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# A Challenge for the Next Decade:

## *Preserving Affordable Rental Housing*

by Laura Burns

*Many of Maine's low-income families and elderly residents have been able to secure affordable housing with help from a Section 8 certificate, which allows residents to pay no more than 30% of their income toward rent and ensures the federal government will make up the difference. Over the years, much of the development of Section 8 housing projects has been assisted by financial incentives and agreements between private and non-profit owners and the federal government. Yet recent changes in federal legislation remove many of these incentives and the agreements that go with them. As a result, some of Maine's affordable housing supply may disappear as private owners convert their properties to market-rate rental housing.  Laura Burns outlines the recent changes in federal legislation and discusses their potential impact on Maine's communities. Currently in Maine, there are 3,500 assisted rental apartments with Section 8 contracts scheduled to expire in the next five years. Without any incentives to renew, the owners of these projects face the economic decision of whether to continue to provide affordable housing without any of the incentives or guarantees that previously existed, or to convert their properties to market rate. Burns argues that local and state officials must do what they can now to keep the state's already scarce supply of affordable housing in place.*

## INTRODUCTION

A remarkable number of low-income households in the United States are not getting the help they need to secure affordable rental housing. Nationwide, more than one million families are on waiting lists for housing assistance and most will wait years before they will be helped.<sup>1</sup> Many low-income families and elderly residents are helped through Section 8 certificates, paying 30% of their income towards rent with the government making up the difference. Many Maine cities—including Portland and South Portland—have waiting lists for Section 8 assistance that are so long, they have been closed to all further applicants. The estimated waiting period for assistance through the Section 8 program is three to twelve months in Westbrook and Lewiston, and two or more years in Bangor and Augusta. In Chicago, when the waiting list was re-opened for two weeks in the summer of 1997, one hundred thousand families applied.<sup>2</sup>

The challenge of housing our poor is not new. However, the production of new government-subsidized housing has slowed in recent years because of pressure to reduce federal spending. An improving economy—resulting in increased rents—has further reduced the supply of affordable housing. Moreover, 35% of the nation's 4.8 million assisted renters live in housing that was built by private developers who received financial incentives in exchange for serving this need. These incentives—and the agreements that go with them—are expiring and, at the owner's option, some of this affordable housing may disappear from the already limited supply. Recent legislation and changes to the Section 8 program may encourage even more owners to “opt out,” and remove their housing from this essential rental pool.

This has direct implications for Maine's cities and towns. While Maine enjoys the highest rate of homeownership in the nation—76.5%<sup>3</sup>—it also has a high percentage of renter households receiving assistance—19% compared to the nationwide level of 14%.<sup>4</sup> Of the 27,500 assisted renter households in Maine,<sup>5</sup> 10,750, or 39%, live in units that may be converted to market-rate housing and disappear from the affordable housing stock. One-third of these units face that option in the next five years. Some communities may be hard hit by these changes.

In the coming years, local and state policymakers and affordable housing advocates will need to work even harder than before to serve the housing needs of Maine's low-income renters. This article reviews the Section 8 program and recent changes to it, and discusses how such changes will affect Maine communities.

## MORE ABOUT NEED:

In 1995, 35% of the nation's 97.7 million households were renters. In that year, 14.7 million households had incomes below the poverty level (\$15,200 for a family of four), and 8.6 million of those households were renters. This means that in 1995, fully 25% of our renter population was below the poverty level and these households spent, on average, 62% of their income on rent.

There are still many more households with incomes above the poverty level struggling to pay market rents. Between 1993 and 1995 alone, nine hundred thousand apartment units that were affordable to this very-low-income renter group were lost through demolition, rent increases or conversion to another use—a 9% decrease in low-rent apartments provided by the market.

In 1997, worst-case need—defined as unassisted renters who earn below 50% of the area median income but are spending more than 50% of their income on rent, or as those who are living in substandard housing, or as those who are involuntarily displaced—rose to an all-time high of 5.3 million households. These households account for 12.5 million people—including 4.5 million children, nearly 1.5 million senior citizens, and between 1.1 million and 1.4 million adults with disabilities. All of these households would qualify for housing aid from the Department of Housing and Urban Development, but the Department does not have enough funding to help them.

During these times of an improving economy  
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our poorer renters are facing harder times.

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### THE NEED FOR SUBSIDIZED HOUSING

Through various programs, the government, provides subsidy to 4.8 million low-income renters in housing units assisted or regulated by the government.<sup>6</sup> In Maine, assistance is provided to 27,500 renters. These subsidized households include: 4,700 Maine renters living in publicly owned housing managed by a Public or Indian Housing Authority; 9,450 Maine renters who rent apartments from private owners and who pay rent, in part, with a tenant-based Section 8 certificate or voucher (the tenant chooses where they want to live, provided the rent does not exceed certain limits); 10,750 renters occupying multi-family properties, privately owned and managed, which were financed by, or are directly subsidized by, the government; and 2,600 residents who live in privately owned rental properties built with proceeds from the sale of low-income housing tax credits. These tax credits are funded by the government in the form of foregone tax dollars and are issued for the purpose of creating affordable housing.<sup>7</sup>

You won't always know when you drive by an assisted housing unit and some of the residents may surprise you. Multi-family developments subsidized by tax credits are reserved for households earning no more than 60% of the area median income. At the recently renovated Lafayette Square Apartments in Portland, some units are reserved for tax credit eligible households. In Portland, a family of three earning as much as \$25,000 a year and spending \$625 per month on rent and utilities would still qualify as tax credit eligible.

For the low-income renters that are not assisted through these programs, the only other place to look for assistance is in the open market. When the marketplace provides rental opportunities at low rents, it does so because the apartments are in lesser demand, they are in poor condition or are in inferior locations. The supply of this non-regulated, "affordable" housing grows or shrinks with a moving economy. A tightening rental market results in a reduced supply of affordable housing as rents rise beyond the means of lower-income renters. Tenants must then spend more of their income on rent, move to smaller or less desirable apartments, or become homeless. During these times of

an improving economy many of us appreciate progress; however, our poorer renters are facing harder times.

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### ASSISTED MULTI-FAMILY HOUSING AT RISK OF CONVERSION

In this time of improving markets, when more affordable housing is needed, the nation and Maine are facing an additional challenge to retain the existing supply. A large portion of the subsidized housing portfolio—about 1.7 million of the 4.8 million units—was built between 1961 and 1983 with the help of government financing and guarantees. Many of these properties are nearing the expiration of subsidy contracts and other affordability agreements, and could be converted to market rate housing.

The rental units known as the "assisted multi-family portfolio" are generally divided into two groups. The "older assisted housing," about 700,000 units, was predominantly financed under the Department of Housing and Urban Development's (HUD) Section 221(d) 3 and Section 236 Programs, and was developed in the 1960s and 1970s by private developers. These programs offered low-interest loans to build or substantially renovate multi-family rental housing, and required an agreement to rent to low-income households at HUD-restricted rents. The programs provided loans with either a 1% or 3% interest rate and forty-year repayment terms. The low rates let the owners charge lower rents than they otherwise would have been able. The forty-year financing programs gave the owner a very important option to pay the loan off early, after only twenty years, if the owner elected to do so. Upon early prepayment, the housing could be converted to market rents.

In the mid 1970s, as fuel prices rose dramatically and operating costs increased, owners had difficulty paying all operating and debt costs while still maintaining HUD-approved rents. In response, HUD used the Section 8 Program, which allowed the government to pay project-based rent subsidies, to make up the difference between the tenants' rent and the cost to operate the property. This enabled the owners to continue renting to low-income residents.

The second type of assisted multi-family housing, consisting of one million rental units, is known as the “newer assisted housing,” and was developed through the Section 8 New Construction/Substantial Rehabilitation Program. This program, passed by Congress in 1974, replaced the low-rate mortgage programs with programs that relied on project-based rent subsidies. Section 8 contracts were provided—essentially guaranteeing the rents—and they allowed developers to obtain private financing. As an additional inducement to private lenders, the Federal Housing Administration (FHA) provided insurance for some of the loans for up to forty years. Section 8 contracts for some of the projects were provided with thirty- or forty-year terms but some others, particularly those that had FHA insurance, had contracts in place for only fifteen to twenty years. Private lenders were not concerned about the short term of the Section 8 contracts because the loans were insured. State Housing Finance Agencies or the Farmers Home Administration financed some of the non-FHA-insured projects that received Section 8 contracts. Maine State Housing Authority (MSHA) was one of the state housing finance agencies that provided these non-insured loans. Most of MSHA’s loans have thirty- to forty-year contracts.

Two problems were created: First, owners of the older projects, which have become known as expiring-use projects, have the right to pre-pay the loan after twenty years and convert the housing to market rents; the pre-payment releases the owner of all affordability restrictions. Low-income residents would no longer be able to afford to live in these apartments, which would disappear from the nation’s limited affordable housing stock. These residents would be displaced, forced to find other housing, and some would face homelessness. In communities that have prospered over the last twenty years, real estate values have increased and the decision to sell or convert these properties could be very lucrative for the owner. The highest quality, best-maintained and best-managed properties are at the greatest risk of pre-payment and conversion from affordable to market-rate housing. The projects at the lowest risk of pre-payment are those in poor condition, with a history of mismanagement, and located in declining markets.

The second problem we face is financial: Many newer assisted-housing projects, known as “expiring-contract projects,” have subsidies that expire after twenty years, while the FHA mortgage insurance—which had a forty-year term—still has twenty more years to go. The risk here is two-fold. First, as Section 8 contracts expire the owners also have a right to pre-pay and convert the housing to market. Second, if the owners don’t want to or can’t

convert to market, but HUD fails to renew the Section 8 contract, the owner may be unable to pay the project’s bills. A reduced rent won’t be sufficient for adequate maintenance in addition to debt payments and could result in the project’s physical deterioration as well as default on a federally insured mortgage. Default by the owners would allow the private lenders to demand payment of the entire loan balance from the FHA insurance fund. As of 1997, an estimated fourteen thousand rental properties, with an unpaid aggregate principal balance of \$38 billion, had loans insured by the Federal Housing Administration. Ten thousand of these fourteen projects had project-based rental assistance under the Section 8 Program. Clearly, failure to renew the Section 8 contracts would have an enormous impact on the affordable housing supply, as well as massive financial impact on the government. Even more bad news—much of the housing is in need of repair and upgrade, and will require more investment in order to make the housing last.

#### CONGRESSIONAL RESPONSE

Congress has been dealing with this national problem for the last decade. In the late 1980s the largest concern seemed to be the loss of affordable units. But as costs became more of an issue, Congress has responded by protecting its financial interests, with the potential result that fewer units will be available to low-income renters. The legislation that has been passed removes some of the economic incentives for owners to continue with the program.

In 1987, when potential pre-payment dates loomed for the first of the 3,600 expiring use projects, Congress responded by passing a moratorium on the pre-payment of the loans. Owners, who had intended to exercise their legal rights to convert the housing, were prohibited from doing so. Three years later, Congress passed relatively complicated legislation, known as the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA), which allowed eligible owners to sell or convert but only after giving tenants, tenant associations, and tenant-endorsed non-profit organizations an opportunity to buy. In 1996, after a four-month government shutdown, Congress restored the rights of these owners to pre-pay and convert to market. One thousand of the 3,600 expiring-use projects had been funded under the LIHPRHA program, but the remaining 2,600 projects were eligible once again for conversion to market. Between 1996, when eligibility to pre-pay was restored, and October 1998, owners of six hundred multi-family projects in forty states, providing fifty thousand units of affordable housing, pre-paid

### THE FAIR MARKET RENT DEBATE:

The United States Department of Housing and Urban Development has used “Fair Market Rents” (FMR) to determine Section 8 contract rents. Yet there are reasons why an affordable housing project might need to command rents that are higher than the FMR. Some projects have high operating costs because of the need for additional security, or because of specific maintenance requirements. Projects with large units and more bedrooms tend to house larger families and may have higher turnover costs. Projects set aside for low-income families and for elderly residents generally have a higher concentration of “twenty-four-hour” residents (family households may have a parent at home with children all day). This results in higher than average utility costs and more wear and tear on the apartment. Some of the need for higher rents may be directly attributed to the original development cost. Projects developed in the 1980s experienced high land acquisition and construction costs and, in some cases, high mortgage interest rates.

### FAIR MARKET RENTS IN MAINE:

The average rent for 288 Section 8 contracts reviewed in Maine is equal to 160% of the area FMR. More specifically, The Signal Group reviewed sixteen project-based contracts in Portland that provide housing to 1,048 elderly and family households. Among these projects, Section 8 contracts ranged from 50% to 213% of the FMR for Cumberland County. For example, one-bedroom units had contract rents between \$244 and \$1,025 per month. In contrast, The Signal Group also surveyed market rental rates in Portland in October 1998. The sample of apartment complexes surveyed showed that one-bedroom unit rents ranged from \$380 to \$1,100 per month. Hence, the sampled one-bedroom market rents range from 79% to 228% of the FMR. Adjustments up or down for age, location, and amenities must be made to determine true market.

their mortgages and converted their properties to market-rate housing. Each month, on average, 2,500 units have silently disappeared from the affordable housing stock as a result of the elimination of the LIHPRHA program.

The second group of properties—the expiring contract properties—became a major issue for Congress and housing policy makers in the mid-1990s. Most of the Section 8 contracts, originated in the late 1970s, were coming up for renewal. According to HUD’s estimates, the annual cost of renewing these Section 8 contracts would eventually rise to a level equal to 75% of HUD’s total annual budget.<sup>8</sup> Additional factors came to light as Congress struggled with the cost of renewal. First, more than 15% of the portfolio was financially or physically distressed, including some that suffered from mismanagement. Second, a substantial number of housing units that were up for renewal for project-based assistance had Section 8 contracts at rent levels higher than the market rent for the area. These high rents became the primary focus of the debate as policymakers questioned the foundation of the program. Owners began to defend themselves against accusations of abusing the system.

In response to the expiring contract problem, Congress passed the Multi-family Assisted Housing Reform and Affordability Act of 1997 (MAHRA). MAHRA provides for renewal of Section 8 contracts on an annual basis but, for the federally insured mortgages, contract rents will no longer be renewed at levels above the “comparable market rent.” Comparable market rent will be determined on a project-by-project basis, and is intended to represent what the unit would rent for if it were competing in the open marketplace for tenants without subsidy.

Some FHA-insured projects will face a rent reduction and, consequently, will be unable to make their mortgage payments. For these projects, HUD will reduce the loan amount by making a direct payment to the lender for a portion of the outstanding debt. HUD will take a subordinate mortgage position to secure repayment of this obligation. Any necessary repairs also will be determined, mutually between the owner and HUD, and the cost will be shared between the private owner and the government. For non-FHA-insured projects with over-market rents, owners may also face a rent reduction, but not if it means that the owner cannot pay its current operating costs and debt obligations. These owners may lose some of the profit they have been collecting over the years.

If a rent reduction on a FHA-insured project requires debt restructure, and the owner accepts the Section 8 contract renewal, they must renew their commitment to affordable housing for

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another thirty years. The Section 8 contracts will be for only a year and, at HUD's option, can be renewed annually throughout the compliance period. The reasoning behind the program is that, if at any time in the future HUD does not or cannot renew the Section 8 contract, the project could convert to market-rate and still support its operating and debt costs. Then the lost affordable housing is not compounded by a financial loss to the insurance fund.

Owners who go through this process will be expected to share profits with HUD. In addition, there may be serious tax implications from the restructuring. If HUD makes a partial payment to the lender, and the new subordinate loan from HUD cannot reasonably be expected to be repaid through cash flow, then the IRS will view this as cancellation of indebtedness income, and will tax the owners accordingly. In addition, owners will be required to participate in the repair costs. These negative economic issues associated with restructuring may mean that some owners choose to leave the program and pre-pay their loans. Certainly, the owners with the best projects in the best markets will have the greatest incentive to opt out, and for those owners required to share their profit with HUD, participation in the program may not make sense. This will result in a reduced supply of affordable housing.

MAHRA went into effect in October 1998, but implementation will be complicated and will take several years. The actual negotiation between the owner and the government to determine rental rates, project operating expenses, and the amount of debt to be repaid to the lender has been delegated to local Participating Administrative Entities, which will also determine repair needs and the new debt structure. This will affect the way owners do business, or choose not to do business, with HUD. MSHA participated with HUD in a demonstration program last year and has been approved as a Participating Administrative Entity under the MAHRA program.

The 1999 HUD budget signed by President Clinton on October 21, 1998 is, according to a press release from HUD, "the best housing budget in a decade." The budget, at \$24.6 billion, is \$2 billion more than last year's budget and includes some major new initiatives for HUD. Thirty-nine percent of this year's budget—more than \$9.5 billion—will go to the Section 8

Program. The money will be used to address the financial problems surrounding the existing government-assisted multi-family housing. For those owners who choose to stay in the program, the funds will be used to renew expiring contracts under the new rules. The modest budget increases to new construction programs are not enough to replace the units that will be lost from the affordable housing supply when owners who choose not to stay in the program convert their properties to market rents.

#### THE IMPACT ON MAINE

There are 3,500 assisted units in 104 projects in Maine that have Section 8 contracts scheduled to expire in the next five years. The largest concentrations are in Cumberland (793 units) and Androscoggin (788 units) counties. York, Kennebec and Penobscot counties each have over three hundred units scheduled to expire in the coming five years. In projecting the likelihood of project renewal, one factor to consider is whether the project's owner is a for-profit or not-for-profit entity. In the

#### MORE ON THE HUD BUDGET:

The 1998 appropriations bill provides new housing assistance vouchers for ninety thousand low- and moderate-income families and authorizes one hundred thousand more vouchers to be issued in 2000 and 2001. Housing production programs like the Community Development Block Grant (CDBG) Program and HOME were afforded minor budget increases over last year of 2% and 7% respectively. HOPE VI—a program designed to replace decaying public housing with new apartments, and to help residents get access to education, training and jobs—received a 14% increase in funding over last year.

The alternative to sign up with HUD for thirty years, face tax consequences and receive only limited cash flow may be just enough to send the owners to the marketplace.

case of not-for-profit developers, economics play a less important role in decision-making, and the provision of affordable housing is likely to be the major concern of the agency. Another factor to consider in establishing the likelihood of conversion is the market area where the project is located. Some regions, like Lewiston, are still more depressed than other regions and the market might not be strong enough to encourage owners to convert. Southern Maine, which has seen recent population growth and increasing rents and values, is in greater danger of experiencing these conversions. In communities like Portland, Falmouth, and Cape Elizabeth owners could see a real economic upside as a result of conversion.

Lewiston's affordable housing supply, which has contract rents that average 161% of the FMR, includes 491 units due to expire in the next five years. Four hundred fifty-six of these units, in eight projects, will be affected by MAHRA. Each one has rents above the FMR and nearly half are owned by for-profit entities. Each of these owners will need to consider their economic options. Competing in the market for tenants and prepaying the mortgage may not be viable. But for project owners in stronger markets (potentially twenty-two projects or fourteen hundred units in Maine), there may be a real economic benefit. The alternative to sign up with HUD for thirty years, face tax consequences and receive only limited cash flow may be just enough to send the owners to the marketplace.

### CONCLUSION

The residents of expiring contract projects will be affected the most. Many of these residents have no other options. Many are unemployed or under-employed and, if they lost their apartment, would be at risk of becoming homeless. The improving market already has eliminated other low-cost options and has put many Maine families on the street. Hence it is our low-income renters with the greatest need that have the greatest potential of being affected by these legislative changes. Although MAHRA does provide some temporary relief to tenants of properties converting to market, the units will be lost forever and future affordable housing needs will not be met.

Federal policy, it seems, cannot be changed. As a result, owners face real economic choices and a decision whether to stay in or opt out of these programs. Maine's policymakers and local officials must do what they can to keep the state's affordable housing in place. We must be proactive in our response to this challenge. This includes understanding what owners are facing and offering incentives and help in order to meet a common goal. Owners should not be viewed as "bad guys." They signed up for these programs under one set of rules, and are being asked to sign up again under a completely different set of rules, which, in many cases, eliminate their financial incentives for doing so.

Twenty or more years ago, private developers partnered with government to build this housing. If asked to partner again, they will need and expect new incentives. There are financial tools available that state and local communities can put to use, but the owners may need to be enticed back into the program. No longer can "Not In My Back Yard"—or NIMBY—be tolerated. Local tax relief can be provided, and grants, loans and subsidy dollars need to be considered for these properties. Low-income housing tax credits, a scarce resource in Maine, may be the only option for some projects. Housing subsidies face strong competition, but preserving housing is as important as producing it, and each project and its local impact must be considered. We won't always be given a choice to preserve the affordable housing stock, but when we are given the opportunity, we must do what we can to protect it. 🐟



*Laura Burns has been in the affordable housing development and finance business since 1985. Ms. Burns spent seven years with the Boston Redevelopment Authority, was a chief operating officer for a nationwide affordable housing developer, and co-founded The Signal Group in 1995. The Signal Group consults to owners, lenders, and investors of affordable housing, and currently represents owners affected by the legislation of MAHRA.*



## ENDNOTES:

1. United States Department of Housing and Urban Development, letter from Secretary Andrew Cuomo, April 1998.
2. *ibid.*
3. United States Census Bureau.
4. The United States census Bureau reported that in 1995, 145,000 households in Maine rented (total households was equal to 483,000), and 27,500 of those received assistance. At the same time the total number of renter households in the United States was 34,500,000 (total households was equal to 97,700,000), and 4,800,000 received assistance.
5. United States Department of Housing and Urban Development, picture of subsidized households, 1998.
6. *ibid.*
7. *ibid.*
8. National Low-Income Housing Coalition/National Congress for Community Economic Development. June 18, 1996. "Federal Policy in Transition, A National Briefing Book on Housing, Economic and Community Development."