Public Housing Preservation: Lessons from the Private Sector

by the National Association of Housing and Redevelopment Officials

This paper identifies lessons of relevance for the preservation of public housing, drawing upon the historical experiences of private-sector entities in the development, ownership, and recapitalization of federally assisted, affordable, multifamily housing. The paper considers what the involvement of such entities tells us about *asset* sustainability. Based upon these lessons, the paper examines the dynamics that tended to undermine asset sustainability, in particular evaluating the nature of the incentives that encouraged private ownership of and investment in such housing. Next the paper considers what the involvement of private entities tells us about *portfolio* sustainability. The paper begins with a summary of the current state of public housing.

The Current State of Public Housing

Public housing is real estate with a federal program overlay. As of the turn of the 21st century, the real estate portfolio of approximately 1.2 million units had a combined capital needs backlog estimated by one study to be in excess of $24 billion. The backlog derives from consistent underfunding of the public housing capital grant program combined with features of the federal program overlay that cause it to impede the efforts of public housing agencies (PHAs) seeking to address the physical and market obsolescence of the real estate. These features include but are not limited to an unsatisfactory contractual arrangement between PHAs and the U.S. Department of Housing and Urban Development (HUD), described below, and the persistent underfunding of operations, which results in the use of capital funds to support operations.

Absent a dramatic change in the relationship between PHAs and HUD, the U.S. public housing portfolio is at risk of loss. Already, more than 177,000 apartments have left the public housing program since 1995, according to one recent estimate.[i] HUD data show that nearly 220,000 units were approved for removal from the start of fiscal year 1988 through late April 2008.[ii] Though many of these units were distressed and their removal was therefore appropriate, losses of hard units from the public housing inventory can occur for a variety of reasons. HUD's Special Applications Center reviews requests for demolition (full or partial), sale, or lease and for conversion of the public housing subsidy to tenant-based rental assistance (which may entail conversion of the real estate to market-rate housing).

Despite the steady loss of public housing units, there has been relatively little focus on public housing preservation.[1] In contrast, the loss of units from the privately owned, publicly assisted inventory ("the HUD-assisted inventory") has been recognized by many to be a crisis and has received much attention from federal, state, and local policymakers and program stakeholders. A fairly robust set of tools has evolved to support the preservation of assisted housing, and an omnibus preservation bill is in the works to refine and broaden the toolkit. The recently enacted Housing and Economic Recovery Act of 2008 contained several modifications to the Low Income Housing Tax Credit (LIHTC) that improve its utility as a tool to preserve assisted housing. Neither bill contains provisions directly targeted to public housing preservation. Meanwhile, the traditional public housing resources — the annual operating and capital grant programs — are consistently underfunded relative to need.

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[1] For purposes of this paper, "preservation" is defined as a process that achieves the physical revitalization of the real estate using resources that make it possible for an owner to make a renewed, long-term commitment to affordability.

Among the primary obstacles to public housing preservation is the nature of the PHA contractual arrangement with HUD. Whereas private owners enter into a Housing Assistance Payments (HAP)[2] contract with HUD that commits the Agency to pay the difference between 30 percent of a tenant's adjusted income and the contract rent on the unit, PHAs enjoy no such commitment. The Annual Contributions Contract (ACC) between a PHA and HUD is a one-sided document that requires the PHA to abide by the regulations of HUD's Office of Public and Indian Housing (PIH) without in turn obliging HUD to provide adequate operating support. Annual operating funding provided to PHA-owned properties under the ACC is in FY 2008 prorated at roughly 82 percent of what the regulatory formula specifies it should be, not taking utility expenditures into account. Thus the ACC not only fails to assure that PHAs will enjoy adequate operating support, but by doing so it also substantially prevents them from leveraging private debt or equity to address their capital needs backlog.[3] The HAP is perhaps the key tool available to private owners seeking to leverage private resources to preserve assisted housing. The ACC is among the key barriers preventing PHAs from doing so.

Adding urgency to the need for a comprehensive public housing preservation strategy is a recent change in how operating subsidy is distributed. The change involves a shift in federal grant funding from the *agency* level to the *project* level and was accompanied by the adoption of an "asset management" oversight model at HUD. "Asset management" requires PHAs to employ project-based accounting, budgeting, management, and reporting. Where PHAs once received annual operating subsidy grant funds that they would then allocate on a cost basis to the properties within their portfolios, they now receive annual allocations of grant funding tied by formula to individual projects. This change was implemented for a number of reasons, not least of which was to begin to move public housing into the real estate mainstream. Among the tools available to mainstream real estate owners is the ability to leverage private debt and equity to recapitalize their individual properties. The shift to asset management at HUD was not, however, accompanied by the sorts of changes that would facilitate leveraging (e.g., reform of the ACC such that it requires HUD adequately to fund PHA operations). So, while asset management will inevitably call out in high relief the poorly performing properties within a PHA's portfolio, PHAs will remain incapable of leveraging private resources to address the capital needs backlog of all of the assets within their portfolios. Asset management may be among the factors contributing to the accelerating pace of loss of public housing units.

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While the public housing industry has quarrels with how HUD is implementing "asset management," PHAs increasingly recognize that a shift to a project-based (or asset-based) ownership model is a critical first step in the preservation of public housing. Among other things, such a shift will make it possible for lenders and investors to evaluate the risks of investing in the real estate. The critical second step is yet to occur: making available to PHAs a meaningful contract with HUD — similar to a HAP — that assures the long-term, predictable funding of individual assets. Such a step would go a long way toward minimizing risk. Beyond these two steps, a central challenge facing public housing today has to do with isolating and addressing other elements of the federal program that inhibit PHAs' ability to address the physical and market obsolescence of their assets. For example, though they have since 1998 had clear

[2] The statutory authority for the Sec. 8 project-based assistance programs that are administered via HAP contracts has been repealed, but many of the contracts continue to be funded under contract renewal authority.

[3] PHAs may use the Capital Fund Financing Program (CFFP) to leverage resources, but the underwriting of the program (typically at 3.0 debt service coverage) means that for every one property whose capital needs are addressed through an influx of private capital, roughly two more remain dependent on appropriated funds.

statutory authority to permit a security interest in their public housing properties, PHAs lack any regulatory guidance on how to do so.

Drawing on themes from the historical involvement of private-sector entities in federally assisted, affordable, multifamily housing development, ownership, and preservation, this paper will identify key lessons that could usefully inform the nation's efforts to preserve public housing with the twin goals of asset and portfolio sustainability in mind.

Asset Sustainability[4] [iii]

The public housing program came into being with the U.S. Housing Act of 1937. Over time, new production programs were enacted to engage private-sector developers and owners in the provision of affordable rental housing. The knowledge gained from the involvement of such entities in the development, ownership, and preservation of HUD's assisted inventory could usefully inform the nation's efforts to preserve public housing properties, beginning with lessons about asset sustainability.

The Housing Act of 1961 brought into being a subsidized–interest rate mortgage program that was designed specifically to involve private-sector developers in the production and ownership of multifamily rental housing for moderate-income families ineligible for public housing but unable to afford decent shelter in the open market. The program, known as the Section 221(d)(3) below-market interest rate (BMIR) program, was superseded in the Housing Act of 1968, when a similar program (Section 236) was enacted, targeted to low- and moderate-income households. Production under both programs picked up after the 1969 Tax Reform Act established favorable income tax treatments for profit-motivated investors in low-income housing.

In 1973, the Section 236 program was repealed. A new program tailored to private-sector entities, the Section 8 New Construction/Substantial Rehabilitation (NC/SR) program, was enacted in 1974. This program delivered affordability not through a subsidized mortgage, but through a project-based contract (the HAP, described earlier) between an owner and HUD that guaranteed affordability for residents and obligated HUD to pay the owner the difference between the tenant payment and the contract rent. Owners under this program enjoyed the same favorable tax treatments as those enjoyed by pre-1974 owners.

A lot of rental housing was produced under the HUD-assisted programs. Part of the reason for this outcome is that the benefits to the developer were strong and the perceived risks were minimal. For example, the developers under the Section 221(d)(3) BMIR and Section 236 programs received a Federal Housing Administration (FHA)-insured construction loan and an FHA-insured permanent loan (with a subsidized interest rate). In exchange, the developer committed to maintain occupancy restrictions for anywhere from 20 to 40 years. The subsidized interest rate was intended to assure that rents would be competitive, keeping vacancy rates low. Tenants paid flat rents intended to cover debt service at the subsidized interest rate, estimated operating costs, and, for profit-motivated developers, a limited return.[5] Under the Section 8 NC/SR program, the development budget was based on total development costs (TDCs), with initial contract rents derived working backward from development costs. Contract rents were intended to cover debt service, operating expenses, and a return to the owner.

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[4] Many of the ideas presented in this section are based directly on background papers prepared by Charles S. Wilkins Jr. for the congressionally mandated Millennial Housing Commission, for which the author served as director of operations.

[5] Tenants of Section 221(d)(3) BMIR properties paid flat rents. In Section 236 properties, tenants with incomes below a HUD-established ceiling paid a basic rent intended to cover debt service at the subsidized interest rate, estimated operating costs, and a limited return. Tenants with incomes above the ceiling paid the lesser of 25 percent (later raised to 30 percent) of their income or the Section 236 Market Rent (intended to cover debt service, etc., at the stated rate of interest on the mortgage (i.e., an unsubsidized interest rate)).

Several characteristics of the HUD-assisted programs provide useful lessons specific to asset sustainability. These lessons are summarized below.

Development cost limits can have adverse consequences. Under the Section 221(d)(3) BMIR and Section 236 programs, the mortgage loan amount was based on a percentage of TDCs (rather than on the value of the property). To assure that TDCs were "reasonable," HUD employed cost limits. Initial cost underwriting was so tight that developers tended to design to HUD's minimum property standards, resulting in such things as skip elevators, extremely small rooms, units with no air conditioning or carpeting, and the use of electric baseboard heating. The development standards also affected property siting, such that properties tended to be located in areas with relatively low land costs.[6] Combined with federal preferences for admission that were later imposed via project-based rental assistance contracts that were put into place to support operations and keep rents affordable,[7] these factors ultimately contributed to the concentration of poverty, which put downward pressure on property values and had negative consequences for operations and asset sustainability going forward.

The lesson for public housing preservation is that the urge to adopt development cost caps should be resisted in favor of a more flexible approach that enables PHAs to rehabilitate to a standard that will contribute to sustaining the value of the asset in the local marketplace — while assuring continued affordability for the public housing program's traditional clientele. The newly revitalized property must also be underwritten for the long haul, as described next.

Sustainable underwriting is essential. The assisted housing programs relied heavily on debt. Developers under the Section 221(d)(3) BMIR and Section 236 programs received FHA-insured, below market debt. For profit-motivated sponsors, the amount of the debt was equal to 90 percent of TDCs. Section 8 NC/SR developers typically obtained market-rate debt; the amount of debt was in many cases in excess of the properties' economic value.

The mortgage-debt driven nature of the programs was accompanied by an overly aggressive approach to underwriting. For example, developers tended to understate their anticipated operating expenses in order to maximize the amount of debt the property could support. Vacancy rates were optimistically underwritten, because rents would be affordable. Initial rents were set based on the costs to operate a property, without an appropriately thorough assessment of whether the rents could be supported in the local market. All of these factors had adverse consequences for the sustainability of individual assets.

For the Section 221(d)(3) BMIR and Section 236 programs, whose annual rent increases were supposed to be based on costs, the inflation of the 1970s proved to be disastrous. As operating expenses jumped, costs would have pushed rents above the levels allowed by HUD. In these cases, rather than accept an owner's expense projections, asset management staff tended to "edit" the budget downward. Deferred maintenance needs began to mount, and properties got into real trouble.

The lesson for public housing preservation is that policies intended to assure long-term affordability must be accompanied by policies that promote asset viability — from the point of underwriting. Underwriting must be adequate not only to sustain operations, but it must also take into account the need for eventual recapitalization, as described next.

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[6] Because PHAs typically negotiated a "payment in lieu of taxes" with the local jurisdiction, jurisdictions tended to encourage these siting decisions, so that higher-value land could be reserved for owners paying property taxes at the full rate.

[7] As inflation took hold, Sec. 8 assistance (called "Loan Management Set Aside," or LMSA) was made available to properties developed under the Sec. 221(d)(3) BMIR and Sec. 236 programs so that rental payments to owners could be increased to bolster operations while holding tenant rents constant.

Recapitalization with renewed affordability must be contemplated in a property's operating budget. Under the HUD-assisted programs, the formula-based reserve deposits were low, in part because it was expected that the properties' recapitalization needs could be addressed through resyndication or conversion to market — and the loss of affordability. The latter option became politically untenable; the former was eliminated by the Tax Reform Act of 1986, which is described in detail in the next section.

The adequacy of a capital reserve can become a determining factor with regard to long-term affordability depending upon the market in which a property is located and the options available to the owner. For example, the owner of a property in a strong rental market may have the option to address capital needs by converting to market-rate rents, while the rents in a weak market may obviate this option for an owner. Likewise, an owner in a strong market may wish to sell to an organization that will preserve affordability, in which case the purchaser will need to cobble together resources to cover not only the sales price of the property (and the owner's exit tax liability, discussed below), but any rehabilitation costs. Often, the rehabilitation needs of properties in weak markets exceed the levels that can be supported by debt alone, in which case tax credits, soft debt, and grants will be needed.

The lesson for public housing preservation is simply that adequate resources for the eventual recapitalization of a property serving public housing clientele should be included in the property's operating budget. The alternative — dependence upon periodic infusions of capital from outside sources — is a high-risk proposition against the goal of renewed, long-term affordability. Not only should such a reserve be funded, but it should be funded at a level intended to cover the full capital needs of the asset at the end of 20 years. The adequacy of the level of funding should be evaluated periodically throughout the 20-year span and adjusted as necessary.

The goal of the assisted housing programs was to bring private development expertise to the production of affordable housing, and the programs generally succeeded in achieving that goal. The programs also mandated that owners commit to delivering affordability for anywhere from 20 to 40 years. The programs did not necessarily require or incentivize an equivalent commitment to protecting the value of the asset, however. While the reality of development cost limits, tight underwriting, and inadequate capital reserves might reasonably have been predicted not to sustain the value of the assets developed under these programs, there were other dynamics at work that tended to exacerbate these factors. These dynamics are described in the next section.

Owner Motivation

Developers who participated in the Section 221(d)(3) BMIR and Section 236 programs generally did not expect to realize cash flow from operations. The much greater financial incentive for program participation was the ability to engage in "tax-shelter syndication," a process under which developers could sell a percentage interest in the property to investors seeking tax losses. To attract investors, the developer needed to guarantee that the property would be built, leased up and stabilized, and produce tax losses. Tax losses were generated through the depreciation of investments in buildings and the amortization of financing and organizational costs, and by owners choosing to spend on deductible items, such as repairs and interest,[8] to the extent that they had an option. Irrespective of all else, the investors derived their benefit from the asset so long as mortgage payments were made.

The 1980s brought two pieces of legislation that first enriched the tax benefits for investors in real estate, then eliminated them. This tax policy reversal generally had a negative effect on the assets developed under the HUD-assisted programs. The reason for this outcome has much to do with the expectations of owners and investors who participated in the programs, described above. While there were owners whose participation was well-intentioned *vis-à-vis* the mission of providing long-term affordability, in retrospect

[8] Replacements, principal payments, and deposits to reserves were all non-deductible.

it is clear that the incentive structure of the programs essentially cultivated an owner and investor class whose motivation for participating in the programs could as a practical matter be divorced from this mission. The nature of the tax reversal and its effects are described below.

The Economic Recovery Tax Act of 1981 (ERTA) enriched the tax benefits for investors in commercial and residential real estate. It established extremely favorable terms for the accelerated depreciation of commercial and residential real property.[9] With these accelerated write-offs in place, properties began to change hands. Those who could not themselves use ERTA's depreciation allowances were permitted to sell them to others. Sales prices climbed,[10] as did debt per property, setting the stage in part for the savings and loan debacle.

Sales within the affordable portfolio generally involved the purchaser assuming the existing FHA-insured mortgage and providing the seller with a purchase money note (PMN). The note created additional deductions for the purchaser, since the principal amount was virtually all depreciable, and the interest that was accruing (and not being paid) created deductions. This method of transfer kept the existing affordability restrictions (and any subsidized mortgage and/or project-based rental assistance contract) in place, and it kept hard debt constant. It also burdened the asset with yet another obligation.

Meanwhile, owners had few incentives to address their properties' operational or capital needs. For example, investors suffered no loss of tax benefits if the properties in which they held an interest were not maintained to a suitable standard. In addition, distributions to profit-motivated investors (paid out of cash flow) were limited; any cash flow beyond what could be distributed was placed in a residual receipts account tied to the property. This limited-distribution structure eliminated any bottom-line incentive for investors to assure that properties were well managed. Finally, project-based Section 8 assistance was gradually applied to Section 221(d)(3) BMIR and Section 236 units to prop up operations and restore rents to affordable levels. This action diminished the likelihood of properties heading into default and, in doing so, assured that tax losses would continue to be available to investors.

ERTA was intended to stimulate housing production; by 1985, it had contributed to a glut of overbuilding in many markets. Congress responded to this situation and widespread abuses with the Tax Reform Act of 1986 (TRA). Among other things, TRA eliminated accelerated cost recovery, requiring taxpayers to depreciate the cost of residential rental property using a straight-line method over a 27.5-year period. Importantly, TRA declared that the losses being generated by existing and new investments in real estate were "passive" losses that could be used only to offset income from "passive" sources. In short, the 1986 Act eliminated the tax benefits anticipated by pre-1986 investors in real estate.

In repealing tax-shelter syndication, Congress recognized that there would be a disproportionate effect on the production of affordable rental housing, because the Section 8 NC/SR program had been terminated three years earlier. This was among the reasons that Congress established in the 1986 Act a new production resource called the Low-Income Housing Tax Credit (LIHTC).

The LIHTC represents a significant improvement over tax-shelter syndication with regard to asset sustainability. For example, tax credits are subject to recapture by the Internal Revenue Service if a property in which the credits are invested fails physical compliance standards or other program requirements. LIHTC investors therefore lean heavily on the state agencies that allocate credits to maintain strong oversight of the properties during the initial 10-year credit period and the additional 5-year period that together make up the LIHTC "compliance period." With regard to affordability, the

[9] Specifically, ERTA set the depreciation period at 15 years and permitted investors to use a 175-percent declining-balance method in the early years (known as "accelerated cost recovery"). The terms for low-income rental housing were even more propitious, with investors permitted to use a 200-percent declining-balance method.

[10] The depreciable amount of a purchased property was based on its sales price.

LIHTC is not as deeply targeted as the project-based Section 8 program; LIHTC-financed properties serve the traditional Section 8/public housing population only with the layering-in of additional subsidy.

The repeal of tax-shelter syndication eliminated investor interest in affordable rental housing. For one thing, the LIHTC program — which became the only game in town — was enacted as a demonstration program. It wasn't until the program became permanent 5 years later that corporate investors — primarily motivated by Community Reinvestment Act obligations — developed an appetite for credit investment.[11] In the interim, the limited partner investors in affordable HUD-assisted properties for whom the benefits of owning had been eliminated found few buyers. The lack of buyers was not the only barrier to sale. A persistent challenge from the era of tax-shelter syndication lingers, impeding sales. Specifically, investors face a tax liability upon sale ("exit tax") equivalent to the value of their tax losses in excess of their cash investment. For owners who choose to retain ownership until death, the tax-on-sale problem goes away and their heirs enjoy a step up in basis. Among the available options, avoiding the tax problem in this manner may provide the greatest return to owners (or, more accurately, to their estates). Certainly, mission-oriented *purchasers* who would take care of property needs and maintain affordability are challenged to cobble together the resources to purchase the properties, fix them up, *and* cover owner exit taxes. In the meantime, the current owners lack any incentive to maintain the assets.

The effects of these tax reversals on the properties developed under the HUD-assisted programs demonstrate how important it is for owner and investor participation to align with program mission. If both the owner and the investor view the property as a means to an end other than the provision of a viable asset that will deliver long-term affordability, the dynamic is weighted against the mission outcome. *With public housing, the motivation of the owner is aligned with the program goals by definition.* PHAs have a vested interest in the long-term viability of their assets. Importantly, their interest does not contemplate an increase in value for the purpose of future sale, but the maintenance of value for the continued delivery of affordability to the nation's lowest-income renters. This absolute alignment of interests between owner and mission is perhaps among the strongest arguments in favor of preserving public housing assets.

Portfolio Sustainability

PHAs, like pre-1986 owners of real estate, must make decisions based on bottom-line considerations. A portfolio owner who fails to do so with respect to each asset can put its entire portfolio at risk. The sustainability of each individual asset is important for the sake of that asset and the renters who rely on its viability; each asset must also be evaluated in terms of whether it contributes to or detracts from the sustainability of the overall portfolio. The challenges inherent to owning multiple individual assets with mission goals is something about which public housing agencies know a great deal. So too do the high-capacity, not-for-profit organizations that are engaged in the development, ownership, and preservation of HUD-assisted housing. The lessons from their experiences could usefully inform efforts to preserve public housing from the point of view of portfolio sustainability and are summarized below.

The long-term stewardship of individual assets should be rewarded. The Section 202 program is available solely to not-for-profit organizations and is intended to assist them in providing affordable housing for very low–income elderly renters. From 1959 until the early 1990s, the Section 202 program involved a 40-year direct federal loan.[12] Most of the developments financed between 1977 and 1990 have relatively high interest rates — often higher than 10 percent. Owners seeking to *prepay* these high–interest rate loans within the context of a preservation refinancing encounter an obstacle at HUD.

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[11] Under the LIHTC, the amount of credit that investors other than C corporations can use to offset personal income tax liabilities is limited.

[12] Section 202 became a grant program in the early 1990s.

Specifically, HUD tends to inhibit access to refinancing proceeds.[13] The same limitation applies to not-for-profit owners of Section 221(d)(3) BMIR and Section 236 properties seeking to prepay. The practice has the effect of undermining an owners' ability to benefit from years of responsible ownership and management — practices that contributed to the creation of proceeds (i.e., equity).[14] Along the same lines, HUD regulations also generally prohibit distributions to not-for-profit owners.

The lesson for public housing preservation is that any public housing preservation program should assert the ability of PHAs to access cash flow and equity going forward, so long as the capital and operating needs of the properties are met and resident rents remain deeply targeted and affordable. The simple notion behind this lesson is that good ownership and management cannot be imposed by regulation as effectively as it can be incentivized.[15] Pegging PHA rewards to property operations would also help to impose "market discipline" on the program and thereby improve how it is perceived. Finally, PHAs should be given broad latitude to use distributions or refinancing proceeds to support mission purposes. For example, a PHA might use such resources to provide resident services or downpayment assistance, to implement energy-efficiency measures or technologies, or to develop or acquire new affordable housing. Distributions are also among the resources that should be available to compensate strong PHA portfolio management, as discussed next.

The effective management of a portfolio of assets should be compensated. Multi-asset owners of affordable housing are uniquely positioned to use their overall portfolio strength to sustain weak individual assets. Specifically, they should be permitted to flow cash from strong assets to weak ones. Where single-asset owners are vulnerable to dramatic increases in the costs of such things as utilities, insurance, and property taxes, multi-asset owners can weather these shocks, so long as they have access to cash from strong assets and are able to use it as needed within their portfolios.

A growing "movement" within the not-for-profit owner community seeks to persuade LIHTC allocating agencies that asset management functions should be compensated in the form of an above-the-line asset management fee. The fee is conceived as something that will not only compensate owners for the reporting and other obligations required by the tax credit program, but also for the social value they provide in terms of leveraging portfolio strength to sustain overall operations.

The lesson for public housing preservation is simply that asset management functions should be reliably compensated. As with access to distributions and proceeds, one argument for an above-the-line asset management fee is that affordable real estate often carries unfunded mission requirements that can sap the already scarce resources that are otherwise available to support portfolio management, as described below.

Unfunded mission requirements can compromise assets and operations. The experiences of mission-oriented entities that use the tax credit for new development and preservation reveal that mission goals can conflict with business realities. For example, many states express a preference in their Qualified Allocation Plans (QAPs) for properties with fewer than 50 units, especially to serve special-needs populations, or they target tax credit allocations to properties intending to serve extremely low–income (ELI) renters. Both of these program goals align with the ownership goals of mission-motivated

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[13] Owners of projects approved between approximately 1977 and 1982 may prepay without HUD approval; others require HUD approval to prepay.

[14] This HUD practice also has the effect of contributing to the loss of affordable units. This is so because single-asset, not-for-profit entities who might otherwise be inclined to sell to preservation entities instead simply wait out the use restrictions on the property. Once the use restrictions have lapsed, the entities can sell to any purchaser for whatever price the market will bear without any limitation on the use of proceeds.

[15] One area for further research would be a comparison of the costs of regulatory oversight versus the costs of ownership/management incentives.

organizations. States also tend to impose unfunded threshold preferences for things like resident services,[16] which mission-motivated owners recognize to be valuable and generally desire to provide.

The underwriting of tax credit transactions tends however not to reflect the bottom-line effects of such preferences and requirements (nor should it necessarily do so). As a result, the underwriting tends to be overly tight against the owner's goal of obtaining cash flow to support portfolio management activities. For example, properties targeted to ELI renters may require soft debt, the repayment of which claims a portion of available cash flow. Funding for services stakes a claim on cash flow, as well. And small properties obviate any efficiencies that might be realized through economies of scale. Mission-oriented entities that need access to tax credit capital and share the "mission goals" behind the preferences face a dilemma: pursue mission at some risk to portfolio-level operations or proceed only with those deals whose pro forma operating budgets make bottom-line sense.

The lesson for public housing preservation is simply that targeting, service provision, or other mission requirements that cannot be supported by rents or within a property's operating budget can compromise owner operations. Among the options available to remedy this outcome is access to a project-based rental assistance contract such as the HAP, described earlier. Though funding for resident services would not customarily be included in a property's operating budget, so long as it would not push contract rents above market, this option could be considered. In addition to deriving a benefit from the strong ownership and management of the assets in their portfolios, PHAs should enjoy greater latitude to assure the market viability of those assets, as described below.

Market standards matter, even for the lowest-income residents. The not-for-profit owners of Section 202 properties seeking to preserve their assets have encountered a challenge in the form of HUD's unwillingness to permit unit reconfiguration to align with market demand. Specifically, these properties generally have a high proportion of efficiency units that have proven to be unpopular with elderly renters. High vacancy rates at these properties can put the entire buildings at risk. Many of the properties have project-based Section 8 contracts in place, which should facilitate their preservation. HUD's practice of requiring one-for-one replacement of Section 8–assisted units however stymies the efforts of such sponsors to reconfigure the small efficiencies into more marketable one-bedroom units. The practice not only undermines asset sustainability, but it also places a strain on the owner of the asset — especially if the owner has a mission reason that compels it to keep the property on its books. By contrast, a recent GAO report cited the example of an owner of an 82-unit Section 8–assisted property in Chicago who opted out when HUD refused to permit contract renewal with three fewer units.[iv]

The lesson for public housing preservation is that recapitalization offers an opportunity to address not only physical obsolescence, but also market obsolescence, and that policies should provide adequate flexibility to achieve both goals simultaneously. Should such flexibility result in a net loss of public housing units from an individual PHA's portfolio, the regional, statewide, or national redistribution of such units should be encouraged so as to assure that no net loss of units occurs overall. If PHAs are required to adhere to policies that inhibit their ability to address the market obsolescence of the individual public housing assets within their portfolios, then they will eventually be pushed to evaluate the wisdom of maintaining the assets as public housing.

Many of the challenges faced by high-capacity, large-scale not-for-profit organizations seeking to recapitalize or acquire HUD-assisted properties derive from the policies and practices described earlier that undermined asset sustainability. Additional challenges, as described directly above, result from policies and practices that either deprive such owners of the benefits of strong ownership and management or put them in the position of having to choose between the bottom line and their mission

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[16] States give additional points for resident services in their QAPs, for example, but then do not permit above-the-line funding of such services.

goals. Any public housing preservation policy should take into account the experiences of not-for-profit portfolio owners with respect to their differential treatment under HUD programs. The lessons learned by not-for-profit entities using the tax credit program to develop and preserve deeply affordable rental housing should also be considered. Both PHAs and not-for-profit organizations engaged in the ownership and management of real estate should enjoy incentives tied to the bottom-line performance of their assets. They certainly assume the risks tied to nonperformance.

Conclusion

The public housing program has been around since 1937. Despite struggles getting the program enacted and a steady stream of opposition from before the program's inception right up until today, it continues, in part because it provides such a critical resource in communities across the United States. The commitment of PHAs to owning and operating public housing is also an important reason for the program's continuation. Their struggles to sustain their assets consistent with the program's mission must be recognized and assuaged, primarily by restructuring the program to reflect lessons learned from nearly 50 years of private-sector involvement in the development, ownership, and preservation of affordable rental housing. A public housing preservation program that draws upon such lessons to address the program's structural flaws has great upside potential both in terms of cementing a multisector commitment to the program and with regard to outcomes for tenants, properties, owners, and the communities in which public housing assets are located.

Endnotes

[i] "Preliminary 'Facts' on Public Housing," Barbara Sard, Leah Staub, Will Fischer, Center on Budget and Policy Priorities, memo dated April 30, 2008.

[ii] Detailed national report provided to NAHRO.

[iii] The following papers, prepared by Charles S. Wilkins, Jr., of The Compass Group for the Millennial Housing Commission, provided the basis for many of the ideas presented in this section: "Background Paper: Pre-LIHTC Affordable Housing—Historical Context"; "Background Paper: Preservation Tax Incentive"; "Concept Paper: Long Term Sustainability and Affordability."

[iv] "Project-Based Rental Assistance: HUD Should Update Its Policies and Procedures to Keep Pace with the Changing Housing Market," Government Accountability Office (GAO–07–290), April 2007.