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CHALK TALK

PUBLIC HOUSING INFRASTRUCTURE SPENDING – PART III

By Greg Byrne

Today's video is the final in a three-part series on public housing infrastructure spending.

In the first two videos, we made a stab at estimating the capital needs in public housing, which could quite plausibly be $85 billion. In other words, it really is a big number. We then looked at what ability there was with current public housing funding to leverage private debt and equity to augment any infrastructure funds. There, too, we found that there was significant potential, although nowhere near enough to meet current national needs.

This final video looks at meeting public housing's capital needs by reasonably increasing operating subsidies to help PHAs better leverage private debt and equity, and then see what gaps must be filled in with capital funding. It's a different approach than what's contemplated in the current Infrastructure bills but it's essentially how all other forms of assisted housing are redeveloped when needed. And it may well also be the most cost-effective approach for preserving and recapitalizing the public housing stock in the long-run.

A System of Reasonable Rents

A powerful mechanism to allow housing authorities to leverage financing, while also placing a property on a robust, long-term foundation, is to ensure each property has a contract rent that is a reasonable market rent. And how much would that cost?

To keep things simple, let's assume that the reasonable rent for all public housing properties was equal to 100% of HUD's Fair Market Rents, or FMRs. Remember, FMRs represent the 40th percentile rent of renters recently moving into non-luxury apartments. So, it varies across geographies, and can be thought of as something like the "mid-market rent" of all rents in a local market.

Today, if you listed the approximately 6,600 hundred public housing properties nationwide in order of their current public housing funding relative to HUD FMRs, the median, meaning project number 3,300, would have a rent equal to 86% of FMR. However, there's lots of very small properties in the public housing inventory that skew things. A better picture is a unit-weighted average, which is closer to 78% of FMR, meaning that, today, in the aggregate, public housing funding is substantially below FMR – or about $260 per unit per month (PUM) below HUD's FMRs.

As an aside, it's worth noting that increasing, or trueing up, public housing funding levels to FMRs was the original proposal for the Rental Assistance Demonstration (RAD) program when converting assistance to Section 8 project-based contracts. At the time, however, Congress had already directed billions of dollars to prop up the overall housing system in response to the Great Recession of 2008; it felt it could not do more to help public housing. That's why then-Secretary Donovan agreed to start RAD without additional funding. And indeed, for nearly 10 years now, it has operated as a "no-additional cost" program.

But let's re-look at that concept now. What would that cost? Then, we'll look at what that would afford in additional leverage in helping with our capital backlog.

The total value of funding all public housing projects at 100% of the FMR, adjusting for tenant- vs project-paid utilities, comes to $13.9 billion. That compares with current funding today in public housing of about $11 billion, of which $3.5 billion represents tenant rents and federal Operating and Capital subsidies come to $7.5 billion.

Account	2020 Annual Amount ($ billions)
Tenant Rents	$3.5
Operating Fund	$4.6
Capital Fund	$2.9
Total Public Housing Funding	$11.0

While maybe not a precise formula for getting all converted public housing rents to a more reasonable standard, using an average rent standard set at 100% of FMR is a decent proxy. And, when set at that level, we come up with total additional operating subsidy need for PHAs across the country of $2.9 billion on top of current public housing funding that can be used to convert assistance, which we'll round to $3 billion for ease of discussion. In other words, to get public housing on roughly the same contract-based rent system as the Section 8 assisted multifamily stock, Congress would have to agree to fund the program with $3 billion more per year than it does now.

Sum of Contract Rents at 100% of FMR, adjusted for tenant-paid utilities	$13.9 billion
Less: Current Public Housing Funding	$11.0 billion
Equals: Additional Annual Subsidy	$2.9 billion

We now have a sense of the scale of what it might take to fully support public housing at a reasonable rent standard—compared to what PHAs can now get via a "no-additional cost" RAD conversion of assistance. It's worth noting, too, that this amount is a about 10% less than what PHAs get in the way of Tenant Protection Vouchers, or TPVS, when using the Section 18 Demo/Dispo program, including when those TPVs are combined with RAD in the menu of RAD-Section 18 blends that HUD has introduced in the last couple of years.

Additional Leveraging Potential

What would an additional $3 billion annually–or, on a unit-weighted average, an additional $260 PUM in operating subsidies, generate in first mortgage proceeds?

At today's interest rates (let's use 4%), and assuming a 30-year term and a 1.2 debt coverage ratio, this infusion of subsidy would afford additional net operating income available for debt service that could readily raise on the order of $44.5 billion in mortgage capital, or $46,000/unit for redeveloping public housing properties nationwide. Now, remember, under RAD, even at current funding, PHAs have already shown the ability to raise $36,000/unit in first mortgage proceeds and another $44,000/unit in tax credit equity.

So that's over $100,000 per unit in potential total debt and equity financing that could be realized by effectively "trueing up" current RAD rents to FMR levels and as extended to other forms of Section 8-funded multifamily housing.

That's an astounding number relative to our overall capital needs that might be $85 billion. It could readily address properties requiring moderate or little rehab and go a long way in meeting the higher costs of substantial rehab and replacement housing. Indeed, some amount of gap funding is typically needed in most affordable housing new construction and sub rehab projects. This is even more true for public housing. Its needs are much deeper than other stocks of affordable housing, so it will have bigger gaps as a consequence.

Competing Subsidy Models

But where should we inject these new operating subsidies – into the public housing system or into a Section 8 subsidy program?

Let's address an underlying question that been asked since the beginning of the Rental Assistance Demonstration. Why not just fund the conventional public housing system with needed levels of Operating and Capital Funds each year? Wouldn't that eventually solve the capital backlog problem and enable PHAs to better maintain and fix-up their housing when needed?

- First off, we face the huge capital backlog that we have today because Congress has never funded public housing at the levels that industry organizations have requested for years—whose efforts have been thwarted by the grossly underestimated HUD-funded research on capital needs. Remember, since 1999, we've lost about 220,000 units of public housing that we didn't have the funds to repair or replace.
- Second, if we're fortunate enough to get an infusion of $80 billion dollars being discussed in the current $3.5 trillion "social infrastructure bill," that could fill in a huge pothole today. But it's not a good bet, and likely a continuing unanswered prayer, that Congress would *also* be willing to add $3 billion in additional funding year after year to the same system that dug the hole we're in now in the first place. That situation seems even more apparent since production of our first Chalk Talk in this series. And that would just accumulate another huge capital backlog in the years ahead.

Frankly, Congress wouldn't be wrong in resting on this conclusion. The public housing model as it evolved over the years has never had sound fundamentals. At the outset, the federal government paid only to *construct* public housing units, offering no operating subsidies. Subsequently, as local agencies couldn't operate their inventories with just declining rent receipts from the increasingly poorer and poorer tenants they were asked to house, Congress began to offer limited operating and capital repair funds in annual budget cycles.

For whatever reasons, these subsidies have never been enough. Capital funds in particular were never adequate to support basic life-cycle upgrades as needed to ensure effective preservation of the stock.

Moreover, in being completely dependent on public funding, the conventional public housing model never created—and even stymied—basic mechanisms for attracting non-public funds that are the foundation of all other residential housing in the United States.

Up and down annual appropriations funding have precluded PHAs from offering firm long-term contract rents with built-in adjustments for inflation essential in leveraging private debt and equity investments. Public housing has also suffered from restrictive use agreements (known as a Declaration of Trust), which ironically were intended to secure the inadequate public investment made when building units were originally built. More questionably, public housing has no system of reserves for replacement, which explains a lot behind our current backlog of needed improvements.

Taken together, these characteristics are deal killers for PHAs when seeking other non-public debt and equity funds to augment chronically insufficient public funding. Over time, it's become increasingly clear that the conventional public housing funding system was built on a patchwork of paradoxical financial assumptions. It's no surprise we're left with the problems we have today.

On the other hand, the Rental Assistance Demonstration has already amply demonstrated that converting to the Section 8 funding platform, freeing properties of the restrictive DoT and offering long-term subsidy contracts adjusted for increasing operating costs—even on its original "no- additional cost" basis--makes a quantifiable difference. So far, RAD converted properties have generated $12.13 billion in additional capital to fix up PHA properties—by simply converting the same (insufficient) amount of available public housing into the proven Section 8 based operating subsidies.

If we want to consider the best way of increasing rental subsidies to enable PHAs to leverage additional funds needed to compensate for the structural deficiencies of the conventional public housing system, it makes absolutely no sense to direct those funds back into that same conventional public housing system. We'll just end up with the same problems that we have today over and over again.

All this to say, the public housing model is really a false choice. A much better bet would be to add needed subsidies to the proven Section-8 based funding system, and simply drop RAD's original "no-additional cost" provision as Congress now considers making more funds available for fixing up and preserving the public housing stock.

How Would This Work?

To recap, it seems that the most efficient and effective way to address public housing's accumulated backlog of needs, and to make sure we don't let that happen again, would be to convert the entire stock to the Section 8 platform with some combination of:

- reasonable rents,
- maximum debt and equity leverage, and
- capital grants to fill gaps to help replace or substantially rehab that portion of the stock with extremely high capital needs and/or where prescribed FMRs are unusually low to provide any leveraging potential.

For example, if the rehab needs of a certain property were $150,000/unit, and the project could raise $100,000/unit in leverage with rents at FMR, additional gap funding would be needed for the remaining $50,000/unit in rehab costs.

Additional needed gap funding could be paired to and underwritten by HUD in the same review and underwriting process used now for processing RAD-Section 18 blend awards (the whole intent of which is to help solve for the problem of RAD rents that are well below FMR).

This approach should also be extended to both public housing units not yet converted to the Section 8 platform and those that have already converted under RAD but with less than fair market rents.

How to Get There

As we've outlined, getting to reasonable rents will require a $3 billion *annual* increase in Section 8 project-based funding,

No doubt other even more streamlined reasonable rent-optimal leverage-gap funding approaches could be devised by HUD and PHAs. Regardless of the approach, we should respect established Section 8 and RAD policies when converting public housing to the Section 8 platform.

The standard Section 8 rent structure that limits tenant contributions to no more than 30% of income and established RAD policies has to remain a fixed part of the equation. So should many of RAD's now well-accepted measures important to PHAs and residents. These would include but not necessarily be limited to perpetual renewal of Section 8 contracts; 1-for-1 replacement of current units with reasonable de-minimus changes in unit configurations; no displacement and re-screening of residents if moving into different units to accommodate construction realities; continued engagement of residents in the conversion process; and more.

RAD has demonstrated a viable and fairly well accepted pathway for effectively converting public housing to the Section 8 platform. When coupled with reasonable fair market rents and needed gap funding targeted to the oldest and deepest needs properties, it can be an even better formula for converting all public housing to more stable footing for the future.

Final Comments/Recommendations

That's it for our three part-series on infrastructure spending. I never intended for this series to be the final say on all matters relating to meeting public housing's capital needs. It's a large, complex subject. I have, however, wanted to help frame-out both how to think about the size of the need and how best to meet that need, within the context of what might be an historical moment to solve public housing's funding problem. We've established that the needs are, no doubt, quite substantial and that there is significant ability even within existing funding levels to leverage private debt and equity to augment any infrastructure funding. We also have some sense of what the additional annual subsidy would be to true-up public housing subsidies to market rents.

As it seems increasingly likely that Congress will be looking to trim down the proposed $3.5 trillion social infrastructure bill, it may prove difficult for it to drop $85 or more billion all-at-once into the public housing system. It may, however, be able to start by increasing annual Section 8 subsidy levels for PHAs comparable to what's provided to other owners and managers of affordable housing. With that, they will be able to leverage substantial sums of additional debt and equity. Plus, much less in the way of capital grant funding would be required to address properties needing substantial rehab or to be replaced now and in the future.

We'd still require capital subsidy to fill the gaps, but it would be substantially less than the amounts currently being debated on the Hill. How much in capital subsidy would be needed? Factors such as the use of 4% or 9% tax credits, variable construction costs and the exact number of units requiring replacement make this difficult to estimate. But it could possibly be something on the order of $15-25 billion in total. And that amount could be phased in over several years as PHAs line up local plans, redevelopment teams and financing.

Reasonably increasing operating subsidies and providing gap funding on par with other affordable housing would put public housing on a much stronger subsidy platform than it's ever had to work with. It's probably the best way to ensure that investments in the nation's public housing inventory being proposed today will be used wisely to preserve it over time.

Finally, I'd like to thank various colleagues in the industry who are working on these issues and who were willing to allow me to run by them some of the ideas and calculations presented here.

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