housing to Convert to Alternative Subsidy Systems.** The Commission could recommend the creation of opportunities for at least some public housing properties to convert to alternative forms of subsidy delivery. One example is to give tenants vouchers while requiring the property to meet reasonable standards and to continue to house voucher holders. Another is conversion to project-based §8, perhaps for some but not all units, instead of public housing Operating Fund and Capital Fund.

6.3. **Allow Public Housing to Privatize.** The Commission could recommend the creation of opportunities for the transfer of public housing properties to preserving entities, with appropriate use agreements providing for very long term affordable housing use.

6.4. **Allow PHAs to Access Mortgage Financing For Renovations.** The Commission could recommend enacting authority for at least some PHAs to convert their stock to a more market-like system, in conjunction with the ability to borrow (perhaps with FHA credit enhancement) against the market value of their portfolios.

6.5. **Allow Conversion to a New PHA Governance System.** Congress could create opportunities for at least some PHAs to convert to private not-for-profit status, with Board members who are not appointed through the political system.

6.6. **Cap PHA Administrative Costs.** Congress could enact reforms that limit PHA administrative costs to reasonable levels, in the interest of directing additional funding to the maintenance and operation of the portfolio.

7. **Encourage Local Government Preservation Initiatives.** The Commission could recommend encouraging local governments to create modest incentives (such as partial real estate tax abatements) for the acquisition of unregulated affordable apartments by preserving entities.

8. **Expand Debt Restructuring Beyond HUD's Mark to Market Program.** The Commission could recommend that Mark to Market principles be adopted by RHS and State HFAs when making preservation decisions for existing RHS and LIHTC properties.

AUTHOR

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APPENDIX 1: MAKING PRESERVATION DECISIONS

QUESTIONS TO ANSWER

1. *Location* – is this location OK for apartments? If this site were vacant, would we want to build apartments here?

2. *Rental vs. Homeownership* – is the neighborhood mix OK? Or is the neighborhood housing stock over-weighted with apartments?

3. *Homeownership* – should homeownership be introduced into this property? If so, what is the right way to do it?

4. *Resident profile* – is the current resident profile OK, or does the property need to be repositioned?

5. *Income Mix* – what is the current income mix? Is that mix OK? Is the property capable of attracting higher income households, or could it be capable of doing so with appropriate improvements? If so, would we want to attract at least some higher income households?

6. *Density* – is the total number of units OK? If the property is too dense, can the density be reduced without incurring unmanageable resident relocation problems?

7. *Unit mix* – is the current unit mix (number of bedrooms and baths) OK?

8. *Floor plans* – are the existing floor plans functional?

9. *Buildings* – are the existing buildings structurally sound?

10. *Defensible space* – is the current layout of buildings, parking and common areas adequately crime-resistant?

11. *Degree of renovation needed* – does the property need little or no capital investment? Moderate rehabilitation? Substantial rehabilitation? More?

12. *Resident displacement* – can the needed renovations be done with residents in place? If not, are there adequate relocation resources?

13. *Demolition* – should we consider partial or full demolition? If so, what are possible re-uses for the site? Any problems re-using the site? Any barriers to demolition?

14. *Community space* – is there adequate community space?

15. *Costs* – is the ideal approach cost-effective? Is there a compromise approach that optimizes cost and community quality?

APPENDIX 2: PROPERTY ASSESSMENT PROTOCOL FOR LONG TERM SUSTAINABILITY AND AFFORDABILITY

THE MARK TO MARKET PROPERTY ASSESSMENT PROCESS

The following is an outline of the property assessment process followed in HUD's Mark to Market program, mentioned in the paper as an example of a process that is adequate to position a property for long-term affordability and viability. The M2M process has the following features:

- **Open Process.** Property assessors consult the property owner, property management company, residents, local government, HUD Hub or Program Center, and others who have an interest in the property's operations and long-term viability.

- **Assessment of Ownership and Management.** Property assessors determine whether the owner (or purchaser) and property management company are capable and committed to the property. Approval is contingent upon acceptable ownership and management.

- **Market Rent Analysis.** Property assessors obtain a third party Rent Comparability Study from a state certified general appraiser. Property assessors also personally evaluate the property, neighborhood, and comparable properties. The property assessor reaches an independent market rent conclusion, taking into account the appraiser's conclusions but departing from them where appropriate. The property assessor also reaches independent conclusions regarding vacancy, collection losses, and income other than rents.

- **Physical Condition Assessment.** Property assessors obtain a third party assessment of the property's current physical condition and of the major repairs and replacements needed to keep the property viable for the next 20 years. The property assessor reaches independent conclusions regarding the property's current condition, any repairs or upgrades needed to bring the property into competitive condition, and how best to fund a Reserve for Replacements that is adequate to fund the property's ongoing major physical needs.

- **Operations Analysis.** Property assessors determine the level of operating expenses reasonably required to maintain the long-term viability of the property.

- **Underwriting Analysis.** Property assessors determine the amount of first mortgage debt that can be supported at market rents and with an operating budget that is adequate, without being excessive, to maintain the long term viability of the property.

The assessment is market-specific and includes opportunities for local government and the local PHA to provide input. The assessment is property-specific, assessing the actual needs of each property rather than using rules of thumb or averages. This type of process is time consuming and involves a great deal of expert judgment. Accordingly, it is important to select assessors carefully.

APPENDIX 3: "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[32]. 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).

[32] For affordable housing, it is important to measure debt service coverage carefully. The traditional debt service coverage ratio (vs. NOI) will be inadequate whenever the property has a high expense ratio and a low NOI ("1.20 of a small number is a small number"). Thus, the traditional DSCR should be supplemented with other measurements such as coverage as a percentage of EGI, coverage as a percentage of operating expenses, and coverage in dollars per unit.

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[33]. 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[34].

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[35]:

- 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

[33] 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.

[34] 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.

[35] This requires, of course, that the overall developer fee is reasonable in relation to risk and cost. Deferring a portion of a fee that is already too low would be counterproductive.

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 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.