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The 2018-2019 Public Housing Investment Update

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ROD SOLOMON

EDITOR'S NOTE: An older, uncorrected version of this article was mistakenly posted earlier. This is the corrected, most up-to-date version of the article. We regret the error.

Since mid-2017, the landscape has changed considerably for efforts to preserve, renovate or replace more than 1 million public housing units, with HUD-estimated $26 billion of capital needs as of 2010 and significantly higher estimates today. After years of discussion, a tax overhaul was enacted with some clearly negative but not terminal results for such efforts, and some potentially important benefits. Then, surprisingly, Congress enacted appropriations for public housing capital at a considerably higher level than they have been for many years, Congress also dramatically increased the number of public housing units that can be converted to long-term Section 8 contracts under HUD's Rental Assistance Demonstration (RAD). Then, HUD liberalized rules under which public housing authorities (PHAs) can access Section 8 vouchers with higher subsidy levels than RAD, to be project-based at developments whose capital needs make RAD by itself financially infeasible.

Tax Changes and Challenges

The low-income housing tax credit (Tax Credit), both on its own and in conjunction with RAD, has been a substantial source of capital for public housing or alternative project-based voucher (PBV) investments. This has been true both for the much more powerful but also highly competed-for 9 percent Tax Credits and for 4 percent Tax Credits that become available with use of tax-exempt "private activity" bonds. Those bonds are subject to state-by-state caps that states allocate among multi-family housing and other eligible uses. The allocations generally are high enough to allow for the unlimited availability of 4 percent Tax Credits, with a few notable exception states. While 4 percent Tax Credits create too shallow a subsidy to generate overwhelming demand on their own in view of their relatively low tenant income requirements, they work well with long-term Section 8 contracts and generated over $2.3 billion in RAD investments through September 2017.

For low-income housing investments, "it could have been worse" seemed like a good first take regarding the tax changes. The tax overhaul was likely to be problematic because the President's and Congress' basic goal of lowering the corporate tax rate would mean that Tax Credits in the aggregate become less attractive to corporate purchasers, who now would have reduced tax liability. The corporate tax rate was reduced considerably. Novogradac & Company, a leading accounting and consultant firm in the subsidized housing industry, initially estimated that the new law's impact would be roughly 230,000 fewer Tax Credit units produced over the next decade--a 16 percent reduction.

While proposals to eliminate the Tax Credits faded prior to the 2017-2018 Congress, the House of Representatives tax bill would have eliminated private activity bonds and along with them, 4 percent Tax Credits. The Senate, however, prevailed and included both an increase in the amount of 9 percent Tax Credits to be available over the coming five years and an "income averaging" provision that will allow tiers of Tax-Credit-subsidized tenants with up to 80 percent rather than 60 percent of area median income (AMI), as long as lower-income tiers in the same project keep the average below 60 percent of AMI. That provision will help public housing reinvestments, by allowing public housing households with incomes between 60 percent and 80 percent of AMI to stay without forcing loss of Tax Credit for their units. Congress did not include other proposals that would have enhanced the value or increased the availability of 4 percent Tax Credits, which also would have facilitated these transactions.

It remains to be seen whether a potentially enormous tax incentive for investment in "Opportunity Zones" that was included in the tax law could attract funding that assists the preservation effort. That would seem to depend on investors' views on whether developments with long-term Section 8 contracts are sufficiently income-generating on a cash flow basis to warrant their tax-favored investments. According to HUD's December 2018 press release announcing that Secretary Ben Carson will lead a White House Opportunity and Revitalization Council, there are approximately 380,000 public housing units located in Opportunity Zones.

Appropriations—Breakthrough?

After a generation of allowing the public housing Capital Fund or its predecessor to decline despite enormous public housing capital needs, Congress increased funding to $2.75 billion – a more than 40 percent increase from 2017 to 2018. Congress seems ready to follow suit for 2019, hopefully soon with a resolution to the government shutdown, with both chambers' appropriations bills containing similar funding to 2018 and ignoring the Administration budget proposal to zero out the Capital Fund.

This an important step, but whether it indicates lasting additional Congressional priority for addressing public housing capital needs is unclear. The 2018 funding increase was facilitated by the 2-year budget agreement, which provides significant increases for both domestic and non-domestic discretionary spending, and increased military spending.

By most economists' reckoning, the massive tax cuts virtually assure continuing massive deficits. How the new Congress will translate that information to public housing Capital Fund appropriations is of course unclear. Congressional priorities may place more emphasis on safety- net programs at least for a few years, but it is premature to predict that the new funding level will continue on a long-term basis.

RAD Progress

In 2018, Congress increased the RAD cap from 225,000 units to 455,000 units, over 40 percent of the universe of public housing units -- an affirmation of the program's great success thus far. By the end of 2018, almost 110,000 public housing units had been converted to Section 8 under RAD. The General Accounting Office (GAO) found that closed RAD transactions through September 30, 2017 (74,709 units) generated $4.4 billion

in construction costs ($58,895 per unit). As of November 2018, HUD estimated that the capital generated for construction investment was approximately $5.75 billion.

The GAO study examined the financial sources for these transactions. Of a total of $7.32 billion, exclusive of PHA take-back financing, the largest sources were 4 percent Tax Credit equity ($2.30 billion), new first mortgages ($1.71 billion) and 9 percent Tax Credits ($0.98 billion)—68 percent of all sources. The GAO also recalculated leveraging ratios of funds for recapitalization to public housing funds from HUD's earlier claims, and came up with far lower but still impressive ratios—7.44 if all non-public housing sources are considered to be leveraged by public housing sources, 1.43 if only non-federal sources are considered to be leveraged by public housing sources (i.e., not resulting from Tax Credits or other federal funds) and 1.23 if only private sources are considered to be leveraged (i.e., neither federally-derived sources nor other state or local funds). These numbers show RAD's substantial marshaling of other federal sources including Tax Credits, as well as significant private funding sources that, for the most part, had not been available for the public housing preservation or replacement effort.

The GAO study also noted that the RAD provisions to preserve long-term affordability are untested and would allow for reduced targeting to extremely low-income families and for significant rent increases in the event of foreclosure. But the underlying challenge is to ensure the sound funding and management of these projects, so that such measures are not needed. Apart from avoiding an appropriations melt-down, in part this will involve the feasibility of recapitalizing the properties in another 15-20 years. The properties are somewhat protected in the interim by required capital replacement reserves at levels justified to HUD to meet expected new capital needs, but whether rents limited to annual adjustments for state-by-state estimates of operating cost increases (annual "operating cost adjustment factors," or OCAFs) under RAD rules will be sufficient for recapitalization and under what circumstances needs further focus.

The HUD RAD staff's designation as a 2017 Finalist for a Samuel J. Heyman ("Sammie") Management Excellence award given to outstanding government managers by the Partnership for Public Service is worth noting. HUD's effort to work with its PHA, other governmental and private-sector partners to balance difficult interests and protect residents while launching a high-volume development program has been unique.

Beyond RAD Funding

It has been clear from the beginning that because RAD rents reflect the basic RAD statutory compromise that subsidy levels initially must result in no additional costs relative to public housing subsidies, they will be too low to allow RAD to work for many public housing properties. HUD promptly adjusted those rents for new and pending RAD projects to reflect the higher 2018 public housing Capital Fund appropriations. While important, the average amount is in the $62/month range, which is not enough to make transactions feasible in many cases. HUD adjusted the RAD rents further as of January 2019 to reflect the more modest increase in 2018 Operating Fund appropriations.

Recognizing the insufficiency of RAD funding for some of the public housing stock, HUD has taken several steps to make tenant protection vouchers (TPVs) available in conjunction with or instead of RAD. HUD

approves the commitment of TPVs upon HUD's approval of public housing disposition or demolition; PHAs then can project base the TPVS to former public housing units under a process facilitated by the Housing Opportunity Through Modernization Act of 2016. This is helpful because, for many PHAs, TPVs at typical voucher rents have higher values than RAD rents.

While the point is to make additional resources available for public housing preservation, rehabilitation and replacement, the extent to which this would occur varies widely across the country. TPVs are likely to increase resources relative to RAD to a much greater degree where market rents are relatively high, as in large metropolitan areas on both coasts. Not surprisingly, the most dramatic examples of successfully combining RAD and project-based vouchers (PBV), either on a portfolio basis or within developments, have occurred in high-rent communities (San Francisco, Cambridge (MA)).

HUD's initial effort of this type, made possible by notice in March 2018 (the March Notice), is to allow developments to consist of three-fourths RAD, one-fourth approval of units for disposition/TPVs if they are for new construction or substantial rehabilitation and do not use scarce 9 percent Tax Credits. HUD, however, set the definition of "substantial rehabilitation" at a relatively stringent level (60% of HUD-set local Housing Construction Cost limitations) that will require roughly $60,000-70,000 of rehabilitation per unit on average and more in high-cost areas. Even with partial use of the TPVs this may be a difficult threshold to reach without the use of 9 percent Tax Credits, unless funding contributions are available from sources other than 4 percent Tax Credit equity and first mortgages.

Similarly, HUD issued a notice in July 2018 that allows RAD projects to be "rent-bundled" with otherwise unrelated PBV projects—i.e., the rents for the two or more projects could be reallocated among units at the projects. The effectiveness of that step depends on owners of non-RAD PBV projects accepting rents significantly below the maximum they otherwise could receive an annual rent increases limited to OCAFs.

A step HUD has not taken thus far is to allow all PHAs to commit a portion of their voucher funds to supplement RAD rents and thus make projects feasible. This is allowable now only for agencies in the Moving to Work (MTW) demonstration, but HUD has sufficient legal authority under RAD to allow all PHAs to do it. A number of MTW PHAs have taken advantage of this flexibility, including Cambridge, San Bernardino, Tacoma and others.

There is a significant trade-off involved in this strategy unless voucher appropriations are increased, however, because the commitment of voucher funds must translate into fewer voucher families served or lower subsidy levels per voucher family. In view of this concern, HUD could put limits on the expansion of such flexibility for non-MTW agencies—e.g., voucher funding to be committed at no more than half per unit of the PHA's average voucher per-unit subsidy -- so that the number of families that can be served with available voucher funds is not decreased by any greater amount to support priority low-income housing revitalization.

TPVs and PBVs

Apart from RAD and hybrid RAD/TPV approaches, a number of PHAs have relied on conversions through disposition under Section 18 of the U.S. Housing Act of 1937 (the Act) or in a few instances HUD's

"voluntary conversion" program under Section 22 of the Act, and full replacement of public housing with non-RAD TPVs—usually but not always project-based to the former public housing units. HUD discouraged such conversions in 2012 by declaring that disposition approvals generally could not be justified by PHA claims of inadequate funding.

The March Notice makes some common-sense adjustments in the showing of obsolescence that PHAs must make to demonstrate a development's eligibility for disposition approval. This will pave the way for a few more developments to receive the TPVs they need, typically along with other subsidies, to finance necessary renovations or replacement. The March Notice also relieves scattered sites, which typically have high management and maintenance costs, and PHAs disposing of 50 or fewer units that constitute their last public housing units, from meeting an obsolescence test.

The March Notice will provide welcome additional flexibility. It does not break new ground, however, regarding sites whose locations make them functionally obsolete—for example, where the sites will support far higher density and market as well as deeply subsidized units and might be able to support more than one for one replacement of low-income housing units. It would be reasonable for the disposition and TPVs mechanism to be available in such situations, as long as one-for-one replacement of the low-income housing is secured.

Public Housing Program Tools

Congress has continued to fund the Choice Neighborhoods program, whose appropriation increased from $137.5 million for 2017 to $150 million for 2018 and appears likely to be in a similar range for 2019. While not near the levels seen by HOPE VI in its heyday and still only enough to fund about five implementation grants annually, some of which relate to privately-owned Section 8 rather than public housing developments, these grants are large enough to be leveraged to transform entire neighborhoods and not just renovate public or Section 8 housing.

HUD's Energy Performance Contracting (EPC) program, in which energy-conserving improvements are financed by public housing operating subsidies that PHAs are allowed to retain although their subsidy needs have dropped as a result of reduced energy bills caused by those improvements, has continued to generate some investments even though conversion of units later to RAD would end public housing subsidies and thus force the prepayment of EPC loans. The EPC program resulted in new financing in the $70 -125 million range for each of the last three years (2015-2017). A provision of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 will allow small rural PHAs to retain operating subsidy savings in a similar manner, without going through the extensive HUD approval process for EPC borrowings.

From its inception, HUD's Capital Fund Financing Program (CFFP) has resulted in almost $5 billion in funds borrowed against pledges of future Capital Fund appropriations. Most of the activity in recent years, however, has been refundings to reduce the debt service on outstanding borrowings by taking advantage of lower interest rates relative to those at the time of the original borrowing. New CFFP borrowings would require lender or bond purchaser confidence that public housing Capital Fund appropriations will hold up over the years and are

limited by PHAs' plans to take units out of the public housing inventory through RAD or other actions, reducing the number of units and thus the size of funding Capital Fund grants.

Prior to RAD, the public housing mixed finance program was the mechanism through which Tax Credits could be used for the improvement of public housing. Use of that mechanism has declined with the availability of RAD, the erosion of public housing appropriations upon which public housing mixed-finance transactions must depend, and the virtual elimination of the HOPE VI program that fueled mixed-finance transactions through large up-front public housing funding. The volume of approvals has fallen from approximately $1.43 billion in Fiscal Year (FY) 2011 and $1.054 billion in FY 2012 to $579 million in FY 2017 and $298 million through 11 months of FY 2018. The extent to which the reductions in public housing investments have resulted from the availability of RAD or would have happened anyway in view of deteriorating public housing appropriations must be considered in an assessment of RAD's net impact.

Discussions over the past year have intensified regarding PHAs' limited use of HUD's ability to allow the mortgaging of public housing property to leverage funding (called Section 30 after the applicable section of the U.S. Housing Act of 1937). Use has been limited significantly because HUD has not allowed mortgaging to result in the elimination of public housing restrictions in the event of foreclosure. RAD's success in leveraging of private lending indicates that the low-income housing use restrictions are not the problem as much as lenders' unwillingness to count on the public housing appropriations structure, relative to RAD's Section 8 contract structure, for the long term.

NYCHA and Chicago

This article would not be complete without reference to the situation of the New York City Housing Authority (NYCHA). A 2016-2017 internal study indicating basic capital needs of $31.8 billion over the next five years—more than the HUD study's 2010 capital backlog estimate for the entire nation. NYCHA also has been the subject of extensive litigation resulting in a proposed consent decree for a court-appointed monitor with a mission to ensure that basic public housing conditions, including lead paint, mold and elevators are addressed. This proposed decree recently was rejected by a U.S. District Court judge, who urged HUD to take the lead. NYCHA's situation calls for an entirely different level of commitment and innovation from the rest of the public housing system.

The Chicago Housing Authority, with public housing so dysfunctional and dangerous a generation ago that the demolition and replacement of 58 gallery-style family high-rises was required, has made great progress, investing approximately $240 million in reserves that had accumulated when its redevelopment programs stalled during the Great Recession. The CHA also undertook a Section 8 lease-up effort that added over 9,000 households to the program between fiscal 2013 and fiscal 2016.

Recommendations

While gains have been made on balance and the RAD program has been an outstanding catalyst to support path-breaking local and public/private initiatives, there is still plenty of work to do before we have a comprehensive set of initiatives that address the preservation or replacement of the entire public housing

stock. We have made great progress but are still falling short in important instances, and not just in New York City. In addition to incremental steps such as HUD allowing PHAs to use voucher resources more flexibly as specified above and Congress enacting favorable 4% Tax Credit changes, Congress should look for opportunities to enable major gains - whether ensuring that Opportunity Zones can assist low-income housing, providing large-scale funds in an infrastructure bill to facilitate preservation, or otherwise.

Rod Solomon is an attorney with Hawkins Delafield & Wood LLP in Washington, D.C. He can be reached at rsolomon@hawkins.com.