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HUD'S QUIET RESCUE PLAN FOR VERY SMALL PHAs

By Greg Byrne

The public housing stock today stands at about one million units. We tend to think of public housing in terms of big cities – New York, Miami, Boston, or Detroit. In fact, there are around 860 public housing agencies (PHAs) that operate 50 or fewer public housing units. These very small PHAs account for 30% of all PHAs nationwide and mostly operate in rural communities, far from HUD's field offices.

Over the years, very small PHAs have been tied to many of the same program rules that govern their big-city counterparts, which has meant an almost insufferable level of regulation for organizations that often rely on part-time staff. While there have been many attempts to streamline program rules for very small PHAs, real reform has been elusive.

But now HUD has a bold program for very small PHAs, one that would not only accomplish the long-sought goal of streamlining but could raise hundreds of millions of dollars in new first mortgage proceeds to address needed repairs. For some agencies, it will even result in a boost in funding. However, you won't find this truly landmark program within the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act, the proposed 2021 American Jobs Act (the "infrastructure" bill), or any other emergency spending package. Instead, it is tucked inside a 2018 administrative notice on demolitions and dispositions, with little fanfare.

This paper looks at this not-so-new opportunity for very small PHAs and offers some suggestions that would expand participation.

A Special Nod to Very Small PHAs

On March 22, 2018, via PIH Notice 2018-04, HUD issued revised guidance implementing Section 18 of the Housing Act of 1937, which governs the demolition and disposition of public housing.¹ For most of public housing's history, a PHA was required to replace each public housing unit removed from inventory with another "hard" unit, which had some disastrous consequences, particularly for the neighborhoods surrounding severely distressed projects, given that there was essentially no funding for replacement housing. Then, in 1998, Congress eliminated

¹ PIH Notice 2018-04, Demolition and/or Disposition of Public Housing Property, Eligibility for Tenant Protection Vouchers and Associated Requirements, March 22, 2018.

that one-for-one requirement, allowing for the removal of units from public housing under certain circumstances, the most common of which was physical obsolescence.

People mostly associate Section 18 with the demolition and disposition of some of the worst public housing – say, Robert Taylor Homes in Chicago. It turns out, however, that HUD has enormous discretion under Section 18 and, among other program clarifications, HUD utilized that discretion in PIH Notice 2018-04 to make very small PHAs automatically eligible for Section 18, with no requirement to prove obsolescence or to present any other show of need. In effect, a very small PHA can now choose to exit the public housing program by little more than raising its hand.²

When units are removed through Section 18, HUD provides a Section 8 voucher (called a “Tenant Protection Voucher”, or TPV) for each unit occupied within 24 months of HUD’s approval. These TPVs are intended to make communities “whole” for the number of units removed through Section 18 (subject to the 24-month rule). Then, a PHA has two options with these TPVs. It can choose either to issue those vouchers to residents who want to find housing on the private market (including renting in-place) or the PHA can choose to “project-base” the vouchers to preserve the asset as long-term affordable housing (called Project-Based Vouchers, or PBVs).³

In other words, all very small PHAs can now jump the public housing program to become an owner of Section 8 housing.⁴

The Advantages of Converting

And why would a very small PHA want to leave public housing and become a Section 8 owner? The reasons why a very small PHA would want to convert are the same as any other PHA and worth repeating here.⁵

The first is more stable funding. The public housing program suffers from uneven and uncertain annual appropriations whereas the Section 8 program has benefitted from vastly more predictable funding. Indeed, the Section 8 PBV contracts have built-in adjustments to keep up with inflation, something that just doesn’t exist in public housing.⁶

² Very small PHAs can also opt to convert to Section 8 under the Rental Assistance Demonstration (RAD) program, as well as the Streamlined Voluntary Conversion (SVC) program. However, Section 18 ‘50 or Fewer’ is often the most advantageous and expeditious route for very small PHAs to convert to Section 8.

³ When it project-bases the TPVs, the PHA must offer the PBV assistance to the existing resident.

⁴ HUD has also greatly expanded the number of conversion options for small PHAs (51-250 units), only that they are not as “automatic” as Section 18 for PHAs with 50 or fewer units.

⁵ Although not required under Section 18, most very small PHAs are likely to continue to preserve the assets as affordable housing, i.e., to project-base the TPVs. On occasion, some very small PHAs may decide that the residents would be better off, and would prefer, to use the vouchers to find housing elsewhere. HUD appropriately leaves that decision to each PHA.

⁶ In the PBV program, an owner can request an annual adjustment in the rent to keep up with changes in the market.

The second is the opportunity for higher – and, for some, substantially higher – funding. When a PHA converts a project under Section 18, the project is no longer constrained by current public housing funding (which is the case for conversions under RAD). Instead, if the PHA project-bases the TPVs, the contract rents are based on the lower of the reasonable rent or 110% of HUD’s Fair Market Rent (FMR).⁷ It is estimated that somewhere around half of very small PHAs would have rents that are higher under PBVs than current public housing funding.⁸ In effect, HUD has decided there are compelling advantages in terms of program administration by converting these very small PHAs to Section 8, even at higher costs.

The third is the ability to leverage private debt (first mortgage proceeds) to finance needed repairs. Nationwide, very small PHAs could readily raise an average of about \$22,000/unit in first mortgage proceeds by converting to Section 8 and project-basing the TPVs.⁹ By way of context, the 2010 Abt Capital Needs Study (the most recent study on public housing capital needs) estimated that the median capital needs for small PHAs was about \$14,000/unit.¹⁰ Even allowing both for inflation and for challenges in the methodology of the Abt study, the capital needs of these smaller PHAs could be largely eliminated by converting to Section 8 and leveraging private debt. It is essentially equivalent to HUD writing a check for \$600 million to very small PHAs to meet their capital needs (27,000 units x \$22,000/unit). In fact, because the majority of very small PHA projects will qualify as “existing housing” under the PBV program, which is defined as “substantially meeting Housing Quality Standards (HQS)”, the units can immediately be placed under a PBV contract. Later, when the PHA decides to undertake repairs, those repairs will generally not be subject to Davis-Bacon wage requirements, which makes it easier for lenders to underwrite these small loans.

The final and likely most compelling reason why a very small PHA would want to convert to Section 8 is to achieve a degree of administrative relief that wildly

⁷ The “reasonable rent” is essentially the market rent for the unit, only that, in comparison with HUD’s multifamily programs, the methodology for determining reasonable/market rent is less formal.

⁸ Unfortunately, HUD does not capture “market” or “reasonable” rents for every public housing project, which is a controlling factor in determining PBV rents. However, the median public housing funding for very small PHAs in 2020, adjusted to include utility allowances, was equal to 96% of the FMR. It seems reasonable that the rents that public housing projects could command would be somewhat less than the FMR. Therefore, about half of all very small PHAs could be expected to see an increase in funding. About 12% of very small PHAs are currently funded at below 70% of the FMR and would likely see the largest increase in funding.

⁹ To arrive at this estimate, I assumed that, were a project to convert at current public housing funding levels, the combined tenant rents and operating subsidy would cover operating expenses and the amount of the Capital Fund grant would essentially need to cover replacement reserves, cash flow, and debt service payments. In 2020, the median Capital Fund grant to very small PHAs was \$160 per unit monthly (PUM). Assuming \$40 PUM for replacement reserve deposits, a debt coverage ratio of 1.15, and a 30-year loan at 4% interest, the resulting loan amount would be \$22,000/unit. Again, this estimate is based on current public housing funding and does not take into consideration higher funding that might be available to very small PHAs who convert through Section 18 and project-base the TPVs.

¹⁰ The 2010 Abt Capital Needs Study did not break out very small PHAs but determined that small PHAs (below 250 units) had median inspection-based needs of \$9,481/unit. In addition, it identified \$4,321/unit nationwide for additions relating to lead-based paint abatement, accommodating persons with disabilities, and improving energy and water efficiency, for a combined total of \$13,802/unit. See, Capital Needs in the Public Housing Program, Abt Associates, November 24, 2010.

exceeds any previous industry proposals for regulatory streamlining.¹¹ Let me explain. Since few very small PHAs currently operate a voucher program, when they convert to PBVs they will need to partner with another PHA to serve as the voucher administrator. In turn, the voucher administrator, as part of the administrative fee that HUD pays it, will now assume all tasks associated with administering the waiting list, determining applicant eligibility, collecting tenant income verifications, conducting annual tenant certifications, and calculating tenant rents, i.e., virtually all of the activities related to administering a federal subsidy program.¹² And, of course, by converting to Section 8, the PHA also leaves behind all the previous requirements of the public housing program, from the Public Housing Assessment System to Five-Year Plans. Indeed, if a very small PHA converts to Section 8 PBVs via Section 18, it no longer has any requirement whatsoever to submit annual financial statements to HUD. A very small PHA becomes, literally, just an owner that has a contract to provide housing for low-income households for a period of time. In essence, conversion through Section 18 for very small PHAs really is the final solution in small PHA reform. I don't think it can get any better.

A Very Soft Roll-Out

After many years banging at HUD to streamline the public housing program, most very small PHAs are still somewhat in shock and only a handful have applied for Section 18. Although understandable in not wanting to feel heavy-handed, HUD's roll-out has probably been too timid and it could do more to promote the program and, importantly, to educate PHA boards that conversion to Section 8 simply changes the subsidy platform and doesn't fundamentally change a PHA's mission (or its staffing, which is another concern of very small PHAs).

Still, congrats to HUD in recognizing that letting very small PHAs convert to Section 8 makes a lot of sense from an administrative perspective. Although very small PHAs account for a quarter of all PHAs, they represent less than 3% of the total public housing inventory. A disproportionate share of HUD's administrative resources is dedicated to serving these remote, very small agencies and converting them to Section 8 would reduce the overall bureaucratic footprint.

¹¹ Among others, see the Small Housing Authority Reform Proposal (SHARP) by the Public Housing Authorities Directors Association.

¹² The PHA doesn't necessarily need to project-base the assistance. It can also just decide to issue the TPVs to the residents and let them remain in the units or to find housing elsewhere. Some very small PHAs have chosen not to project-base the assistance because they feel that their product is strong enough such that, if any tenants do move, they will have no trouble attracting other low-income households, either those with vouchers or simply others looking for good, affordable housing.

Model Upgrades

Beyond simply doing more to get the message out, what could HUD do to greatly expand participation? Three particular areas are worth mentioning.¹³

The first is that, being a “disposition” program, Section 18 actually requires a PHA to dispose of the asset to a separate legal entity (as opposed to simply removing or releasing it from the public housing program). Now, most PHAs meet this requirement by simply transferring the asset for \$1 to a non-profit arm of the PHA, which allows the existing PHA board to maintain an on-going interest in the project. However, for many very small PHAs, such a disposition just seems odd, unnecessary, and raises eyebrows, creating another barrier to conversion. It would be preferable if HUD could find a way to allow very small PHAs to continue to own the asset under the umbrella of the PHA without having to formally dispose of the asset.¹⁴

The second is that some very small PHAs are inconveniently distant from the nearest voucher administrator, making it a less attractive deal for the voucher administrator. HUD should consider a special fee to voucher agencies that have to administer PBVs outside a reasonable catchment area to compensate them for the extra travel and related costs. Alternatively, HUD could consider creating new voucher agencies in underserved areas.

Finally, it would be extremely helpful for HUD to provide some relief to the PBV contract rent requirements in markets with very low rents. While very small PHAs along the coastal regions of the Northeast, Mid-Atlantic, Southeast, and West will mostly see a huge increase in rents as they convert from public housing to Section 8 via Section 18 (a function of the large delta between public housing funding levels and market rents), many PHAs in very low rent markets, including rural Oklahoma, Nebraska, and Kansas, among others, would have their funding actually decrease if they convert. That is because their current public housing funding is already at or above market and, under the PBV program, a project can never get more than the reasonable (market) rent. Of course, these PHAs could still convert at their current funding levels under RAD PBRA but they would not enjoy the same regulatory

¹³ It is also worth mentioning that, if a very small PHA were to convert through Section 18 '50 or Fewer', it would not be allowed to carry-over any operating reserves into the converted project. The PHA would need to spend those funds before it converted, which is based on HUD's interpretation of statute. Since operating reserves average about \$3,000/unit annually, a very small PHA with 25 units might then have \$75,000 in operating reserves that it might need to spend. If a PHA didn't want to spend those funds prior to conversion, but wanted to carry them over to the converted project, it could pursue a “blended” transaction where at least one unit converts via RAD (which has broader legal authority to use public housing funds to support conversion) and the remaining units convert via Section 18. HUD has recently indicated that this work-around is permissible.

¹⁴ HUD has found a similar carve-out for mixed-finance projects when they convert through Section 18, i.e., they are not required to formally dispose of the asset.

streamlining that would come with PBV conversions.¹⁵ Moreover, the amounts in question – where public housing funding exceeds the reasonable rent or 110% of FMR – are often not more than \$50 per unit monthly, i.e., levels that would be inconsequential to HUD but material to these very small PHAs. To fix this problem, HUD could consider a grandfathering provision that would allow these PHAs to convert to PBVs at current public housing funding levels, something akin to the “exception rents” that were permitted for PBRA projects under the Mark to Market restructuring program, or some other way to reconsider what a “reasonable” rent is in these low-market areas.¹⁶

Very Small PHAs Amid a Very Large Strategy

Very small PHAs play an important role in delivering affordable housing in, predominantly, rural areas. By transferring the tasks of subsidy administration to a voucher agency, conversion to Section 8 can help strengthen these organizations by allowing them to concentrate on the core tasks of ownership (and, for some, increasing their funding).

Today, very small PHAs are the only group where HUD has created an automatic out through Section 18.¹⁷ With a little more outreach, some added nudging, and a few program tweaks, we should be able to put very small PHAs “in the books”, wherein we can turn all energies to converting the rest of the public housing inventory.

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¹⁵ Under RAD, a PHA can convert to either Section 8 PBRA or PBV. Under PBRA, PHAs are allowed to keep current funding up to 120% of FMR, without any consideration of market rent. Only a handful of very small PHAs have current funding above 120% of FMR. So, nearly every very small PHA could still convert to RAD PBRA to keep its current funding. However, I feel that the ability to transition the subsidy administration functions to the voucher administrator via the PBV program is particularly compelling for very small agencies. Larger agencies are able to devote the time and energy to learn these tasks, just as private PBRA owners learn these tasks.

¹⁶ To the extent that such a relaxation of the reasonable rent rules would require legislation, PHA industry groups might want to consider carrying the flag.

¹⁷ Under the Streamlined Voluntary Conversion (SVC) program, all PHAs with 250 or fewer units can also leave the public housing program and receive Section 8 TPVs; however, to project-base the TPVs, a PHA must obtain tenant consent. Section 18 allows for project-basing without tenant consent.