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Creative Capital: Financing the Preservation of Affordable Housing

Two affordable housing communities were preserved by mixing and matching a complex set of tax credits, loans, grants, bonds, and other sources of income.

THE NEED TO PRESERVE AND IMPROVE the nation's affordable housing stock has never been greater. According to the Cambridge, Massachusetts–based Joint Center for Housing Studies of Harvard University, the number of households paying more than half of their incomes toward housing costs increased by 1.9 million from 2001 to 2004. Nowhere in the United States can an individual making minimum wage afford to pay the average rent for a typical one-bedroom apartment, according to the National Low Income Housing Coalition, yet the supply of affordable housing—especially for the very poor—continues to decline. Between 1995 and 2005, more than 1.2 million affordable housing units were lost.

The future does not look promising, either. The government is no longer providing new rental subsidies and the situation is compounded by the fact that the nation's inventory of subsidized housing continues to age and is in need of recapitalization. In addition, the first units developed under the low-income housing tax credit program are beginning to reach the end of their compliance period, which in many instances means the need for recapitalization and/or the potential loss of units as a result of conversion to other uses. The Washington, D.C.–based National Housing Trust (NHT) estimates that 180,000 low-income housing tax credit units are at risk over the next ten years. Finally, there are an estimated 3 million units of unsubsidized housing that provide shelter to households of low and moderate income that are in jeopardy of being lost to condemnation because of living conditions or conversion to alternative uses for other target markets.

The National Housing Trust/Enterprise Preservation Corporation (NHT/Enterprise) has yet to develop one simple model for financing the preservation of affordable housing. Doing so is not possible given the uniqueness of every project and an ever-changing regulatory environment that affects the financial resources and programs available to finance preservation transactions. The best guide is experience, which provides examples of approaches and problem-solving techniques that work. The developer's task is to match and combine approaches

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and resolutions from past transactions to future projects.

Underwriting can be particularly daunting in the federally assisted portfolio of affordable housing. The introduction of new programs over time, combined with programmatic changes, has yielded a variety of federally assisted housing "flavors." In many instances, these flavors have been mixed, providing further complexity. Each project presents opportunities in the form of financial resources that are available for specific project flavors, and hurdles, such as matching the property to these new financial resources and blending regulatory requirements of both old and new.

Two communities developed by NHT/Enterprise proved particularly challenging: Meridian Manor, a 34-unit, 100 percent Section 8 cooperative in Washington, D.C.; and 51st and King Street, a 96-unit, affordable family rental property in Chicago, with multiple finance sources and affordability restrictions that resulted in a complex array of rents serving a variety of income levels. Each provides a useful glimpse of what it takes to preserve affordable housing.

Meridian Manor

The history leading up to the financing of Meridian Manor is as intriguing as the financing itself. Indeed, Meridian Manor's past greatly influenced development of the financing plan and dictated certain conditions the plan had to meet.

In 1991, the residents of Meridian Manor sued the owner of the building because of housing code violations and an illegal rent increase. They prevailed in 1993 and were awarded a $1 million judgment against the landlord. When the owner could not pay the judgment, the parties agreed that the building would be conveyed to the residents. The residents organized themselves as the Arch Bishop Rivera y Damas Cooperative and became the official owners of the building. However, the city condemned the structure for code violations soon thereafter and the residents were forced to relocate.

Though no longer living at the property, a core group of cooperative members remained committed to saving their homes. After several false starts, the cooperative assembled a team of development and legal consultants, including the Harrison Institute of Public Law, a housing and community development law clinic affiliated with Georgetown University, and MiCasa, Inc., a local nonprofit organization with a successful track record of developing affordable housing. They recommended that the cooperative retain an experienced developer who could handle the day-to-day development work, and who would provide lenders and investors with the level of comfort necessary to fund the project. In the summer of 2000, Arch Bishop selected NHT/Enterprise as its development partner.

Creating a feasible financial plan proved to be difficult. The residents had very low incomes, making their ability to pay carrying charges fall far short of the amounts necessary to operate a cooperative, their desired form of ownership. Knowing how hard and for how long they had been fighting to save their homes, nobody wanted to conclude that it could not be done.

Compounding matters, market rents were insufficient to support enough debt to fund necessary repairs and improvements. For successful financing, equity or additional subsidy funding was needed. With subsidy dollars in short supply, low-income housing tax credits—i.e., equity—were the most logical match. The 9 percent tax credit process in D.C. is extremely competitive and timely. However, the District was not close to reaching its private activity bond cap. The District of Columbia Housing Finance Agency could issue private activity tax-exempt bonds and Meridian Manor could receive an automatic allocation of 4 percent low-income housing tax credits. The use of tax

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The city of Washington, D.C., condemned Meridian Manor (facing page) for code violations after the building was conveyed to a cooperative formed by residents, but the cooperative assembled a team of development and legal consultants to save the residents' homes. The existing resident population at 51st and King Street in Chicago (left and below) consisted of households with multiple income levels, which made establishing a workable rent structure a complex task.

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By piecing together a variety of tax credits, bonds, grants, loans, and other funding sources, NHT/Enterprise was able to fund $3.1 million of rehabilitation for 51st and King Street, or $32,000 per apartment.

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credits posed a problem, however. Tax credit financing requires the property to be owned by a limited partnership or limited liability company—which was incompatible with the cooperative structure desired by the residents. Further, adding tax credits to the mix did not solve the affordability problem for very low-income households.

Setting aside the ownership structure issue, an additional rental subsidy seemed to be the only means to deliver affordability to this group of very low-income residents. But what type of rental subsidy was available? Ultimately, the solution was provided by the District of Columbia Housing Authority (DCHA). Pulling from a rare resource, DCHA committed to providing a full 15-year term, Section 8 contract for the property.

The Harrison Institute undertook the next challenge: the merging of the cooperative concept with a Section 8 and low-income housing tax credit form of financing and ownership. The resolution came in the form of a proposed structure that blends the concept of a cooperative property with a rental property—a hybrid "rental-cooperative." Under this structure, the cooperative has two roles. First, it participates as the managing general partner. A limited liability company was formed to serve as managing general partner of the tax credit partnership with Arch Bishop and NHT/Enterprise as its members. This ensured cooperative participation in major decisions affecting the property. In addition, the cooperative leases back the entire property, at an amount equal to the tax credit rents, and is responsible for establishing policies and practices for operating the property and oversight of management. At the end of the 15-year tax credit compliance period, the cooperative will have the opportunity to acquire the property for an amount equal to the unpaid principal balance of debt and investor exit taxes. This structure allows the residents to have a sense of ownership in the short term, oversee operations of the property, and, over time, learn how to operate and function as a cooperative while gathering resources to acquire the property in whole at year 15.

Solving these critical issues allowed NHT/Enterprise to focus on accumulating sufficient gap funding to make the transaction feasible. NHT/Enterprise applied for historic designation from the National Park Service. The project was approved, making it possible to benefit from the sale of historic tax credits. The cooperative applied for and received a grant from the Federal Home Loan Bank's Affordable Housing Program (AHP), which it in turn lent to the project. The loan, at an interest rate of 0 percent, is due in 17 years, or upon sale or refinance of the property, whichever is earlier. The final piece of the puzzle was provided by yet a third D.C. housing agency, the District of Columbia Department of Housing and Community Development (DHCD), which funded the remaining gap with a $400,000 soft loan.

The Section 8 contract rents were set at comparable market rents and underwritten to support private activity bonds of $2.4 million. Low-income housing tax credits provided $1.15 million in equity, and the sale of historic tax credits yielded an additional $740,000. The AHP grant/loan totaled $289,000 and the city participated with a $400,000 loan. The $5 million development budget funded a $2.8 mil-

TABLE 1: FUNDING SOURCES FOR 51st AND KING STREET

Source	Amount	Interest Rate	Loan Amortization	Loan Term	Notes
Private activity bonds	$4,250,000	6.04%	40 years	40 years	Credit enhanced and secured by an FHA 221(d)(4) mortgage
Bonds supported by IRP decoupling	$750,000	6.04%	11 years	11 years	4%
Low-income housing tax credits	$2,500,000	N/A	N/A	N/A	
Illinois Housing Development Authority	$750,000	0.00%	100 years	40 years	
Federal Home Loan Bank Affordable Housing Program	$500,000	0.00%	No payments due until maturity	45 years	Granted to NHT/Enterprise then lent into the project

lion gut renovation. The cooperative shares in the developer fee and ongoing cash flow. In addition, it receives 100 percent of all the income derived from the centralized laundry facility located on site. These funds allow the cooperative to pay for ongoing administrative expenses, have on-site programs, and save for their future acquisition of the property after year 15. Proceeds from the repayment of the $289,000 AHP grant that the cooperative lent to the property will also be available for the cooperative to apply toward the purchase of the building. Combined, these resources should establish a strong financial base assisting the residents with acquiring and further preserving their homes after year 15.

51st and King Street

In 2002, NHT/Enterprise teamed up with the Chicago Community Development Corporation (CCDC) to save 51st and King Street, a 96-unit housing property in Chicago that was partially Section 8 subsidized. Ultimately, the feat was accomplished using a variety of funding sources. Because each source had its own affordability requirements and the existing resident population consisted of households with multiple income levels, establishing a workable rent structure was a complex task.

The property, located in the historic Bronzeville neighborhood on Chicago's south side, was initially built in 1896. It was renovated in 1973 and refinanced with a U.S. Department of Housing and Urban Development (HUD) Section 236 mortgage. The property consists of 12 contiguous buildings that constitute an entire city block with a courtyard in the middle. Located on the edge of a revitalizing area, and adjacent to a new tax increment financing district established by the city to spur budding revitalization efforts, conversion to another use in the near future was no longer unthinkable in 2002. It would soon be feasible for the owner to prepay the mortgage and convert the property to apartments catering to higher-income families, or convert the units to condominiums. The result would be the loss of affordable housing and the displacement of 96 families.

Under the regime of a 236 mortgage, HUD provides an ongoing stream of income to the property that is sized such that the effective interest rate on the mortgage is 1 percent, a subsidy that is called the interest reduction payment (IRP). In exchange for this subsidized mortgage, owners are required to calculate two rents: the baseline rent, a budget-based rent assuming the mortgage at a 1 percent interest rate; and the ceiling rent, a budget-based rent assuming the market mortgage origination interest rate. The first is the "236 basic rent"; the latter is the "236 market rent." Tenants pay the amount of the basic rent or 30 percent of their income toward rent, whichever is greater, but not more than the 236 market rent.

When NHT/Enterprise became involved with the transaction, the property had 38 project-based Section 8 apartments. Section 8 voucher holders occupied an additional 30 apartments.

TABLE 2: FUNDING RESTRICTIONS FOR 51st AND KING STREET

Source/Program	Units at or Below 50 Percent AMI	Tenant Pays	Units at or Below 60 Percent AMI	Tenant Pays	Units at or Below 80 Percent AMI	Tenant Pays	Term of Restrictions
IRP decoupling					96	30% of income; no more than 236 market rent	16 years
Tax-exempt bonds			39	30% of 60% of area median income (AMI)			As long as the bonds remain outstanding
Low-income housing tax credits			92	30% of 60% of AMI			15 years
IHDA loan	68	30% of 50% of AMI			23	30% of 80% of AMI	40 years, regardless of whether loan is prepaid
AHP grant	68	30% of 50% of AMI	23	30% of 60% of AMI			15 years
Project-based Section 8	Tenant pays 30 percent of his or her income toward rent. Total rent collected from both tenant and HUD is based on a budget-based rent calculation, and no more than street rents.						
Enhanced vouchers	Tenant pays 30 percent of his or her income toward rent. Total rent collected from both tenant and HUD is capped at street rents.						
Regular vouchers	Tenant pays 30 percent of his or her income toward rent. Total rent collected from both tenant and HUD is based on a payment standard established by the Chicago Housing Authority.						

In order to qualify for tax credit financing at Meridian Manor, a new ownership structure had to be established. The cooperative that owned the building entered into a hybrid "rental-cooperative" structure that allowed it to participate as managing general partner. The cooperative partnered with NHT/Enterprise to form a limited liability company, and leases back the entire property at an amount equal to the tax credit rents. At the end of the 15-year tax credit compliance period, the cooperative will have the opportunity to acquire the property for an amount equal to the unpaid principal balance of debt and investor taxes.

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The remaining households had a range of incomes and received no subsidies.

The financing plan incorporated:

▷ private activity bonds and 4 percent low-income housing tax credits;
▷ "decoupling" the IRP;
▷ 4 percent low-income housing tax credits;
▷ a secondary soft loan from the Illinois Housing Development Authority (IHDA);
▷ a grant from the Federal Home Loan Bank's Affordable Housing Program (AHP);
▷ a budget-based rent increases for both the Section 8 and unsubsidized apartments;
▷ portable enhanced Section 8 vouchers for qualified residents living in unsubsidized units;
▷ a rent increase phase-in program for residents who did not qualify for Section 8; and
▷ deferral of a portion of the developer's fee.

Table 1 summarizes the amounts and terms of each source. Note that $750,000 was raised by "decoupling" the IRP. Decoupling is a technique that borrowers may use to prevent future IRP from being surrendered upon prepayment of a 236 mortgage. In exchange for retaining this resource, the borrower must agree to certain affordability restrictions (discussed below). At 51st and King, decoupling funded 25 percent ($7,800 per unit) of the renovation budget.

All sources combined total $8.8 million. In addition to acquisition and other soft costs, this development budget funded $3.1 million of rehabilitation, or $32,000 per apartment.

Financial resources intended for the development or preservation of affordable housing come with a host of restrictions. Table 2 summarizes the restrictions associated with each source of funds at 51st and King Street and demonstrates just how complex a rent structure can become when using several public-purpose funding sources. (The resources listed would not necessarily be the same for other projects.)

In order to support that portion of the first mortgage not serviced from ongoing IRP, NHT/Enterprise sought a rent increase. Because the property rents were governed by both the 236 mortgage and a project-based Section 8 contract, the rent increase had to be processed on two fronts, under two different sets of HUD guidelines.

The calculated rent increases were significant, averaging 37 percent. Pursuant to rules established by Congress, residents living in an unsubsidized unit but who met the qualifications for entry into the Section 8 program were provided with enhanced portable vouchers.

For a handful of tenants whose incomes were too high to qualify for enhanced vouchers, a new rent was phased in over a three- to five-year period to minimize the impact of the increase. There was a cost to phasing in rents, however. The property would suffer a shortfall of income during the first three to five years, during which time the rents were being raised to the underwritten amounts. This shortfall was prefunded by establishing a sinking fund in the development budget.

Bringing the necessary financial resources together to preserve these 96 units of affordable housing spawned a web of overlaying rent and income restrictions that must be managed on a regular basis to ensure that the property remains in full compliance with various programs. Doing so requires calculating no less than half a dozen rents, evaluating many income levels, ongoing income verifications, and matching households to appropriate restriction categories.

NHT/Enterprise and its partners creatively resolved a number of complicated issues to save Meridian Manor and 51st and King. Two very different models had the same basic result: keeping the residents in good housing over the long haul in a structure that works socially and financially. And while the two models are very different, they do share one common attribute—creative preservation financing. **MFT**

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