

A F F O R D A B L E H O U S I N G

ISSUES

SHIMBERG CENTER FOR AFFORDABLE HOUSING

M.E. Rinker, Sr., School of Building Construction • College of Design, Construction & Planning • PO Box 115703, University of Florida, Gainesville, FL 32611-5703 TEL: (352) 273-1192 • SUNCOM: 622-7697 • FAX: (352) 392-4364

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Preservation of the Affordable Housing Stock

For decades, the government response to the need for affordable housing was focused on new construction of multifamily rental properties, either directly through public housing or indirectly in the form of assistance to private developers. The focus shifted to a demand-side tenant-based subsidy system during the 1980's. New construction of affordable housing has been unable to keep pace with demand and has slowed down due to challenging project economics. This is coupled with an ongoing loss of existing affordable units due to conversion to market-rate housing or dilapidation. Preservation of the affordable housing stock has become an important approach to meet current and future housing needs. This newsletter will frame the preservation topic by discussing the terms of three federal programs under which affordable housing was constructed by the private sector, perspectives of property owners, and opportunities and obstacles for preservation.

Supply and Demand

“Mr. Chairman, the outlook for housing for low-income Americans over the next 15 years is grim. The facts are relatively easy to summarize:

- We have never provided enough subsidized housing to meet the demand;
- We are unable to provide enough funds to properly maintain our existing housing stock;
- The housing demands of the poor are likely to increase over the next few years;
- The ranks of the homeless are growing because of a complex set of conditions, and we have done relatively little to stem the tide, and;
- We risk the loss of a substantial number of 236 and 221(d)(3) units over the next 15 years.”

This could have been written yesterday, but actually dates back to 1988. It is an opening statement by House Representative Roukema at a hearing on the preservation of low income housing before the federal Subcommittee on Housing and Community Development. Today, the demand for affordable housing units continues to soar, impacted by growing populations, changing formation of households, soaring land values, stagnating incomes, deteriorating properties and continuing loss of affordable units from the housing stock.

New construction of affordable rental properties is not geared to the lowest income groups and has actually slowed down due to unfavorable project economics. At the same time, existing units are being lost. In its 2005 report, the Affordable Housing Study Commission denotes that 5,749 units have been lost in Florida as of March 2005, due to prepayment of federally subsidized mortgages or opt-out from federal rental assistance contracts by private property owners of affordable housing developments. This number understates the extent of the real loss of affordable housing in Florida, because it does not include loss of units under other government programs or loss due to dilapidation. To understand how units could have disappeared and may vanish in the future, the terms of three federal housing programs are discussed next.

From Public to Private

Between the late 1930's and mid-1970's, affordable housing was supplied through the

production of public rental developments by local housing authorities. The federal attitude to housing production shifted in a fundamental way when Kennedy took office in 1961. He explored alternate ways of housing production that would target households with incomes too high to be eligible for public housing but too low to become homeowners. The goal was also to achieve better efficiencies through public-private cooperation. From the early 1960's to the mid-1980's, the federal government created three subsequent housing programs that would stimulate production of moderate- and low-income multifamily rental housing: Section 221(d)(3) Below Market Interest Rate, Section 236 and Section 8 Project-Based assistance.

The Section 221(d)(3) Below Market Interest Rate (BMIR) program was created under the National Housing Act in 1961 to promote construction of affordable housing. It enabled private lenders to originate mortgages on rental housing properties at a three percent interest rate by allowing them to sell these mortgages to Fannie Mae at market. The loans were also insured by the Federal Housing Administration (FHA) to lower the risk to lenders. The rate of return to property owners was restricted to six percent of original equity. The amortization term of the mortgages was 40 years. Most for-profit owners were eligible to prepay after 20 years and terminate the use restriction at that same time. Section 221(d)(3) required large capital outlays up front by Fannie Mae. Due to this budgetary impact, the program was eliminated and replaced by Section 236 in 1968. In Florida, about 23,127 housing units were financed under Section 221(d)(3).

The Section 236 program became law under the Housing Act of 1968 that was enacted by the Johnson Administration. The government provided lenders with a monthly interest reduction payment (IRP) subsidy, which reduced the interest rate on loans to developers of rental housing from market rate to one percent. The amortization term was the same as that for Section 221(d)(3), 40 years with eligibility for prepayment after 20 years. In addition to the mortgage subsidy, the government provided special tax advantages to the property owners such as accelerated depreciation. The rate of return to owners continued to be capped at 6 percent. In 1973, new funding under this program came to a halt when Nixon's government placed a moratorium on all housing programs. In Florida, a total of 8,025 units were funded under Section 236.

In 1974, the federal government introduced two new programs to stimulate construction of affordable rental housing. These programs were established to provide a direct rent subsidy through a contract between the property owner and the local public housing authority. The programs were:

Loan Management Set Aside Program:

Properties built under Section 221(d)(3) and Section 236 were experiencing difficulty in meeting their mortgage obligations due to short-comings in the rents received from tenants. The Loan Management Set Aside (LMSA) program was developed to supplement the rents on those properties. Section 8 contracts were usually for five years with two options to renew for five years at a time. A property owner was given the choice to opt-out of the Section 8 contract upon

expiry instead of renewal. In Florida, over 8,000 units continue to receive project-based rental-assistance through LMSA.

New Construction Program and Substantial Rehabilitation Program: Rental assistance was provided to newly constructed or substantially rehabilitated privately owned rental developments that were funded by any FHA-insured mortgage. The term for assistance was set at 20 years, after which the owner could opt-out or extend by one to five years, subject to annual appropriations by Congress. These Section 8 programs were repealed in 1983. In Florida, about 1,400 units were constructed under these programs.

First Preservation Talk

By the 1980's, federal housing policy had shifted from a supply-side production approach to a demand-side tenant-based subsidy system. New construction of affordable housing slowed down steadily during the 1980's, which went hand in hand with a decline in the number of unassisted private units with affordable rents. Furthermore, the 1980's marked the 20th anniversary of the subsidized mortgages issued under the earliest federal programs. Many of the oldest structures built under the HUD-subsidized programs also faced substantial repair needs. Policy-makers and housing advocates began to recognize the risk that subsidized privately-owned rental units could be lost to the affordable housing stock in any of these three ways:

- Dilapidation and default as a result of lack of cash reserves for capital requirements or due to disinterest of owners, especially for properties in blighted areas.
- Conversion to market-rate rentals or condominiums if the rent levels in the area were higher than the project rents and if tax benefits had expired.
- Redevelopment to non-residential use.

Although the risk of potential loss was identified at the federal level, the extent of prepayments and the impact on residents were uncertain and had not been explored. In 1987, the federal government introduced the Emergency Low Income Housing Preservation Act (ELIHPA). It placed a two-year moratorium on prepayments, while Congress developed a ‘permanent’ solution to protecting affordable units. ELIHPA was replaced by the Low-Income Housing Preservation and Resident Homeownership Act (LIH-PRHA) in 1990. This Act was aimed at preserving privately-owned subsidized properties for their remaining useful life, set at 50 years. The new regulation imposed ‘permanent’ prepayment restrictions and encouraged property owners to refinance or sell to a ‘qualified’ purchaser, an entity that keeps the units affordable.

From an Owner’s Perspective

In 1996, the Clinton Administration adopted the Housing Opportunity Program Extension Act. It restored the right of eligible property owners to prepay a subsidized mortgage as of the 20th anniversary of the loan.

Owners of subsidized properties have contractual rights and obligations that present them with several choices at the time of eligibility of subsidized mortgage prepayment or rental assistance contract expiry: retain the property and maintain affordability; retain the property and convert to market-rate rentals or condominiums; sell to a(nother) ‘preserving entity’ that will maintain affordability; or sell to a(nother) market buyer who will convert to market-rate housing. An owner’s decision may be impacted by a wide variety of inter-connected factors such as the following:

- **Tax benefits:** Tax benefits expire as allowable depreciation reaches zero and mortgage interest deductions are no longer sufficient to offset taxable income. This can be motivation to sell. At the same time, as principal payments increase over the life of a loan, many owners are paying taxes in excess of actual cash received from the allowable limited dividend, referred to as phantom income. The property owner builds up this phantom income and has to pay taxes on this non-cash capital gain upon sale of the property (the exit or recapture tax). In that case, an owner might decide to convert or let the property deteriorate.
- **Physical state of the property:** Aging buildings require capital improvements, but cash reserves often have not been allocated or have been depleted to cover operating expenses. The need for a capital injection may lead to an owner’s decision to sell, convert or let the property dilapidate.
- **Availability of other government funding:** To keep units affordable, substantial government support is needed. But housing budgets have seen major cuts. If funding is lacking or is uncertain for the future, a property owner can be deterred from continuing to operate an affordable housing development.

- **Local market conditions:** Rent restrictions and limited dividends curb cash flows. When a development is located in a market with strong property values, good schools and amenities, low vacancy rates, low poverty and low crime, there is great potential to improve financial returns by converting to market housing.
- **Ownership status:** If the owner is a nonprofit organization, its mandate will be focused on the supply of affordable housing for low income families, and therefore the risk of conversion to market rate rental or condos is marginal. For-profit owners with their eye on the bottom line would be more enticed to terminate subsidies and convert to a market-based system. Portfolio decisions are also driven by a myriad of factors related to corporate strategies and personal motivations such as retirement plans.

Preservation Programs

The issue of preservation has received much attention from all levels of government and organizations such as the National Housing Trust, the Florida Housing Coalition and the Governor's Affordable Housing Study Commission. The attention is no longer only on the oldest properties funded by the three federal programs discussed. The issue of preservation also impacts public housing units, properties funded by the Rural Housing Service, Section 201 units for the elderly, Section 811 units for persons with disabilities, and developments funded under state administered programs such as the Low Income Housing Tax Credits and Multifamily Mortgage Revenue Bonds.

Several programs and strategies have been developed to keep units affordable, including:

- **Enhanced Vouchers:** These are made available by HUD to tenants of properties that convert to market rate rental housing when the owner prepays the mortgage or opts out of the Section 8 rental assistance contract. The Enhanced Voucher will not stay with the unit or tenant, but is terminated when the tenant moves out.
- **Mark-Up-To-Market:** Under this federal program, contracts for Section 8 Project-Based properties with below-market rent levels may be renewed at market rent for a minimum of five years (subject to annual appropriations).
- **Mark-To-Market:** This federal program applies to Section 8 Project-Based properties with FHA insurance and contract rent levels above the prevailing market rents. The mortgage on the property is refinanced in order to reduce the owner's loan payments, and the Section 8 contract is renewed at a lower rent level for 30 years in order to reduce HUD's cost of the subsidy.
- **Low Income Housing Tax Credits:** Several states are setting aside LIHTC's for preservation and may also award extra points to applications that propose to preserve units. Although Florida does not have such a defined allocation, it has funded rehabilitation projects with tax credits.

Obstacles and Opportunities

To date, preservation efforts have been haphazard at most state and local levels. Although some 'preservation tools' exist as discussed above, these come with regulatory restrictions and budgetary uncertainties. Governments and authorities have also been unable to respond

to preservation needs in a proactive manner. This is due to a lack of understanding of the extent of the issue and limited property-level data that would provide insight into the risk of prepayment or opt -out. Around the country, several states and counties have started to create databases of assisted affordable housing developments, often with the goal to develop a better picture of the preservation challenges and opportunities in their jurisdiction. The Florida Housing Data Clearinghouse that is administered by the Shimberg Center for Affordable Housing has developed the Assisted Housing Inventory (<http://www.flhousingdata.shimberg.ufl.edu/>). It contains property-level information for multifamily rental properties in the state of Florida

that receive federal, state and/or local funding. It is a comprehensive and evolving tool for policy-makers and housing professionals.

The Governor's Affordable Housing Study Commission reported that "affordability requirements for approximately 60,000 units will expire over the next 15 years, and many believe these include the units most likely to serve the state's lowest income residents". Preservation is a necessary approach to prevent displacement of families and to address the demand for affordability.

The inquisitive reader is encouraged to visit the following HUD website for the Office of Affordable Housing Preservation –

<http://www.hud.gov/offices/hsg/omhar/>.

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Shimberg Center for Affordable Housing
School of Building Construction
College of Design, Construction & Planning
203 Rinker Hall
Gainesville, FL 32611

