U.S. Department of Housing and Urban Development
Office of Community Planning and Development

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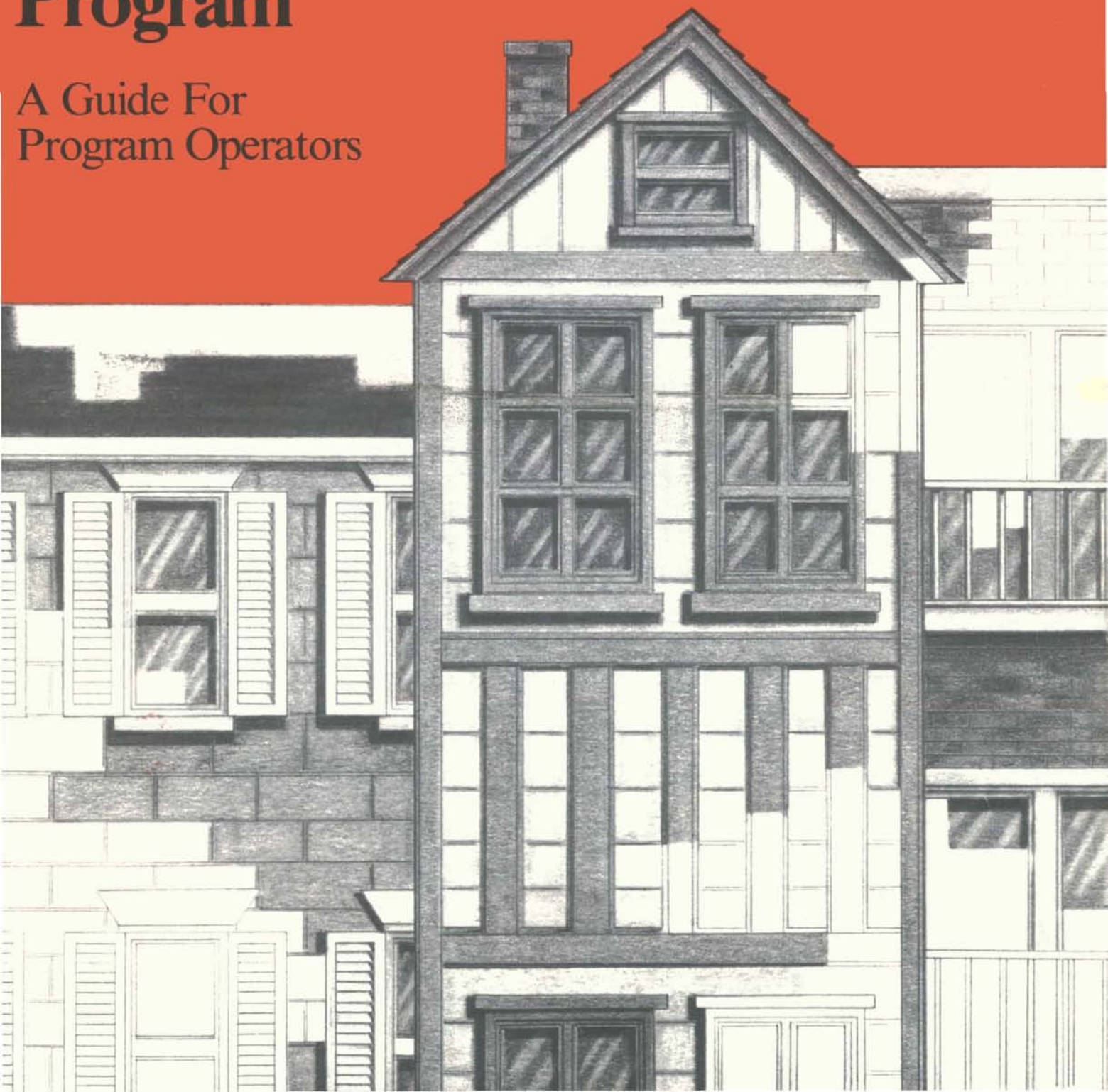
How To Design A Rental Rehabilitation Program

A Guide For Program Operators



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How To Design A Rental Rehabilitation Program

A Guide For Program Operators

Prepared for:
U.S. Department of Housing and Urban Development
Office of Community Planning and Development

Office of Urban Rehabilitation

Foreword

This guidebook has been prepared for state and local housing officials who are contemplating development of a rental rehabilitation program or considering modifications to an existing design. The approach and substance of the material represent the author's experience with rental programs throughout the country. They do not reflect official HUD policy.

A companion publication to this *Guide* contains a set of exercises and worksheets for use by managers and staff. The *Workbook for Program Operators* follows the same outline of topics as the guidebook, providing an opportunity to practice new skills and focus on local program objectives.

This document was written by Peter Richardson, with advice and consultation of Helen Dunlap and Ann Bauman, formerly of the Community Revitalization Training Center (CRTC). It has been prepared by Comprehensive Marketing Systems, Incorporated (CMS, Inc.), under contract with the Office of Urban Rehabilitation, U.S. Department of Housing and Urban Development, Washington, D.C.

Copies of both the *Guide* and the *Workbook* may be obtained free of charge from the Office of Urban Rehabilitation, U.S. Department of Housing and Urban Development, 451 Seventh Street, S.W., Room 7168, Washington, D.C. 20410.

Introduction

Financing improvements to rental properties has become a new challenge for local rehabilitation programs. In most lower-income communities, there is a mixture of owner-occupied and rental housing, and public resources must be directed to each ownership type to have an impact in "turning around" marginal neighborhoods.

A key and growing source of public funds for rental rehabilitation finance has been the Community Development Block Grant (CDBG) program. Since the mid-Seventies, HUD has been actively encouraging local governments to increase their use of CDBG funds for the rehabilitation of rental properties. And since 1981, HUD has been working intensively with localities and states which have committed public funds to the Rental Rehabilitation Demonstration Program, engaging consultants to deliver direct assistance and to conduct training workshops for program operators.

In addition to the CDBG program, cities, counties, and State agencies have a new source of funds for rental rehabilitation purposes. The Rental Rehabilitation Program, supported by HUD Secretary Pierce's 1983 legislative package, provides $150 million in each of Fiscal Years 1984 and 1985 to subsidize the moderate rehabilitation of rental properties. The program also provides housing assistance payments for lower-income renters who occupy rehabilitated units.

Both the new Program and its predecessor, the Demonstration, focus on residential properties containing fewer than 30 units. They emphasize local program design, private financial participation in each project, restrictions on rent control agreements, and benefits for low- and moderate-income tenants.

The financing approach stresses the *separation of subsidies* needed for property improvements from those needed to provide affordable housing for lower-income tenants. In traditional HUD housing programs (such as Section 221(d)(3) and Section 8 Moderate and Substantial Rehabilitation), the *building* and *tenant* subsidies are intertwined and involve multi-year Federal funding commitments.

The scope of this guidebook reflects many of the issues that are faced by participants in the Demonstration and will be faced by grantees in the Rental Rehabilitation Program. However, it is *not* limited to the approach espoused by HUD, and nor is it a manual for designing a rental rehabilitation program that complies with the Demonstration or Program guidelines. Rather, it is intended to provide officials at various government levels with information to design and operate programs regardless of the source of public financing.*

*The materials for this guidebook were written in 1983. Thus, they do not reflect changes in programs and/or regulations that have occurred since then.

The issues addressed are organized in five chapters and represent the sequence of decisions which must normally be made.

Chapter 1, "Neighborhood and Market Analysis," outlines the rationale and data requirements for selecting neighborhoods appropriate for rental rehabilitation assistance.

Chapter 2, "Financial Design Issues," considers a range of public subsidy techniques that may be used to create feasible rehabilitation projects.

Chapter 3, "Approaching Private Lenders," contains both facts about private lending practices and suggestions on attracting private resources into public programs.

Chapter 4, "Administration and Marketing," presents the key elements of an administrative system and how they relate to the overall program design.

Chapter 5, "Tenant Strategies," focuses on the issues of affordability of the units by lower-income tenants once properties have been rehabilitated.

The tone and substance of the guidebook are intended to be instructive and suggestive, but not dogmatic. There is no absolute blueprint for designing local programs—they must reflect local conditions and capabilities. For this reason, recommendations regarding specific guidelines and procedures and the development of particular forms have been omitted. These items must evolve from individual local policy decisions that are made within the framework of the program design process.

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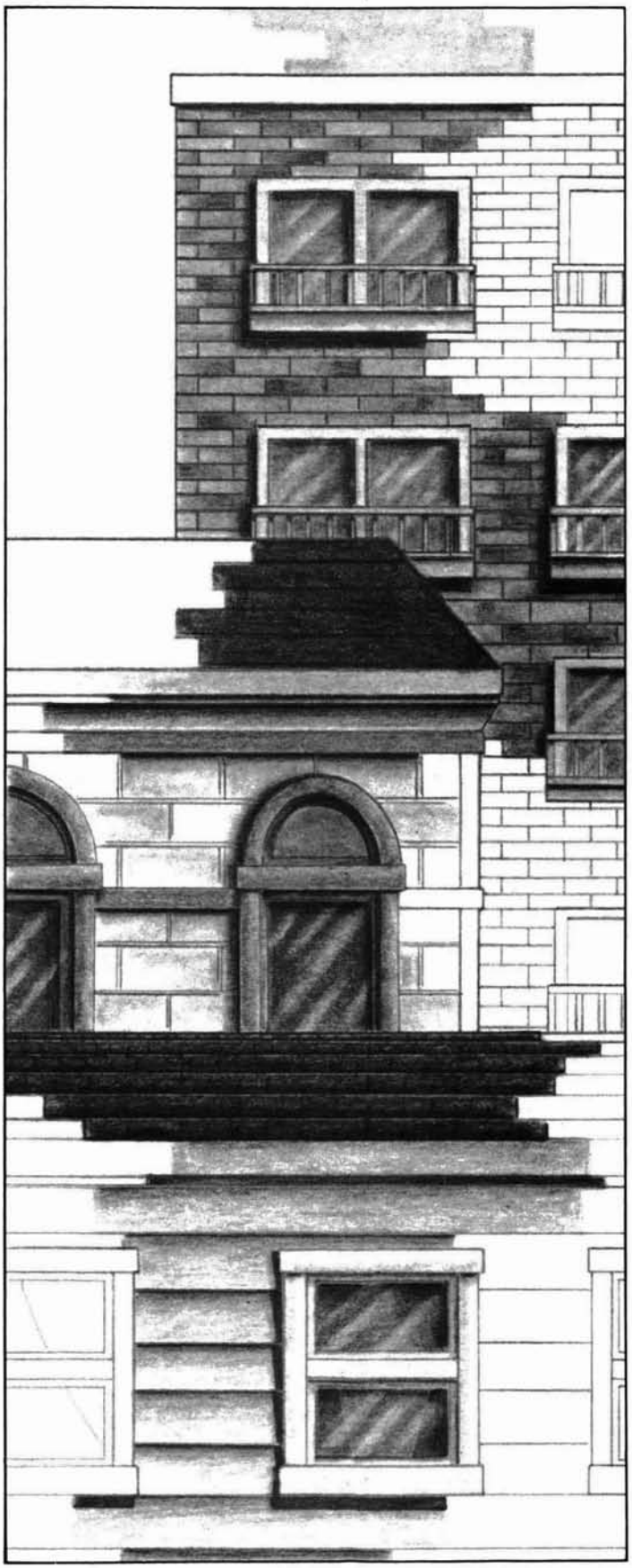


Chapter 1

Neighborhood and Market Analysis

Analyze neighborhood needs? Sure, we can do that. We do it every time we apply for federal funds.

Now, let's see. The 1970 Census showed a total population in the neighborhood of 7,885. In 1980, it was 7,023—an 11 percent decline. The '80 Census also showed that some 1,474 households (that's 63 percent) had annual incomes below the SMSA median.

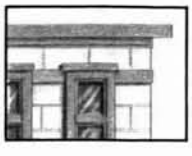
You want more? Okay, 38 percent of the housing units are in substandard condition. The number of AFDC recipients is. . .

Talk about "neighborhood analysis" to veterans of public programs, and they immediately reach for the dusty Data File to show that poor people live there. This reaction is understandable. Most funding sources (including HUD) have traditionally required statistical demonstration of need to justify an allocation. So, local planners crank out a series of numbers to show that their target neighborhood is poorer and in worse condition than any other.

When it comes to rehabilitation program planning and design, however, the purpose of a neighborhood analysis is somewhat different. There is still concern that low- and moderate-income residents will benefit from the public funds that will be used; but the *type* and *presentation* of the data collected should be oriented more to actual program purposes and real-world consequences. The Neighborhood and Market Analysis must relate to local public purposes and design issues, and the data needed is not likely to exist in the files of most planning departments.

Defining public purposes is the first step toward setting program goals. Planners should ask themselves, "What is the program intended to do?" Though the answers may involve competing purposes, they at least provide a guide for analyzing neighborhood conditions. Public purposes commonly identified with rental rehabilitation are:

☐ To upgrade and revitalize the physical conditions in declining areas;
☐ To stabilize the economy of neighborhoods that are moving toward decline;
☐ To prevent displacement of low- and moderate-income tenants in changing neighborhoods while supporting revitalization;
☐ To upgrade or maintain the existing housing stock;
☐ To provide additional affordable housing for low- and moderate-income renters; and
☐ To maintain or increase the tax base in declining neighborhoods.



Why Neighborhood Analysis?

Having gone through a process of establishing—or confirming—the public purposes to be achieved by the program, strategies must be examined that are appropriate for the target neighborhoods being considered. Program strategies should be based on information obtained from analyzing neighborhood conditions. The type and quality of information to be collected should be based on the following questions:

1. What (specifically) do you need to know about the neighborhood?

2. Where do you find the information?

3. What does it tell you once you have found it?

4. What are the characteristics of a neighborhood which is "appropriate" for rental rehabilitation assistance?

The analysis should then be framed to answer three overall questions, each suggesting a series of subordinate issues and information needs:

1. What type of *program design* is appropriate?

Where are the rental units? Are there enough to justify a "program," or are there just a few structures that might best be handled on a project-by-project basis?

Who owns the rental properties? Are they large developers, property managers, or realtors? Or are many of them casual owners of one or two structures?

What is the existing condition of most buildings? Will rehabilitation be extensive and costly? How much will it cost on the average to improve units to comply with local code and/or Housing Quality Standards (HQS)?[1]

Do low- and moderate-income families occupy the buildings? Or would they wish to move there if vacant buildings were rehabilitated?

2. What type of *financial assistance* will be required to achieve the rehabilitation?

Are most rental properties carrying significant debt at the present time? What is the length of ownership? Who holds the mortgages?

Will most landlords resist or welcome opportunities to fix up their properties? Are they currently realizing cash profits and/or tax advantages from property ownership?

[1]Housing Quality Standards (HQS) define the minimum physical conditions that are acceptable under the Section 8 rental assistance program. These standards must be met for units to be counted under local Housing Assistance Plans (HAPs). They are not synonymous with local codes.

Are there other public programs operating in the neighborhood which have set a pattern or momentum for reinvestment?

Will private lenders make loan funds available in the neighborhood? What will be the requirements for private financing in conjunction with the public funds that may be available?

3. How would a private lender *underwrite* loan applications?

Are second mortgage loans feasible? What are the current loan-to-value ratios on most properties?

What are the existing rent levels by unit size? What will be the rent levels after rehabilitation has been completed? Will increased rent levels support any or all of the additional debt?

Is there measurable demand for rehabilitated rental units in the neighborhood? What is the current vacancy rate?

What are the overall economic conditions of the neighborhood? Is there private investment going on? Public investment?

The third series of questions—those dealing with lender underwriting—are critical to a program that contemplates the use of private financing in conjunction with the public funds. If these issues are not addressed in the neighborhood analysis, making it in part a "market analysis," then they will have to be addressed for each project that is submitted to a financial institution for underwriting. Thus, there is a "pay me now or pay me later" feature to the analysis that is frequently overlooked by program planners.[2]

What Do You Need To Know?

The more program planners know about their target neighborhood, the greater their ability to address questions on program designs, financial assistance, and private lender underwriting. At a minimum, however, they should be prepared to answer six specific questions.

1. What are the geographic boundaries of the neighborhood?

On the surface, this appears to be a simple and straightforward question. Just list the streets or other geographical markers (parks, rivers, railroad tracks, highways) that circumscribe the neighborhood as identified in the planning process. Several problems may emerge, however.

The first problem involves the way primary data collectors, such as the Census Bureau and regional planning agencies, define their "statistical areas." They may not be *consistent* with each other, with economic markets, or with community identification. Analysis efforts will be enhanced by the extent to which geographical boundaries that define target areas are consistent with the Census or other statistically-based tracts. If they are not—which will likely be the case—planners must extrapolate the data or find secondary sources to refine the information that is available.

The second problem involves varying conditions *within* selected neighborhoods. Even when the most accurate and current data has been gathered on a particular geographic area, it is not likely that it tells evenly, or homogeneously, what the conditions within the prescribed boundaries are. The simplest way to test for homogeneity is to ask the question: Are the conditions on one street in the area substantially the same as those on any other street? Or, regarding market rent levels, does a unit on one street command approximately the same rent as a unit on any other street, given similarity in their physical size and condition?

If there is significant variation among different streets, then the neighborhood and market analyses must be conducted according to different geographic boundaries. If they are widely different, then different program design features may need to apply to the various sub-markets within a given neighborhood. For example:

"The East End neighborhood encompasses 40 square blocks from Tenth to Twenty-First Street, between Main and Veterans Park. It was built during the same period, and the architecture is similar throughout.

However, the area closer to Downtown (between Tenth and about Fourteenth Street) is in higher demand. There are also certain blocks throughout where property owners have painted and fixed up the facades. Apartments on those streets can run upwards of $375 per month. Two blocks away, the same unit might get only $200."

In this instance, the "neighborhood analysis" would deal with the East End because the entire area is appropriate for

[2]Smaller localities that do not intend to "target" their programs in specific neighborhoods—"the entire town is our target neighborhood"—will still need to develop a market analysis. They may collect the prerequisite information on a neighborhood basis on the front-end (during the planning phase) or after the individual projects have been selected.

rental rehabilitation assistance. The "market analysis," however, would consider the sub-markets: (1) the area between 10th and 14th; (2) the "fixed-up" blocks; and (3) the balance of the neighborhood. If more than three or four distinguishable sub-markets can be identified, it is likely that the neighborhood being analyzed is too large to be considered as a "target area" with a singular approach to rental rehabilitation.

2. How many rental properties are there in the target neighborhood?

A confident knowledge of the *supply* of rental properties in a given neighborhood is important from several points-of-view. The overall question to be asked, however, is: Are there enough units to justify a "program," or are there just a few structures needing assistance to complement an ongoing revitalization effort? Both the actual number of rental units and their percentage to the total number of residential units in the neighborhood must be determined.

The *actual number* of those units needing rehabilitation should be determined in order to estimate the *impact* of the public funds on the overall problem. As a rule-of-thumb, there should be sufficient funds committed to the program to support improvements in from 10-20 percent of the units if physical impact is to result. If the level of funding (for the present and the foreseeable future) is not sufficient to support rehabilitation of at least 10 percent of the units in need, then the size of the neighborhood should be reduced.

The *percentage* of rental units to those owned by their occupants should be determined in order to assess the need for a "program" vis-a-vis a "project-oriented" design. A rule-of-thumb for the percent of rental vs. owner-occupied units is at least 25 percent. If there are fewer than 25 percent rental units, then the neighborhood would not constitute a "rental market," and the overall economic conditions (and impact) become difficult to assess in the process of defining a "program." If a public effort to stimulate the rehabilitation of the few properties located in the neighborhood is still appropriate (to complement an owner-occupied program, for example), then those units should probably be analyzed individually. The public effort thus becomes more project than neighborhood oriented.

3. What are the real market rent levels (by unit size) both before and after rehabilitation?

Real market rents are those which are commanded in the private marketplace and without the support of public subsidies and restrictions. They are not the Section 8 Fair Market Rents (FMRs). Section 8 FMRs are set by HUD; and although they are intended to reflect the real marketplace, many communities have found that it is a statistical coincidence when they do. Program planners need to determine the *effect on rental revenues* that will occur within the market area as a result of rehabilitation.[3]

Information on real market rent levels is important for at least three reasons. The first deals with the question of designing a feasible program that relies to the maximum extent on *private market forces*, eliminating (or clearly identifying) the need for such artificial public supports as rent subsidies or controls after the rehabilitation has been completed. The second reason deals with the *marginal increase in revenues* that may be assumed to repay a rehabilitation loan—even if it must be subsidized. The third reason deals with the question of *affordability* of the after-rehabilitation rents by low- and moderate-income tenants.

Private Market Forces

An improved rental unit should command a higher market rent than one which is in substandard condition. If the unit is located in a neighborhood which is clearly on the upswing, then the rent increase may be dramatic, creating an attractive investment opportunity for the landlord. In marginal or declining neighborhoods, however, several economic questions must be asked:

Will the new rent levels be sufficiently attractive to landlords to induce them to maintain the units over time and make needed repairs? Or, will profits and other financial benefits from property ownership be too limited to support good management?

If private market forces will not support reasonable economic motivations to manage and maintain rental properties, the program may create very short-term impacts in the neighborhood. Private market forces must not be too weak to provide incentives for property management and long-term maintenance. If they are, then the neighborhood is either inappropriate for the program, or additional public controls must be applied along with increased levels of subsidy. Such public controls may involve inspection and maintenance

[3]It is possible that no units in the neighborhood have been recently rehabilitated (or are new), making difficult the task of estimating "after-rehab" rents. In such instances, a sample of standard units should be sought, from which projections may be made. If there are very few (or no) units in the neighborhood which could qualify as "standard," then rent levels on comparable units in proximate neighborhoods should be used as the basis for making after-rehab projections.

agreements with the owner and financial penalties for evidence of poor management. However, these types of agreements may prove difficult and/or costly to regulate over time.

Marginal Increases in Revenues

The revenues realized from property ownership come in the form of gross rents. If a substandard property contains units renting for "X" dollars a month, a rehabilitated unit should rent for "X plus Y" dollars a month. The "Y" amount may be called the "marginal increase" in rent that results from rehabilitation. When the marginal increases for all units are added together, they produce a marginal increase in revenues for the property.

From a program design standpoint, the amount of the marginal increase in revenues could be applied to repaying a rehabilitation loan on a monthly basis.[4] This figure will influence the amount of public funds which must be committed to finance the rehabilitation, as discussed further in Chapter 2.

Affordability

If a marginal increase in rents is supported by private market forces, will low- and moderate-income tenants be able to afford the units? The answer to this question must begin with a definition of "affordability."

HUD used to define affordability as 25 percent of the gross income of tenants eligible for public housing and the Section 8 program. This definition assumed that low- and moderate-income renters could afford food, clothing, and other expenses with 75 percent of their income. Today, HUD requires tenants to pay 30 percent of their incomes for publicly-subsidized rental housing.

Local policies affecting the design and operation of rental rehabilitation programs may adopt HUD's definition of affordability, or they may set different standards based on neighborhood norms and the availability of resources. Some standard must nevertheless be set to establish real-world affordability for after-rehab market rents. (Adoption of the HUD definition will enhance consistency, particularly if Section 8 units are to be used in conjunction with the program.) Once defined, the concept of affordability must then be modified to account for artificial supports or restraints that will be placed on the real market rents.

An example of an *artificial support* is the rent subsidy provided through the Section 8 program. When tenants hold Section 8 certificates, or when they live in rental properties financed through the Section 8 program, "affordability" would be defined by the percentage of income required under the Section 8 program, i.e., 30 percent. Programs which contemplate the use of Section 8 certificates to avert displacement of existing residents, or to provide housing for others who are qualified for Section 8 assistance, must assure that the real market rents do not exceed the Section 8 FMRs. If the neighborhood analysis shows that real market rents exceed the Section 8 FMRs and affordability for low- and moderate-income tenants is a significant public purpose, then programs have three choices: (1) to move to another target neighborhood; (2) petition HUD to amend the FMRs; or (3) institute rent controls and pay for them in the form of higher financing subsidies.

An example of an *artificial restraint* on real market rents would be a rent control or related regulatory agreement. Such an instrument may be established through local ordinance applying to all rental units, or may be a condition of a property owner's acceptance of subsidized financing for the cost of rehabilitation. If an owner agrees to hold rents at a level below those which may otherwise be commanded in the private marketplace, then the program's definition of affordability would serve as the basis for agreed-upon rent levels.

4. What is the vacancy rate for rental units in the neighborhood?

The vacancy rate is a function of demand for rental housing. A high vacancy rate (over 10 percent, for example) indicates a "soft" market and a low level of demand. A low vacancy rate (less than 2 percent, for example) indicates a "tight" market with significant demand for rental housing.

For program planners, a *low vacancy rate* suggests high after-rehab rents and the need for artificial supports, restraints, or both to create a supply of "affordable" housing. Simultaneously, low vacancy rates suggest little incentive for investor-owners to go through the hassle and expense of rehabilitation because of the market demand for units in their existing condition. Inducing owners to rehabilitate is likely to require availability of a substantial public subsidy, public pressure, or both.

On the other hand, a *high vacancy rate* suggests a low marginal increase in rents as a result of rehabilitation. (With other choices, why pay more?) Such conditions may enhance the affordability of rehabilitated units for the low- and moderate-income tenants. However, the cost of rehabilitation financing must be heavily subsidized to create feasible projects.

Neither circumstance—high or low vacancy rates—provides fertile ground for rental rehabilitation programs.

[4]This approach is somewhat simplistic because it assumes that the property is economically feasible in its existing condition; that all expenses after rehabilitation can continue to be paid from before-rehab rents; and that the owner will not retain part of the rent increase as additional profit from the investment.

Rules-of-thumb suggest that vacancy rates between 3 percent and 7 percent are most appropriate for neighborhoods targeted for such programs.

5. How much will it cost per unit to improve the majority of structures in the neighborhood?

The task of projecting building costs must be based on certain rehabilitation standards. These standards should reflect local and state housing codes, as well as Housing Quality Standards. An average cost figure—or a range of projected costs—must be researched and estimated to assure that the rental program is realistic within funding constraints. Planners should eliminate extreme cases (nearly-standard structures and those which are severely dilapidated) if the program is to be designed for the majority of structures in between.

If the rental structures are mostly small (fewer than five units) and if conversions of larger units to smaller ones will not typically be involved,[5] then a projection based on the average cost of improving a single-family structure is an appropriate

[5]Conversions normally require major work on mechanical systems and modifications to interior walls that escalate costs beyond those required in single-family or existing rental configurations.

Chart 1: Information, Questions, and Reasons on Structure Types and Ownership Patterns.

Information	Questions	Reasons
Number of Units per Structure	What percentage of the total are large or small properties? Will the funds available support numerous (25+) applications, or just a few (10–)?	What type of administrative system should be established to run the program? Will the lenders view underwriting differently for 1-4 units vs. 5+ unit structures and thus impact on the type and level of subsidy?
Household Sizes	Are there large or small family units needing housing in the neighborhood?	To respond to demand, should the program target the rehab of large or small units?
Age of the Structures	When were they built? Are the existing systems antiquated, needing costly replacement? Are certain tax advantages available for investors who perform the rehabilitation?	Are the per-unit costs going to be high throughout? Is the neighborhood an historic district that opens certain tax treatments?
Variety of Structures	Are the structures physically homogeneous? Or, is there variation in configuration, design, and condition of the properties?	Can a uniform program design be established? Or, must the design be open and flexible to deal with a range of physical situations?
Ownership Patterns	What type of entities own the properties? Are they active real estate ventures? Passive? "Mom-pop" owners? Professional landlords? Local speculators? What type of mortgage transaction is prevalent in the neighborhood?	Should the design be structured around cash-flow concerns, tax benefits, or both? Should the subsidized financing be expressed as direct subsidies or below-market interest rates? Will the program encourage acquisition and rehab, second mortgages, or refinancing? How will the program deal with contracts for sale?

starting-point. Adjustments *down* may then be made by considering certain economies of scale, i.e., a structure has only one roof and a single foundation that may need repair. Similarly, adjustments *up* may be required if the condition of most rental properties is inferior to those owned by their occupants.

Precise figures are not required for program design strategies developed through the neighborhood analysis. A reasonable range of per-unit costs is adequate, and a "three-quarters" rule-of-thumb appropriate. This rule suggests that the information is useful if it applies to at least three-quarters of the structures. For example:

"What is the minimum cost per unit to rehabilitate, say, three-quarters of the rental properties in the target neighborhood? Will $2,500 do it?"

"And what is the maximum cost? Will 25% of the units require more than, say, $15,000 in improvement costs to meet program standards?"

Most rental programs will not be interested in supporting incidental repairs that are cosmetic in nature (e.g., those costing less than $2,500 per unit); and in deterioriated neighborhoods, it is unlikely that such low per-unit costs will bring structures into compliance with local property codes. Similarly, buildings needing substantial or "gut" rehabilitation would require expenditures of public funds that may be unacceptable. A planning approach that establishes a "treatment range" can be useful to outline the financing parameters of the program design and for articulating rehabilitation standards.

6. What type of rental properties exist in the neighborhood and who owns them?

There are a number of additional data needs relating to the type of structures and ownership patterns that should be gathered in the neighborhood analysis phase. Specifically, certain items of information are needed to answer certain questions for certain reasons, as shown in Chart 1.

What additional information might be gathered?

The six questions that have been highlighted should be answered in the neighborhood analysis for both program design and project underwriting purposes. There may also be additional questions raised by private lenders whose participation in the rehabilitation financing is to be sought. Such questions may require a more full-blown market analysis, dealing with such issues as employment prospects and population trends. If this information is available to program planners, it should be included in a lender presentation.

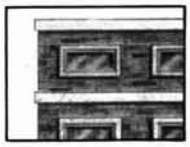
Chart 2: Outline of a Housing Market Analysis

1. **Description of Total Market Area**
   - a. Size (total population);
   - b. Topographical Features;
   - c. Transportation Arteries;
   - d. Direction of Recent Growth;
   - e. Special Features, Characteristics, Considerations
   - f. Community Developments: Planned/In-Process; and
   - g. Map of Area.
2. **Economics of Market Area**
   - a. Brief History of Growth/Developments;
   - b. Employment: Types and Trends;
   - c. Principal Employers;
   - d. Unemployment: Current Levels and Trends; and
   - e. Average Family Income: Current Levels and Trends.
3. **Demographics of Market Area**
   - a. Current Estimate and Future Trends;
   - b. Distribution by Age;
   - c. Distribution by Education;
   - d. Distribution by Household Size; and
   - e. Special Features, i.e., military-connected households.
4. **Conditions of Market Area**
   - a. Housing Supply: Characteristics by Type and Structural Condition;
   - b. Residential Building Activity: Current Estimate and Future Trends;
   - c. Tenure of Occupancy: Current Estimate and Past Trends;
   - d. Vacancy Rates: Owners and Renters;
   - e. Mortgage Market: Activity and Source of Funds;
   - f. Sales Market: Volume, Prices, Inventory and Outlook;
   - g. Rental Market: Existing/New, Prices and Outlook.
5. **Demand for Housing**
   - a. Projected Increase in Households;
   - b. Locations Favorable for Market Absorption;
   - c. Occupancy Potential for Subsidizing/Non-Subsidized Single-Family Units; and
   - d. Occupancy Potential for Subsidized/Non-Subsidized Multifamily Units.

Depending upon the scope of the proposed program, a Housing Market Analysis may be called for.[6] Such a study would provide information on the entire area encompassed by the locality (i.e., the Standard Metropolitan Statistical Area, or SMSA), and would break it down into submarkets. These submarkets would theoretically conform to target neighborhoods.

A Housing Market Analysis would include sections on economics, demographics, market conditions, and demand for housing. It might be organized as shown in Chart 2.

This outline is shown not because this type and level of analysis is needed for most rental rehabilitation programs. It is shown so that planners may compare what they do need with the quality and organization of information that is typically attendant to major development projects. The size and scope of the program will determine whether it constitutes a "major development." One which involves several million dollars in public funds and upwards of $5-10 million in private financing should be fortified with a full-blown market analysis.



Where Do You Find The Information?

The sources and availability of the information needed for a neighborhood and market analysis will, of course, vary from community to community. Some have developed highly automated and accessible data banks; others have sluggish information systems of dubious accuracy. Notwithstanding the traditional sources of secondary data—the U.S. Census, local assessor and registry offices, building departments, etc.—most of the critical information must be developed through visual surveying and personal conversations with key professionals and real estate operators in the neighborhood.

Before scanning sources of information, an understanding of the purpose and usefulness of various data items must be developed. Planners should repeatedly ask the question, "What does this information really tell me about what's going on?" If the answer is "not much," the data should be discarded so as not to clutter the analysis. Potential sources and the information they may be able to provide are shown in Chart 3.

Efforts to contact these and other local sources may be as useful in establishing relationships for ongoing program operations as they are in assembling data. Approaching lenders, real estate brokers, etc., for planning information, for example, will introduce them to the program design and lay groundwork for soliciting their participation once the program is operational.

What Does This Information Tell You?

Scanning the sources of information, the types of data they may provide, and the caveats associated with each, may appear overwhelming to some planners. A word of reassurance: It is not necessary to assemble *all* the data which may be available. In fact, an overload of data may serve to cloud issues more than illuminate them. Once again, the issues are these:

1. What type of program design is appropriate?

2. What type of financial assistance will be required to achieve the rehabilitation?

3. How would a private lender underwrite loan applications?

Each of these issues requires practical, concrete decision-making that should be based on concise, uncluttered information. The key items—rehabilitation costs, rent levels, and demand for rehabilitated units—should be analyzed and then cross-referenced among various sources. The more subjective elements of neighborhood and market analysis involve projections of trends: Will today's conditions apply two, three, or even five years from now when the rehabilitated units are competing in the marketplace? Trends are effectively displayed through historical charts. Where possible, the data base should be supported by more than one source.

Chart 4 shows examples of the type of information that may be collected and the kinds of conclusions that may be drawn from it. (Although the sources of the data are not shown here, they should be noted in a market study report.)

[6]There are private firms that specialize in performing market analyses for major development projects. Such studies may cost between $5,000 and $15,000. If the time and capacity of the planning staff is limited, it may be prudent to engage outside assistance to respond to the information needs of some private lenders. Additionally, some private lenders have market analyses for other projects which may contain data useful to local governments in defining neighborhoods and designing programs.

Chart 3: Potential Sources of Information

Source	Information (Caveats)
U.S. Census, both Population and Housing Reports	Population by Census Tract; household size, composition, etc.; basic conditions. *(Data may be old/inaccurate on a small scale; neighborhood boundaries may not conform with Census Tracts.)*
Local Planning and Building Departments	Both code violations and permits for new construction and rehabilitation; actual numbers and trends, indicating levels of private investment activity. *(Data may not be assembled, particularly according to neighborhood boundaries.)*
Local/County Social Service Agencies	Number of recipients of various forms of public assistance, indicating shelter allowance paid and levels of rental subsidies needed by low-income tenants. *(May be marginally useful in projecting "affordability" if few after-rehab properties are involved.)*
Local Tax Assessor	Ownership patterns, property values, and assessment habits (tax effects of rehab). *(May not be assembled according to neighborhood boundaries/designation.)*
Local/County Registrar of Deeds	Ownership patterns; mortgages and other liens; and longevity of ownership. *(Data may not be assembled.)*
Local Lenders	Mortgage activity (recent, current) and overall lending patterns. *(Data may need to be interpreted.)*
R.L. Polk "Profiles of Change" (if applicable)	Neighborhood housing and economic conditions and trends. *(May not conform to neighborhood boundaries.)*
Professionals in the Real Estate Business: Brokers, Appraisers Owners, Property Managers	Current rent levels; property values; ownership types, trends; etc. *(Information may not be statistically based, though it may be accurate with regard to trends.)*
Newspaper Listings	Existing rent levels; vacancy trends. *(May reflect only "segments" of the rental market.)*
U.S. Postal Service	Vacancy rates. *(Data may not be assembled.)*
Resident Surveys	Incomes; tenancy (owner/renter); housing preferences (demand); etc. *(Primary data collection may be expensive and time-consuming.)*
Utility Companies	Utility costs; trends, conservation cost factors; financing alternatives; vacancies. *(Data may not be assembled.)*
Windshield Surveys	Existing property conditions; identification of submarket areas; projections of rehab costs; location of "keystone" properties; evidence of private market investment.
Local Rent Regulation Agency (if applicable)	Maximum allowable rent levels (after-rehabilitation); other relevant regulations.
Public Housing Authority	Tenant incomes and allowable rent levels; Section 8 FMRs.
School Departments	School enrollment trends relevant to family size projections.

Chart 4: Neighborhood and Market Analysis Report

Data Item				Comment
Housing Profile				
Total Units	**Year**	**Number**	**% Change**	After a decade or so of decline, there are signs of stability and modest development in the neighborhood.
	1960	827		
	1970	805	–2.6	
	1980	848	+5	
Housing Stock Composition:	**1960**	**1970**	**1980**	There has been a clear transition from owner-occupancy to rental. Without evidence of new development, indicates outmigration of homeowners. Majority of units are now investor-owned.
Owner-Occupied	611	472	418	
Rental Units	216	333	430	
Housing Quality:	**1960**	**1970**	**1980**	Sixty-eight percent of units are in "good" or "excellent" condition, indicating sound base over past decade. Most "fair" and "poor" units are rental, however.
Excellent	601	483	526	
Good	108	32	52	
Fair	91	172	153	
Poor	27	118	117	
Vacancies:	**1960**	**1970**	**1980**	The low overall vacancy rate has existed over time and indicates a high demand for rental units—even those in poor condition. (May be difficult to induce investor rehabilitation in such a market.)
As % of Total	3%	4%	1%	
Number of Units With Rehab Permits:		**1980**		Considerable rehabilitation activity appears to be in progress: 120 permits, or 14% of total units.
Conventional		28		
Assisted		91		
Percent of Units More Than 40 Years Old:		**1980** 77%		Indicates moderate- to substantial-rehabilitation costs for units needing improvement.
Percent of Single-Family Sold, 1970-1980:		30%		Confirms transitional nature of community.
Number of Persons Per Occupied Unit in 1980:		4.7		Neighborhood contains large families. Some overcrowding may exist in the rental housing stock.

Economic Profile

Family Income,		**1980:**		Nearly three-quarters of the residents are below the median income for the SMSA. It is likely that 40% are Section 8 eligible.
Less than $5,000		11%		
Between $5,000 and $7,999		16%		
Between $8,000 and $9,999		9%		
Between $10,000 and $14,999		35%		
Between $15,000 and $16,999		14%		
Between $17,000 and $21,999		8%		
Above $22,000		7%		
Median Income, SMSA:		$14,800		
Low Income Renters,		**1980:**		Confirms estimate noted above, suggesting that upwards of half of renters are Section 8 eligible and/or will need rental assistance.
Income Below $5,000		16%		
Income Below $10,000		24%		
Rent Levels:	**"Real" Market**	**S.8 FMR**		Section 8 assistance would qualify tenants to compete for units in neighborhood. The "real" market likely includes unimproved units along with those in good condition.
1 Bedroom	$125	$150		
2 Bedroom	$200	$210		
3 Bedroom	$225	$290		
4 Bedroom	$230	$350		
Unemployment:	**1960**	**1970**	**1980**	**(1983)**	Unemployment has grown modestly over two decades; recent figure is estimate, reflecting overall economic trends.
% of Total	5%	6%	7%	(13%)	

What Can Be Learned From Experiences Of Others In The Field?

Although some have had experience with HUD's Section 312 rehabilitation loans on multifamily properties, most local officials are relative novices in this field of rehabilitation finance. But the state-of-the-art is advancing rapidly.

HUD's Rental Rehabilitation Demonstration Program has contributed measurably to this advance by involving more than a dozen state agencies and several hundred localities in the past two years. The financing approach that has been encouraged in the Demonstration has involved a separation of the public subsidies required for rehabilitation of the buildings from those required by low- and moderate-income tenants to occupy the improved units. The primary source of the building subsidies has been the Community Development Block Grant (CDBG) program; the source of the tenant subsidy has been the Section 8 Existing program.

With regard to neighborhood and market analysis, the following are four useful lessons that have been learned through the Demonstration:

1. Target neighborhoods are frequently selected without adequate information about private market forces.

Planners gravitate toward data on "housing conditions" and "poverty indices," but they do not work well with the type of information that is familiar to real estate investors and lending institutions. Such basic economic factors as "supply" and "demand" for rental housing are overlooked in the process of selecting neighborhoods. If the supply of standard housing is

very limited and the demand is sparse, then heavy public subsidies will be necessary to generate measurable impact on the neighborhood and stimulate private market forces.

2. Neighborhood analysis is not an "ivory tower" event. Planners must get out of the office and become personally familiar with the physical community and the individuals involved in its economy.

It is not uncommon for public officials with owner-occupied rehabilitation experience to know homeowners and community organizations active in target neighborhoods. However, they are not as apt to know realtors, lenders, and investor-owners of rental properties. They may thus encounter initial difficulties collecting planning data.

While some of the information may be collected from secondary sources (in the office), an effective program cannot be designed without a thorough grasp of neighborhood dynamics. It is important for planners to become personally acquainted with key actors, and attempts to involve owners and lenders in the program will be enhanced by the relationships developed during the planning phase.

3. Neighborhood analysis and selection is not a science, and adjustments may need to be made.

There is a tendency among planners to select a target neighborhood and design a program in sequential, but unrelated steps. Reasons for selecting a certain neighborhood may be based on previous single-family experience or political considerations. Program design options may have been learned from another community. If the design and the selection do not fit, one or the other must be changed.

4. Data manipulation based on economic trends involves assumptions that may not hold up over time. Planning efforts should openly acknowledge these and other limitations.

Any professional market study—the type noted as "fullblown"—will begin by reciting a series of caveats. Among the most significant is the disclaimer that unforeseen economic events may dramatically alter the projections presented. Public programs that are designed to intervene in an otherwise private marketplace should acknowledge (within political reason) that certain expectations may not hold up. For example, the forecasted demand for units may not materialize; the neighborhood may suddenly get "hot," inviting speculation in land values and higher-than-projected "real" market rents; or interest rates on private mortgage loans may exceed tolerable levels.

In any event, efforts should be made to project market trends no further than a 3-5 year period, and local officials should be prepared for unanticipated changes even within that period.

From Neighborhood Analysis To Program Design

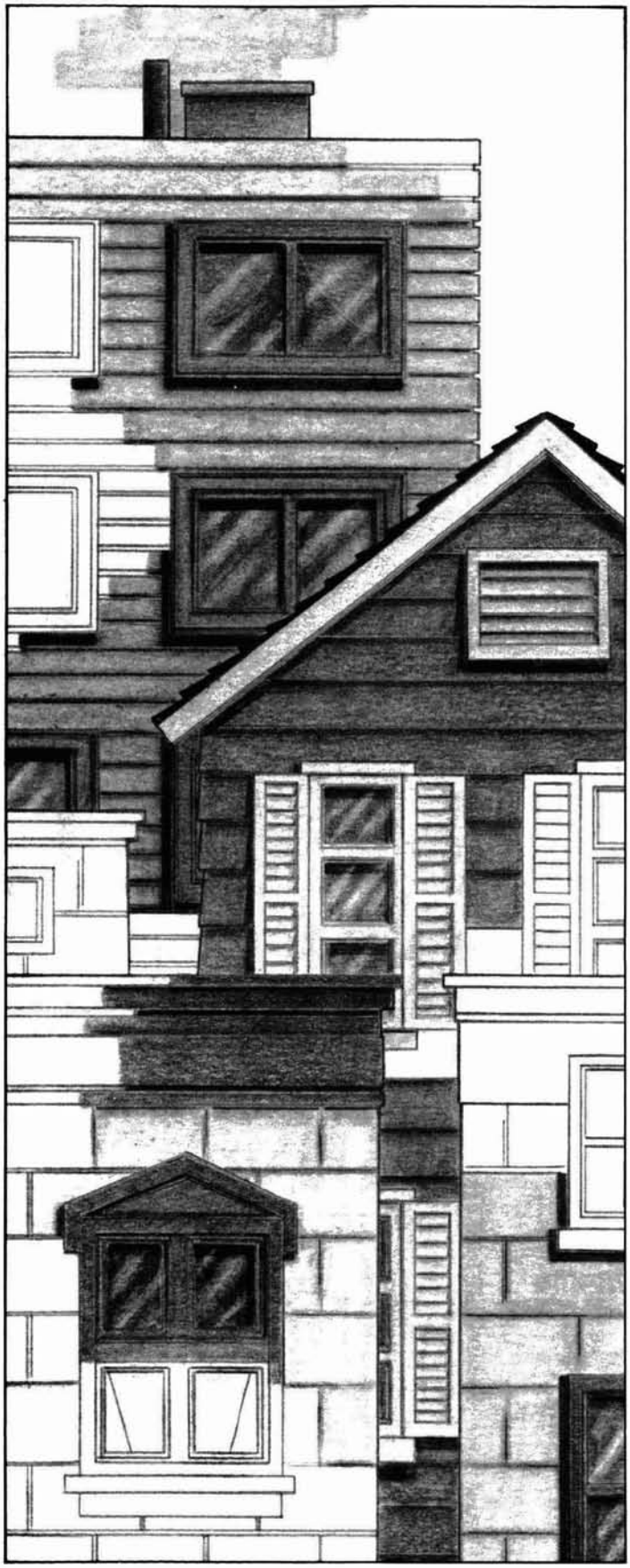
The process of developing a program design should consider financing techniques to be offered. Information on neighborhoods should begin to provide answers to the following questions:

☐ Will direct subsidies induce landlords to reinvest in their properties? How much public subsidy should be offered per unit?

☐ Should subsidized financing be offered at a below-market interest rate? Should this rate vary according to certain conditions?

☐ Should each project be considered on its merits and the financing individually tailored? Or, should the same subsidy apply regardless of the circumstances?

Program planners should be prepared to make changes in the neighborhood selection(s) and the financing techniques envisioned as they move through the process of finalizing a program design.



Chapter 2

Financial Design Issues[1]

In one of our two target neighborhoods, a "gap financing" method works pretty well. The buildings are larger; the cost of rehab is higher; and the owners are generally sophisticated. They understand how to manipulate an Operating Statement.

In the second neighborhood, we're dealing with a different set of circumstances. The properties are one- to four-units; the conditions aren't too bad; and the owners are mostly "mom-and-pop" investors. To them, a proforma is just another foreign word.

So, we've changed from a case-by-case "gap" method to a straight subsidy approach. We'll start by offering a deferred-payment loan for up to 50 percent of the rehab cost, and adjust the percentage downward if there's more demand than we've the funds to handle.

If the cost of borrowing money to rehabilitate rental properties were less expensive and the return on investments were higher, then making improvements to structural conditions might be seen more frequently as a "good investment." The tenants would be happier. They may be willing to pay higher rents. And a greater cash profit might be shown from ownership.

Though somewhat simplistic and theoretical, these statements underpin the design of publicly-sponsored rental rehabilitation programs. Looking at them from the flipside: since repayment obligations on conventional loans cannot be carried by the cash generated by prevailing market rents, or since there is insufficient profit remaining in the investment once repayments have been deducted, landlords have little or no incentive to make improvements to properties in lower-income neighborhoods. Public programs must therefore try to structure loan terms that are both *feasible* within cash-flow constraints and *attractive* from an investment standpoint.

Definitions of "feasible" and "attractive" are often topics for debate between investor-owners, lenders, and public officials. They are qualitative terms that must be quantified in the design process. As a starting-point, the following definitions are offered:

☐ A *feasible investment* is one in which the rental income is sufficient to pay operating costs, debt service, and other predictable expenses and return to the owner a "reasonable" profit.

> What will the rental income be once improvements have been made?
> What items constitute the operating costs?
> What is the debt service and how is it calculated?
> And, what is a "reasonable" profit?

☐ An *attractive investment* is one in which the expenditure of funds for rehabilitation purposes, when compared with other investment choices, provides the owner with a greater "marginal benefit."

> What other choices should be compared?
> What if the structure might otherwise lose its value, or even be condemned?
> How can a "marginal benefit" be computed, and then conveyed to owners?

The questions suggested by these definitions must be addressed in the process of designing a rental rehabilitation program. All of the resources which a public agency possesses should be examined in light of these issues, beginning with its funding capacity.

If applied properly, public funds can provide the lever to reduce the cost of borrowing, create a feasible and attractive investment opportunity, and cause the improvements to occur.

How Can The Cost Of Borrowing Be Reduced?

There are various established methods for using public funds to reduce the cost of borrowing from private sources. Three generic techniques are evidenced in familiar HUD programs with histories dating back to the 1960's. They include:

1. Interest Subsidy Over Time: Public funds can provide regular interest subsidy payments to private lenders, as the FHA Section 236 program has done on multifamily projects since 1968.

2. The Front-End Subsidy: Public funds can be used to pay for part of the principal needed and reduce the amount that must be borrowed conventionally, as UDAG projects throughout the country have done in recent years. Alternatively, a front-end interest subsidy can be paid to lenders for making below-market loans, as some UDAG projects have done.

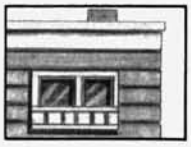
3. Direct Lending: Public funds can be loaned directly by public agencies for all or part of the costs, charging a below-market rate of interest, as the Section 312 loan program has done since 1964.

Each of these three techniques may be examined during the initial program design phase. With the exception of Direct Lending for all of the rehabilitation costs, each technique provides a *lever* to bring private loan funds into the financing package. The selection of the subsidy technique will have a significant impact on the program's production capacity, and it is useful to evaluate them against production goals. The following question should be asked:

"With a fixed allocation of public funds, which financing technique offers the capacity to rehabilitate the most *rental units?"*

[1]Parts of this chapter were prepared by the author for the Match Institution in Washington, D.C., under their contract with the Office of Rehabilitation, Department of Housing and Urban Development, Washington, D.C.

Once production goals have been examined, other considerations involving lender and investor preferences, administrative experience and capacity, and political issues must be taken into account before the technique is settled on. Following the selection of the technique, various program design options should be considered.



What Is The Cost Of Various Subsidy Techniques?

Assume that a rental property with a small existing mortgage needs moderate repairs. It contains 10 apartment units, and each requires an average of $5,000 in rehabilitation to correct local code violations and modernize certain appliances.

The property owner has consulted a private lender for a $50,000 second mortgage loan, discovering that the interest rate would be 16 percent over a 12-year term of repayment. Unwilling to consider such a loan, the owner approached the local rehabilitation agency for assistance. In the process of the initial interview, the following information was revealed:

Longevity of Ownership ..... 15 years

Initial Financing:

Purchase Price	$65,000
Downpayment (@20%)	13,000
First Mortgage (@ 7½% for 20 years)	$52,000

Current Rents:

5 one-bedroom units	$155 per month
5 two-bedroom units	$173 per month

Owner's Cash Profit Per Year $1,300

The rehabilitation agency's neighborhood and market analysis has shown that rehabilitated units in the area can command rents of $190 for one-bedrooms and $230 for two-bedrooms. Thus, if all other expenses remain the same, the owner may anticipate an increase of $510 per month as a result of the improvements, calculated as follows:

One-bedrooms: $190 – $155 = $45 × 5 =	$225
Two-bedrooms: $230 – $173 = $57 × 5 =	$285
Marginal Rent Increase/Month =	$510

With regard to the owner's profit, the agency has an established policy that the maximum cash-on-cash return that will be permitted for program assistance is 12 percent.[2] The owner's current profit of $1,300 is 10 percent of the original cash downpayment. A 12 percent profit would increase this figure to $1,560, or $260 per year and about $22 per month. Thus, the agency and the owner agree that cash available for additional debt, i.e., a rehabilitation loan, would be only $488 per month ($510 minus $22).

Holding constant the 12-year repayment term that was originally offered by the private lender, and assuming a monthly payment of $488, the public agency would have to make available to the owner a loan for $50,000 at a 6 percent interest rate. This transaction would be shown as follows:

$50,000 loan for 144 months at $488/month = 6% interest

The agency, however, does not wish to finance the rehabilitation 100 percent with public funds and begins to examine various techniques to leverage private financing.

1. Interest Subsidy Over Time

The public agency could pay the private lender the amount of interest which would not be collected from the borrower on a monthly basis. This amount would be calculated as the difference between a 16 percent loan (the prevailing market rate) and a 6 percent loan (the rate affordable by the property). The interest subsidy requirement would be computed as follows:

$50,000 loan @ 16% for 144 months =	$783
$50,000 loan @ 6% for 144 months =	$488
Interest Subsidy Requirement/Mo. =	$295

A monthly outlay of $295 would consume $3,540 per year of public funds, and a total of nearly $42,500 over the life of the loan. The per-unit cost over time would be $4,250.

2. Front-End Subsidy

The subsidy-over-time technique would require that the agency either reserve the full $42,500 when the loan is

[2]Cash-on-cash profit is defined as the annual return to the owner in cash ($1,300), expressed as a percentage of the cash required for ownership ($13,000). The 12 percent maximum profit for program assistance was based on other "attractive" investments available to the owner in that marketplace.

originated; or appropriate $3,450 per year for 12 years to honor its commitment; or make an investment of funds that will produce $295 per month for 12 years. Wishing neither to encumber the full $42,500 (an amount equal to 85 percent of the private loan) nor to undertake 144 payments of $295, the agency explores the third option—the investment concept.

Prepaid Interest Subsidy

The agency's obligation to the lender is $295 a month for 144 months. How much public funds would have to be invested, say in 16 percent second mortgage loans, for $295 to be withdrawn monthly? Since the agency wishes to minimize its investment, the balance at the end of 12 years may be zero. This computation is called the *present value* of the monthly obligation over time. The amount computed is called the prepaid interest subsidy. It would be computed as follows:

At 16 % for 12 years with $295 withdrawn monthly, an initial investment of approximately $18,800 must be made.

A prepaid interest subsidy may be viewed as a loan transaction between the agency and the lender as follows:

6% interest for 144 months at $295/month = $18,800 loan

Having received the interest subsidy payment, the lender makes a $50,000 loan at 6 percent interest. If the owner were to pay off the lender's $50,000 loan before the 12-year term expired, then the agency could expect a rebate from the lender for a portion of its prepaid interest subsidy. The concept behind the rebate is that the front-end subsidy payment involves an amount covering the full life of the loan. If the life is shortened through prepayment, then the agency and the lender should agree on a rebate arrangement.

Principal Reduction Payment

With a prepaid interest subsidy, the agency makes a front-end payment to the lender amounting to the present value of its loan obligation. The lender is then free to do whatever it wishes with those funds, and the agency is no longer involved with the loan transaction between the owner and the lender. However, what if the lender does not feel confident that a comparable 16 percent investment can be found to cover the agency's subsidy obligation? Or, what if the lender doesn't wish to show a 6 percent loan for $50,000 on its books—needing to explain it each time the bank examiners come to visit? Or, what if the $50,000 loan exceeds the acceptable limits of the lender's loan-to-value ratios for investment properties?[3] These concerns suggest consideration of a subsidy payment to reduce the principal amount that would otherwise be borrowed from the lender at the outset.

To compute the amount of the principal reduction payment that must come from the agency, the amount of a private loan which is supportable by the property must first be determined. If $488 per month is available, the question is: how much of a loan can this amount support at 16 percent for 12 years? The answer is approximately $31,200, as follows:

At 16 % for 144 months at $488/month = $31,200 loan

Since the property can support a $31,200 loan from the lender, the balance of the principal needed is $18,800. This is the amount of the principal reduction payment to be made by the agency to the borrower. Since the property cannot support any additional loan repayments from monthly cash-flow, the subsidy must be provided as a grant or deferred-payment loan. If a deferred-payment loan is used, carrying a nominal interest charge, it should be secured through a lien on the property and carry a due-on-sale provision. The due-on-sale provision will require the borrower to repay the obligation prior to selling the property or transferring title to it. At its option, the agency may then elect to "roll over" the note and permit the new owner to assume the obligation if the agency determines that public purposes will be served.[4]

It is notable that the subsidy amounts computed through the Prepaid Interest Subsidy and the Principal Reduction Payment techniques are mathematically identical. From the point-of-view of initial cash outlay, each involves a subsidy of $1,880 per unit. Differences in these two treatments arise in the repayment features that may be attached to the subsidies and their acceptability to lenders. Principal Reduction Payments permit considerably more latitude for the public agency as compared with Prepaid Interest Subsidies, and they are easier to operate if multiple lenders are involved with the program.

[3]In the example shown, the remaining principal on the $52,000 first mortgage is about $21,000 after 15 years. With a $50,000 second provided by the lender, the total indebtedness is $71,000. If the loan-to-value ratio cannot exceed 75 percent, the value of the property after rehabilitation must be nearly $95,000 for the loan to be approved.

[4]There is some debate on the need for due-on-sale provisions in deferred-payment loan instruments. They are sometimes instituted as anti-speculation techniques in the event property values appreciate rapidly in target neighborhoods; others argue that they impede natural market forces. Regardless, they do provide the agency with some financial control on the property in the future and an opportunity to retrieve the funding subsidy.

The greater latitude comes from the way the respective techniques are treated in the loan transaction. With Prepaid Interest Subsidies, the effect of the public funds is *consumed* during the life of the loan. Theoretically, the $295 monthly obligation is withdrawn from the agency's "investment" to be matched with the $488 payment made by the borrower. In 12 years, the subsidy will be depleted, and the agency's balance will be zero. If the lender's $50,000 principal loan is paid off prior to the expiration of the 12-year term, then a portion of the subsidy may (and should) be rebated to the agency by the lender as "unearned interest."[5]

On the other hand, Principal Reduction Payments only require that the obligation not draw on the revenues generated by the project during the *initial* years. Otherwise, the project would not be economically feasible. Thereafter, however, a number of choices emerge. If the agency (and the borrower) anticipates that rents will increase faster than operating expenses during the life of the lender's rehabilitation loan, a regular repayment schedule could be instituted at some specified time in the future. Similarly, the deferred-payment loan could balloon at some future time, which would probably require refinancing through private sources. Alternatively, the obligation may be treated as a "perpetual" lien, repayable only at the time of sale. (Other permutations to these options are also possible.) The key feature of this technique is to treat the Principal Reduction Payment as a *distinct loan* that is made to the owner by the agency, even though repayment obligations are deferred.

3. Direct Lending

With front-end subsidies, the agency may expect to receive no regular repayments on the funds it commits to the project—at least during the initial years and barring prepayment of the lender's loan. If some regular return is desired (or required), then the agency must lend at least a portion of the funds directly to the owner, and a revolving loan fund may be created.

Of course, the full $50,000 could be loaned directly at a 6 percent interest rate, and the agency would receive $488 per month in return. However, if part of the public purpose is to involve some private funds in the transaction to maximize production, then an interest rate of less than 6 percent must be charged on the agency's portion. Such an arrangement is called a "participation loan," and maximum leverage of private funds will be achieved if the agency's funds carry no interest charge at all.

A participation loan that includes private funds at 16 percent interest and public funds at 0 percent interest would be assembled as follows:

$16,200 loan @ 16% for 12 years = $235
$33,800 loan @ 0% for 12 years = $253
$50,000 loan @ 6% for 12 years = $488

If the agency loan carried an interest rate of 1 percent or 2 percent, then the principal amount of the public portion would increase, as would the portion of the $488 monthly payment that would be collected by the agency. However, the private loan amount—and the leveraging effect—would simultaneously decrease.[6] In the example shown, an effective 6 percent loan to the owner is created through a 0 percent (principal payments only) public loan involving $33,800, or $3,380 per unit.

Summary

Each of the three subsidy techniques involves distinct financing and policy choices that deal with the *time value of money*. In terms of total cash outlay by the agency, the per-unit costs are as follows:

Interest Subsidy Over Time $4,250

Front-End Subsidy:

Pre-Paid Interest Subsidy $1,880
Principal Reduction Payment $1,880

Direct Lending (Participation Loan) $3,380

A fair evaluation of these techniques, however, should not stop with their per-unit costs. It should also involve a comparison of their effects on the production capacity of the rehabilitation program over time.

[5] One of several computations may be used to determine the rebate of unearned interest. A method commonly used in consumer lending is called the "Rule of 78's." While the mathematics of the Rule of 78's is somewhat complex, most lenders are familiar with the concept and comfortable with the formula used to compute the rebate amount.

[6] The only method to compute the respective principal loan amounts in a participation loan is trial-and-error. The $488 maximum monthly payment is given, along with the interest rates, and various combinations of public and private loans must then be adjusted until they total $50,000.

What Is The Impact Of Various Subsidy Techniques On Program Capacity?

A rehabilitation program's capacity to produce improved units is defined as follows: *the total number of units which may be subsidized with a fixed funding allocation.* To test the various techniques for program capacity, two assumptions must be made and held constant. First, the pre-payment experience on loans made will be the same; and second, the amount of public funds committed to the program is consistent. For simplicity, the following assumptions are made:

☐ None of the loans that are subsidized pay off prior to the 12-year term on the private loans; and

☐ There is a single, $50,000 allocation of public funds.

Accordingly, the following program capacities will exist using each of three basic techniques:

☐ If interest subsidies are paid Over Time, then $3,540 must be paid out during the first year for the initial 10-unit project ($295 per month times 12 months). Since a like amount will be required during each succeeding year with no promise of future funding, the total obligation of $42,500 must be held for subsequent payments. Thus, only about $7,500 will be available for less than 2 further units at $4,250 per unit.

Initial Capacity: 12 Units

☐ If one of the Front-End techniques were used, the 10-unit project would require a public expenditure of $18,800, leaving $31,200 for 16½ further units at $1,880 per unit.

Initial Capacity: 26½ Units

☐ With participation loans that involve Direct Lending, the 10-unit project will consume $33,800, leaving $16,200 for 5 further units at $3,380.

Initial Capacity: 15 Units

However, the principal-only repayments will amount to more than $4,000 per year and permit further loans to be made between years 2 and 12. Such a revolving loan fund will generate approximately 14 additional units needing $5,000 in rehabilitation costs.

Capacity Over Time: 29 Units.

This analysis of program capacity suggests that the first subsidy technique—Interest Subsidy Over Time—should be discarded as too limited unless an appropriate investment vehicle can be found for the public obligation. The policy choices involved in the other two techniques, however, are not as clear. Although 75 percent more units may be rehabilitated during the first year with a Front-End Subsidy (26½ versus 15 units), no short-term recapture of the public funds may be anticipated. After an initial burst, the program will close down. With the Direct Lending technique, this initial capacity will not be reached until about the 10th year; but after that point further clients may be served. Two policy questions thus emerge:

☐ Should the agency design a program for maximum impact today—and then close its doors? Or,
☐ Should the financial design take into account the residual capacity of repayments in the future?

These questions become concrete policy issues when the residual capacity of the program in the future is further scrutinized. There are two key issues that the analysis has not yet addressed: (1) the erosion effects of *inflation* on the value of future repayments, and (2) the escalation impact of *further structural decline* on rehabilitation costs.[7]

With regard to *inflation,* the analysis has assumed that the $5,000-per-unit rehabilitation cost will remain constant over the 12 years. Specifically, it assumes that the revolving loan fund will have the same value in the second, fifth, and eleventh years as it does in the first year. To the contrary, if inflation in construction costs persists, say, at a 10 percent annual level, the real value of the first year's $4,000 in repayments will be only $3,600 in the second year ($4,000 minus $400). This effect will be compounded annually such that the value will fall to nearly $2,500 in the fifth year and to barely $1,300 in the twelfth—only 31 percent of the original value. At this rate of inflation, the program's capacity between years 2 through 12 will fall to fewer than 8 additional units, rather than the intially projected 14. Thus, capacity over time will be closer to 23 than 29 units.

Even when inflation is taken into account, the condition of the structures will not remain constant over the twelve years. For example, if the initial $5,000-per-unit rehabilitation cost included certain roof repairs, it is likely that the entire roof will need replacement over the ensuing years. Over this term, *further structural decline* may double the real cost of rehabilitation, reducing by half again the residual value of the

[7]The administrative costs involved with operating the ongoing program and servicing the loans made should also be considered. Adminsitrative costs have not been included in this analysis because the $50,000 allocation is assumed for financial uses only.

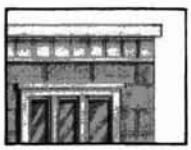
revolving loan fund. The additional 8 units may dip to 5, producing a total capacity closer to 20 units.

The impact of these three subsidy techniques may be summarized as follows:

Technique	Units in Year 1	Units in Yrs. 2-12	Total Units
1. Interest Subsidy Over Time	12	—	12
2. Front-End Subsidy	26½	—	26½
3. Direct Lending	15	5	20

The numerical consequences of this analysis heavily favor the Front-End Subsidy technique. And when certain advantages of the Principal Reduction Payment are taken into account, it stands as preferable to the Prepaid Interest Subsidy. However, public agencies may need to consider policy issues that extend beyond production capacities when they analyze techniques. There may, for example, be strong political biases against front-end subsidies and toward the ability to revolve and reuse the funds over time. "We're not in the give-away business" is a common justification for revolving loan funds. Although the Principal Reduction Payment method with a deferred payment loan is by no means a "give away," this concept is often difficult for political bodies to grasp.

Moreover, some private lenders may feel more comfortable with their position in a participation loan if the public agency has a continuing involvement. There will be some long-term costs associated with servicing direct loans and the leverage is less favorable. Nevertheless, if direct lending is the only technique that is acceptable by local lenders, it must not be discarded by an analysis of production capacity alone.



What Are The Financial Design Options?

Once a decision has been made about the use and the treatment of the public funds to subsidize the cost of private loans, clear guidelines must be developed about eligibility requirements and the means by which the subsidy will be computed and expressed. Normally, the program's design is an expression of the *type and amount of subsidized financing which is available to eligible borrowers.*

Examples of the program design options include:

The Fixed Subsidy: Public funds will provide a set amount of dollars, or a percentage of the rehabilitation costs, such as. . . *". . .$3,500 per unit or 50 percent of the rehab cost, whichever is less."*

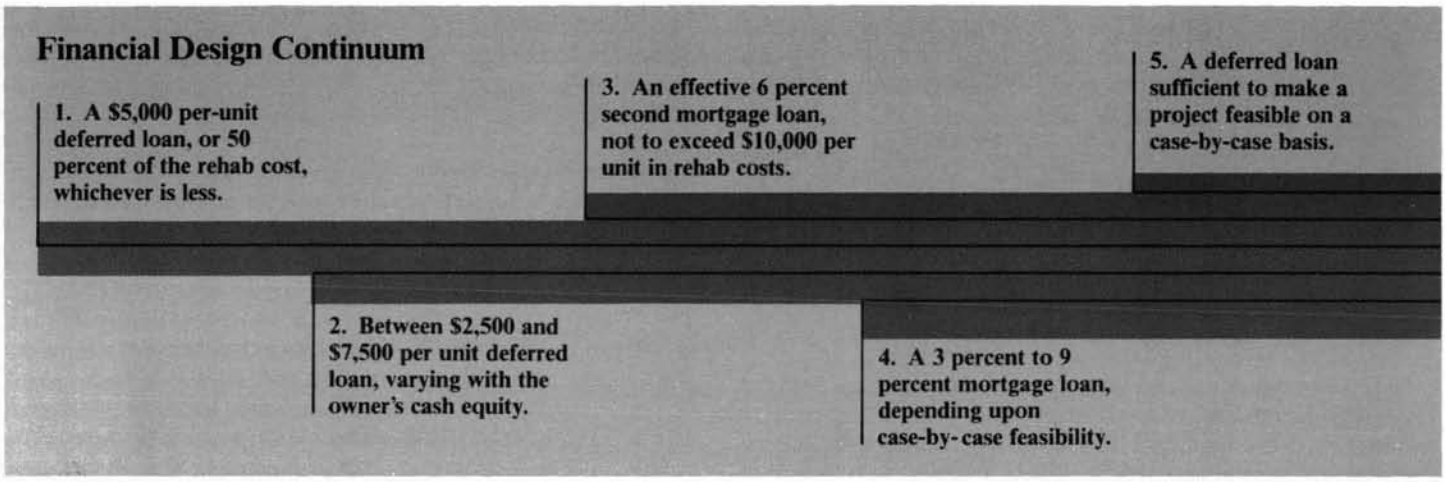
The Below-Market Interest Rate: Public funds will provide an effective below-market rate loan at a set interest charge, such as. . . *". . .a 6 percent second mortgage loan, not to exceed $7,500 per unit."*

The "Gap" Financing: Public funds will provide a front-end subsidy to fill the financing "gap" that exists between a feasible private loan and the rehabilitation cost, such as. . .

". . .a 0 percent, deferred-payment loan not to exceed $5,000 per unit, evaluated on a case-by-case basis."

The choice of an appropriate design option should come from information that is collected on the target area during the Neighborhood and Market Analysis. Specifically, the following factors should be taken into consideration:

Factors	Comments
Number of agency staff	Is the staff large or small? Will others be involved who are not currently employed in the program's administration?
Capability and experience of agency staff	Do staff have experience analyzing investor-owned real estate projects? Do staff understand the underwriting criteria employed by private lenders?
Number of applications that are anticipated	Will there be high demand for program assistance? Will specific marketing efforts be needed to generate demand?
Number of individual projects which may be funded	Are there just a few, larger structures which will be funded? Are there numerous smaller properties on which decisions will have to be made?
Nature and extent of private lender involvement	Will a formal leveraging arrangement be structured? Will investor-owners be expected to secure their own private loan commitments? Will the lenders provide loan packaging assistance?
Characteristics of investor-owners	Are the owners sophisticated in real estate financing matters? Are they mostly owners of smaller properties with cash-flow interests?



Considering these factors, a series of program design options may be arrayed along a *continuum* of choices. This continuum begins with a simple and relatively static design and progresses to those which are more complex and building-sensitive.

These illustrations of possible financial design options may be viewed and analyzed progressively. In general, the options toward the *left* side of the continuum are simpler and involve the following features:

Less program staff involvement. Appropriate for smaller, less-experienced staff and/or programs anticipating a high volume of applications from smaller properties.

Less complicated guidelines. With no need to evaluate individual project feasibility to compute the private loan amount, appropriate for neighborhoods containing less-sophisticated onwers.

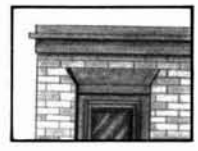
Less formal relationship with private lenders. With subsidy independent of other mortgage terms, appropriate for owners with access to own sources of private funds.

On the other hand, the options toward the *right* side of the continuum involve the following features:

More public control of the subsidy amount. Appropriate for programs anticipating few applications dealing with larger structures.

More information needed on individual projects. With staff involved with underwriting, appropriate for neighborhoods containing larger, more sophisticated owners.

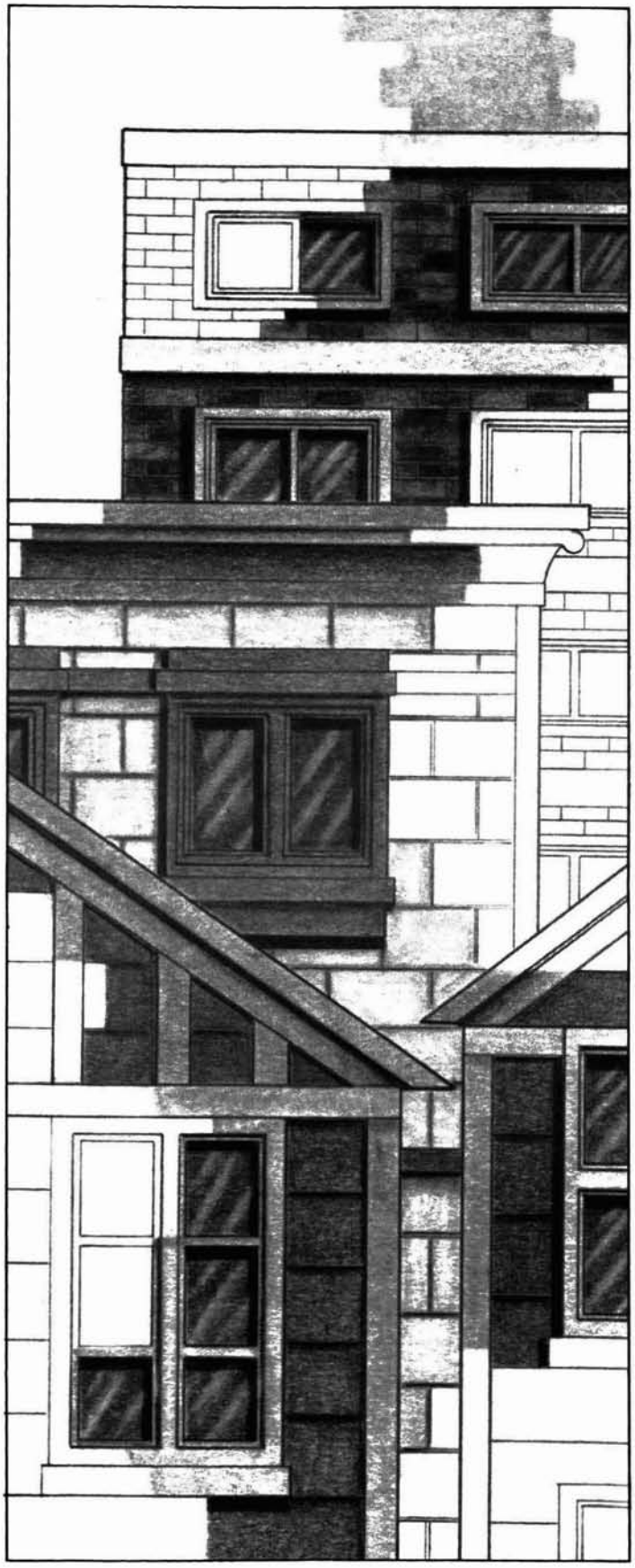
More reliance on negotiated private financing. With fixed below-market loan terms, appropriate for programs with formal leveraging arrangements.



Is There A "Right" Design?

With all the items of information to be assembled during the neighborhood and market analysis phase, and the need to apply them to non-quantifiable, real-world issues, there is no "right" design. What will likely emerge is a compromise with a willingness to make adjustments as program experience suggests. Those communities who have been most successful in the field of rental rehabilitation stress the need to be flexible and willing to make adjustments over time as experience and the economy may dictate.

Before a final design is drawn up for review and approval by local officials, it should be presented and discussed with one or more private lending institutions—and perhaps with some selected investor-owners. With confidence that the design "makes sense" to private lenders, specific guidelines for the program's operation may be developed.



Chapter 3

Approaching Private Lenders[1]

Let's see now, you say you want to talk with someone at our bank about "rehabilitation" loans, right? Well, I guess you'd better see the people in Home Improvements and Consumer Lending.

No, wait a minute. You said that the clients you are working with aren't homeowners—they're "investor" owners. That's different. You'd better talk with the folks in the Commercial and Business Loan Department.

No, no. Hold on. These loans are for apartment buildings, right? That's housing. The Real Estate Department is where you want to go. But bear in mind, they only make first mortgage loans. . .

There was a time—and it wasn't too long ago—when getting through the front door of a bank to talk about "leveraging" was tough enough in itself. Not so today. Aided by such national policy directives as the Community Reinvestment Act and a growing number of successful public-private arrangements to finance below-market home improvement loans, lending officials are comparatively open to discuss proposals initiated by public agencies. Moreover, the arrangements that have been implemented across the country have generally subsidized loans on single-family homes, and this type of lending fits comfortably with the practices of most commercial banks and savings and loan associations.

When it comes to proposals dealing with the rehabilitation of *rental properties,* however, local lenders are likely to be somewhat at a loss. These are not the types of loans typically made by banks and S&Ls, and there may be some confusion on both *how* they should respond and even on *who* within the lender's organization should respond.

The Question Of "How?"

The first obstacle to confront local officials will likely involve the lender's ignorance of the public agency's interest and capabilities in rehabilitation financing. "Why would you want us to do these things? And where do you get your money from, anyway?" As with single-family leveraging initiatives, a get-acquainted step is mandatory and should occur prior to undertaking any substantial negotiations.

Public officials may be able to trade on introductions to lenders established through previous ventures. Alternatively, they may elect to begin fresh with a general meeting of potential participants to explain the basis of their proposal. Both banks and S&Ls should be considered; but those known to be "liquid" (ask for financial reports) or particularly aggressive (who is advertising later hours or higher yields on investments?) or community-oriented (are there branch offices in the neighborhood?) should be approached first. Regardless of the point of contact, some initial effort to articulate—and commit to paper—at least an outline of the agency's proposal should precede the first lender meeting.

Second, the lenders are apt not to be as comfortable as local officials in dealing with programmatic notions. Agency staff understand "housing programs" and "program designs" because these are means by which they get their funding. Lenders, on the other hand, deal with specific projects on identifiable pieces of real estate with numbers attached to them because that's how they make underwriting decisions. Even if they show an openness to discuss participating in a "rental rehab program," few lenders will feel at ease with any commitment until they have "seen a project."

Finally, local officials should bear in mind that the kind of lending activity they are proposing is not the most popular among conventional institutions. And the inexperience of most banks and S&Ls with rental rehab lending may elicit initial reactions ranging from "we don't have any money to lend" to "we don't lend on those types of properties." In fact, with the exception of specialized mortgage companies that deal regularly with investment real estate lending, most local institutions are geared to make mortgage loans of the following types in approximately the following order:

☐ First mortgage loans to refinance existing debt on owner-occupied residential property;

☐ First mortgage loans for new or existing home purchases;

☐ Second mortgage loans on owner-occupied, single-unit properties where they hold the first;

☐ First mortgage loans on two- to four-unit, owner-occupied properties;

☐ First mortgage loans on existing multifamily properties that are rented up and need little or no rehabilitation;

☐ First mortgage loans to take out a construction loan either to build or rehabilitate rental properties; and

☐ Second mortgage loans on rental properties regardless of size, with middle-sized (5 to 30 units) being the least desirable.

While the precise order (and composition) of this listing may be debated, most lenders will agree that they do not seek out loans for rehabilitation of rental properties. Moreover, they will generally prefer not to deal with second mortgages at all! (Likewise, few loans of this type have sought out lenders; there has been little demand from the private marketplace.) The market demand that does exist typically comes from large developers with strong financial statements, sophisticated loan

packages, and lengthy track records. Local officials will thus find that lenders are neither eager for nor experienced with the type of lending needed to make rental rehab programs work.[2]

The question of "how to respond" may also vary with the type of lending institution involved. If business loans were the subject, then a commercial bank would clearly be the appropriate institution to approach. If it were a home mortgage, then an S&L would be logical. Loans on rental rehabilitation projects are made as infrequently by each—unless they involve a construction phase and a permanent take-out. Nonetheless, successful local programs have negotiated operating agreements with both banks and S&Ls.

Banks and S&Ls tend to exhibit certain biases in their lending activities which relate to rental property loan requests. S&Ls will tend to evaluate property more in line with "comparable sales," being less comfortable with "income appraisals" developed through proforma and operating statements. Commercial banks, on the other hand, are less willing to make long-term loan commitments, but they will understand valuations based on capitalization rates and cash-flow analyses, which tend to be higher. Notwithstanding these traditional leanings, the particular response that comes from an institution depends to the greatest extent on the *individual* from whom a response is sought.

The Question Of "Who?"

To answer the question "Who within the lending institution should be approached in the first place?", local officials will need to become familiar with the organization of individual lenders. It is easier with a program designed for owner-occupied properties: rehab loans fall either to the "consumer" loan department (a.k.a., "personal loans") or to the residential real estate department (a.k.a., "home mortgages"). Which of these departments is appropriate will depend on the size of the loan request and whether it will be secured as a mortgage on the property.

Rehabilitation loans for small or middle-sized rental properties have characteristics which may touch on different internal banking divisions. For example:

☐. . .It's a "rehab loan" because it deals with construction issues, and the officers who deal with home improvement financing may need to be involved.

☐. . .It's a "commercial loan" because it deals with an investment issue, suggesting review by those involved with business lending.

☐. . .It's a "real estate loan" because it deals with property appraisals and a secured mortgage, suggesting involvement by those in residential mortgage lending.

Both the approach to the lending decision and the terms of the transaction will vary among these internal divisions, abbreviated as follows:

Loan Type	Typical Terms	Principal Concerns
Construction or "Rehab"	6-12 months; 2-3 points above the Prime interest rate.	That the work get done on time and properly.
Commercial or Business	90-180 days; 2-3 points above the Prime rate.	That the borrower have stable and strong financial statement.
Real Estate or Mortgage	10-15 years; variable rate indexed; at/below Prime.	That rents cover debt service; low loan-to-value ratio.

These distinctions are not exclusive of one another, and different lenders will vary with the emphasis they place on one or another concern. If all of the functions and loan types are organized under a unified "mortgage department" within a bank or S&L, the task of locating the appropriate "who" is simplified; the vice president or senior vice president in charge may be identified. If not, then local officials should initially approach the highest-ranking officer available—either the president or the chief executive officer—and become acquainted.

Beyond the initial acquaintances (both with the organization and the top officials), efforts should immediately commence to locate the aggressive loan officer or branch

[2]If rental programs are designed to subsidize second mortgage loans, and lenders will agree *only* to refinance and place first mortgages, care should be taken to exclude the public subsidy from the overall refinancing package. In other words, if "6 percent rehabilitation loans" are offered, the public subsidy should *not* reduce the interest rate on a first mortgage loan to 6 percent.

manager who will actually be involved with the projects as they are assembled. Whether or not a loan committee will review the applications, this individual will make or break the program—even more than with owner-occupied rehab leveraging arrangements — because rental loans have such a hybrid and non-traditional character.

The Loan Underwriting Decision

"Loan underwriting" is both a process and a product. It is designed to prevent lenders from becoming owners of real estate. When evaluating a mortgage loan, lenders will look for certain assurances that the borrower will not default on repayment obligations, forcing foreclosure. Such assurances may come in various forms and from different sources than the borrower's personal finances.

In general, loan underwriting criteria (the factors used to evaluate applications) fall into two categories, and each is related to a different lender concern. In *residential mortgage lending* the net income and overall financial position of applicants dominate. If there is ample income remaining after expenses and debts are regularly paid, and this income looks to be stable (and even increasing) into the future, the lender will feel comfortable making the loan. In *development financing* the economic viability of the project is the key element. If the project income generated from tenant rents is sufficient to cover operating and debt service costs, then the lender will likewise feel comfortable. The underwriting criteria that are applied to *rental rehabilitation lending* blend factors from each of these general categories, and the decision-making is frequently obscured in the "black box" of the loan review committee.

Analysis of the economic viability of a project is usually more objective than an evaluation of the borrower's financial situation. The lender will be concerned with the location of the property, primarily from the point-of-view of the marketability and comparability of the proposed rents. If the neighborhood is considered "marginal" (as most of those involved with public programs will be) and if few comparably rehabilitated structures exist, then doubts may be raised about the owner's ability to command the rents at their projected levels and/or to maintain projected occupancy levels. The market analysis conducted during the program design phase will become very relevant for underwriting purposes.

It is nearly impossible to make specific the ingredients of a "stable and sufficient" financial statement. The length of time the applicant has been employed (or self-employed); his or her success in other real estate ventures; the amount of disposable income after taxes and other recurrent debts have been paid—these are all items that may be quantified and that the lender would like to see more, rather than less of. Nevertheless, there are important (and highly subjective) "feelings" about an individual's reliability that become crucial in the underwriting process as well. And such feelings may either be abetted or obscured by the presence of the public agency in the loan application.

The Insurance Factor

If a loan is fully insured by another institution, and one in which the lender has confidence, an underwriting decision may be easily made. In effect, the insurer has already underwritten the loan, and the lender needs only to make the funds available.

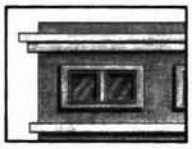
The Federal Housing Administration (FHA), which is a division of HUD, is the principal provider of public mortgage insurance. The FHA is generally considered by private lenders as a desirable insurer because its commitments are backed by the Federal government. However, some lenders shy away from its pro .:s for fear of becoming ensnared in burdensome pape; work, lengthy foreclosure proceedings, and tardy payment on defaulted loans. Justified or not, such criticisms have encouraged some lenders to turn for insurance protection to one or more private mortgage insurance companies.

The availability of mortgage insurance—regardless of source—is defined primarily by the number of units in the rental project. If the property contains four or fewer units, there are several options, particularly if the rehab loan involves refinancing and will result in a first mortgage loan. With the FHA 203(k) program, appraisal standards are liberalized for the rehabilitation of 1-to-4 unit structures, and construction draws are insured. The fees and procedures involved with this first mortgage program are otherwise identical with the basic 203(b) program. Insurance coverage of about 95 percent of the mortgage amount results.

For second mortgage loans, the use of FHA Title I(b) insurance has proven useful in properties requiring less than $37,500 in rehabilitation costs. This maximum loan amount restricts practically the use of Title I(b) to relatively small rental properties. Though case-by-case approval must be secured from HUD area offices for this insurance, fees and paperwork are minimal, and 90 percent of the principal amount of the loan is covered.

There is no FHA insurance program available for second mortgage loans on properties containing more than four units and/or requiring more than $37,500 in rehabilitation. However, if existing debt is to be refinanced and rehab costs are comparatively low, the FHA 223(f) insurance program has proven useful in projects containing as few as 30-40 units. (The FHA 221(d)(4) program is generally appropriate in larger projects requiring substantial rehabilitation.)

Sometimes a competitor, and sometimes a complement, private mortgage insurance companies are increasingly involved with insuring rehab loans. Their coverage ranges from the top 20-25 percent to 100 percent of the principal borrowed. To date, however, private insurance has not been available for second mortgage loans secured to rental properties containing 5 or more units. If some form of loan insurance is the sole prerequisite for private lender participation, rehab agencies may need to consider using available public funds to provide loan guarantees.



The Secondary Market

Primary mortgage lenders deal directly with property owners (or buyers), appraising properties, and underwriting and servicing loans. Banks, S&Ls, and some mortgage companies fall into this category. The secondary mortgage market is a network of institutional investors that buys mortgage loans after they have been closed. The willingness (and enthusiasm) of primary lenders to make loan funds available is increased substantially by the extent to which a secondary market exists to "cash them out" of long-term obligations.

The dominant actors in the secondary mortgage market are the Federal Home Loan Mortgage Corporation (a.k.a., the Mortgage Corporation, Freddie Mac, or FHLMC) and the Federal National Mortgage Association (a.k.a., Fannie Mae or FNMA). Their organizational structures and functions are somewhat different, though their purposes are very similar:

The Mortgage Corporation, created by Congress in 1970, purchases first mortgage loans made on 1-to-4 unit properties and multifamily buildings, as well as home improvement loans. It deals primarily with S&Ls, using uniform mortgage instruments and underwriting guidelines. Loans are purchased either for "immediate delivery" or according to "forward commitments" from approved primary lenders.

Fannie Mae, created in 1934, initially purchased only FHA- or VA-insured loans on single- and multifamily properties; currently, it may also purchase fixed-rate conventional mortgages. It participates in construction and rehabilitation loans and makes direct loans to financial institutions. Recently, FNMA has sold mortgage-backed securities for investment purposes.

In their relationships with primary lenders, these loan purchasers generally deal in large dollar amounts, i.e., a half a million dollars or more per transaction. Thus, primary lenders will assemble a package of loans for sale, either before or after they are closed. These traditional practices make difficult the use of the secondary market for publicly-supported programs.

Nonetheless, both Fannie Mae and the Mortgage Corporation have recently embarked on efforts to create a role for the secondary market in providing rehabilitation loans. FNMA's "Municipal Triparty Participation Program" allows a local lender (the first party) to sell "participations"[3] in its existing portfolio of mortgages to generate additional funds for reinvestment in urban areas. FNMA's purchase of, say, 60 percent of a pool of mortgage loans will yield to it a market rate of interest. A local public agency is the third party, and it also purchases participations in the mortgage pool; but its yield requires no interest payments. The combination of these two secondary market purchases will liquidate up to 90 percent of the assembled portfolio of mortgages and generate a source of funds which may be reloaned at below-market interest rates.

The Mortgage Corporation will purchase multifamily mortgages if they are delivered within two months of approval. The loan term must exceed 10 years and the principal amount $250,000. Only first mortgages are eligible. This program may be useful in conjunction with Freddie Mac's home improvement loan purchase program which is designed for second mortgages on a 1-to-4 unit properties. However, in the multifamily program, a distinct construction loan must be involved, and the lender must gamble that FHLMC's minimum yield requirements will hold if the construction period exceeds two months.

Private institutions, such as insurance companies, are also involved in real estate ventures as both primary and secondary mortgage lenders. Their participation with rental rehabilitation programs, however, must be developed and negotiated on a case-by-case basis. Again, these institutions are accustomed to financings that involve major developments in association with local lenders.

[3]Customarily, primary lenders will assemble a number of mortgage loans for sale *in toto* to a secondary market purchaser. In a "participation," the secondary market investor will purchase a fixed percentage of the value of the assembled mortgages, realizing a like percentage of the repayments in return.

What Is A "Good Deal"?

With all the potential ingredients out there, what is a "good" leveraging deal? In simplest terms, it is one in which the lender(s) is eager to participate. Conversely, an arrangement which is based primarily on concessions will make the lender reluctant at best, and likely to balk at the initial application. In the context of a given locality, a "good deal" might be described by a lender's willingness to give genuine consideration to a refinancing package where the loan-to-value ratio is 40 percent. In another, "good" might mean a commitment of a million dollars to be loaned as second mortgages at 12 percent interest for 20 years.

Normally, local officials will focus on the lender's commitment of an interest rate when evaluating a leveraging arrangement. Most seek long-term, fixed-rate financing—the type that has substantially evaporated over the past three years, but that may still be secured under a "special" agreement. And fixed rates do provide a sense of stability for the borrower and a firm basis for the agency to compute a subsidy amount.

Sometimes lost in the pre-occupation with interest rates is the importance of the term of repayment when calculating monthly loan obligations. In fact, a slight extention of the repayment period can make a high-interest rate loan affordable where it would not otherwise have been. For example, a 15 percent, 10-year loan carries about the same monthly obligation as a 15-year loan at 18 percent interest. Whereas certain homeowners may be enchanted with the day they will own their homes "free and clear," and not be attracted to another long-term mortgage, most investor-owners will focus on the tax benefits and/or marginal profits they realize from monthly cash flows, depreciation, and interest deductions. These factors are normally enhanced by longer-term debt obligations.

Today, however, most lenders will prefer (and perhaps require) shorter-term loans carrying variable or adjustable interest rates so that they will be protected if their cost of funds increases. Thus come the financing gymnastics known as "creative financing."

A private lender's insistence on shorter-term loans can sometimes be accommodated by computing the monthly payments from longer-term amortization tables, but then introducing a shorter-term call-date or balloon payment. In such an arrangement, the lender may be assured of retrieving the remaining principal balance prior to the time that the loan would "pay out." For example, a lender may not wish to commit a principal loan beyond a 5-year period; however, the financing package does not become feasible unless repayments are made over a 15-year term. Such a loan could be drawn up so that monthly payments are made according to a 15-year amortization, but the principal balance outstanding after 5 years becomes due and payable. Such a "balloon note" will require either that the loan be refinanced or that the property be sold by the fifth anniversary. Either option could be reasonably attractive for both the owner and agency objectives, particularly if the neighborhood conditions improve as a result of the rehab program's activities.

With regard to variable or adjustable interest rates, they may cause initial uncertainty, but they need not threaten the stability of a project. Different lenders define and employ these techniques differently; but most incorporate a ceiling and a floor on rate calculations so that neither the borrower nor the lender is dangerously exposed in the event that the mortgage market exhibits dramatic jumps or falls. For example, a 2 percent "cap" would limit a 14 percent mortgage from exceeding 16 percent or falling below 12 percent for the repayment period.

Choices between variable and adjustable rates—if they are available—become more tenuous. In each case, the initial interest rate is set, and then provisions are made in the loan document for recomputing it according to one or another national "index" after a certain period of time.[4] With a "variable-rate" loan, the period of time is relatively short, i.e., every 6 months, or even every month. While the amount of the monthly payment remains the same, the portions of the payment attributed to principal and interest will vary with increases or decreases in the prevailing rate.

With an "adjustable-rate" loan, the period of time between origination and rate review is longer, i.e., 2 or 3 years. For these loans, however, the portions of monthly payments attributed to principal and interest remain fixed and according to standard amortization tables, while the amount of the payment is adjusted up or down.

From the investor's point of view, there are both positive and negative features associated with fixed-rate, variable-rate, and adjustable-rate financing. The traditional stability of fixed-rate loans will, of course, be undercut if current rates go down. The uniform monthly payment sched-

[4]The lending industry has not yet settled on uniform terminology to describe the techniques of so-called "creative financing." The distinctions and definitions used here may not conform with those of certain local lenders who may use such terms as "renegotiable-rate" or "adjustable mortgage loans." The principles of differentiation should nonetheless be useful.

ules associated with variable-rate loans provide comparable stability. Moreover, if rates go up and a larger portion of the monthly payment is attributed to interest, then individual owners will benefit from larger income tax deductions. On the other hand, less principal will have been paid, and "negative amortization" may even increase the principal debt over the loan period.[5] Finally, with adjustable-rate lending, there is stability from the loan-to-value perspective and from the somewhat longer period between rate changes. However, a jump in the monthly payment obligations after a few years could threaten the viability of a rental project whose cash-flow is marginal.

The prospect of a decrease in interest rates is naturally more pleasant to consider—except, perhaps, by the public agency making an initial, one-time subsidy payment based on prevailing rates at loan closing. In such an event, there may be concern that a windfall has been provided to either the owner or the lender, or both. The gamble of a windfall should, however, be evaluated on the same basis as a potential increase in rates: once the loan has closed and the agency has removed itself from its intervention in the loan transaction, it should stay removed and permit private market forces to operate. Otherwise, the agency will find itself over-involved with the complications of short- and long-term vacillations of the mortgage markets.

Ten Questions Frequently Asked By Public Officials About Private Lending

A decade ago, few local politicians and public administrators could conceive of the use of city-controlled funds to make or subsidize real estate loans. Yet, within five years, several thousand local housing rehabilitation programs had emerged throughout the country to provide grants and low-interest loans to lower-income homeowners.

At that time (five years ago), there were equally few public officials who would consider extending the benefits of these rehab programs to absentee landlords and other investor-owners of rental properties. While many may now see that physical, economic, and social goals may be achieved through carefully designed rental rehab programs, local officials exhibit similar uncertainties about several common issues. The following is a list of ten questions frequently asked, along with suggested answers.

1. How do private lenders analyze rehabilitation loans on investor-owned properties?

Infrequently and carefully. With the exception of large developers with extensive real estate experience, local lenders are very cautious about getting involved with rental property finance. And in many parts of the country, they will react with alarm to suggestions that they make second mortgage loans.

When they analyze loan packages, lenders are interested to see that the projected rents are "reasonable," which means "conservative" for a given neighborhood. If comparable rents cannot be shown, then they must be persuaded that the neighborhood is in fact going to "turn around" as a result of the public and private investment generated through the rehab program.

Lenders will also want to see numbers showing that the projected rents will throw off sufficient income to cover operating costs and debt service obligations, plus some positive cash-flow for maintenance, a replacement reserve, and profit for the investor. (If the cash-flow is negative, which is possible during the early years, then the lender will need to understand the owner's financial and tax situation and the reasons why the project is presented as a stable investment.) Whether the owner is small or large, the lender will want to see a "management plan" for assurance that units will be and will remain rented; that rents will be collected; and that the property will be maintained.

Following is an abbreviated proforma, which illustrates the items the lender will scrutinize.

The lender will also want assurances that the rehabilitation work will be completed in a proper and timely fashion. Construction lending is risky, and thus expensive. If a construction loan is involved in the financing package, the lender will likely want to monitor progress through regular inspections, and certainly at the time of draws.

Finally, the lender will want detailed information describing the financial situation of the applicant. The less the rehab project fits into familiar activities of the lender, the more extensive the information that will be required—and the more substantial it must be. (A shaky project may be approved if it is backed by a strong owner; conversely, a proforma showing ample profit will likely be rejected against an unstable credit history.)

[5]A dramatic increase in interest rates may result in a monthly interest obligation that exceeds the initial monthly payment. In this case, the difference between the monthly payment and the amount owing in interest is added to the outstanding principal balance. It is thus possible for a borrower to owe more than the original amount borrowed if rates go up.

Sample Proforma

Project Income

A. Residential Units

Unit Type	No. Units	Rent/Mo/Unit	Rent/Yr/Unit	Gross Income
Efficiency		$	$	$
1 Bd, 1 Ba		$	$	$
2 Bd, 1 Ba		$	$	$
2 Bd, 1½ Ba		$	$	$
etc.				
TOTALS		$	$	$

B. Residential Plus Other (Note: Assumes other income)

Unit Type	Gross Income	Laundry	Parking	Occupancy Rate	Effective Annual Income
Efficiency	$	$	$	%	$
1 Bd, 1 Ba	$	$	$	%	$
2 Bd, 1 Ba	$	$	$	%	$
2 Bd, 1½ Ba	$	$	$	%	$
etc.					
TOTALS	$	$	$		$

Project Expenses (Note: Cost basis for illustration)

A. Management Fee (@ 5% Eff. Annual Income) ..... $
B. Operating Costs ($250/unit/annum) ..... $
C. Maintenance/Insurance ($200/unit/annum) ..... $
D. Operating Reserve ($150/unit/annum) ..... $
E. Property Taxes (@ 1.2% of value) ..... $

TOTAL PROJECT EXPENSES $

NET INCOME $

Mortgage Calculation
(Note: Assumes Second Mortgage)

A. Net Income ..... $
B. Owner's Profit (@ 10%) ..... $
C. Available for Debt Service ..... $
D. Annual Cost of Existing Debt .. $
E. Net Available for Rehab Loan .. $

Feasibility Calculation
(Note: Assumes DPL Subsidy)

A. Projected Cost of Rehab ..... $
B. Public Subsidy Amount ..... $
C. Amount of Loan Application .. $

2. How can public resources be presented to lenders to reduce both actual and perceived risk?

When considering what public agencies "bring to the table," local officials should make clear that it is not limited just to subsidy dollars. Rehab programs find clients, screen them, assist them to determine the scope of work needed, and probably package the loans and perform regular inspections. These are both services and controls that reduce the lender risks, and they must be described and explained.

With regard to the financing package, any participation by the agency which is subordinate to the lender's results in a more favorable loan-to-value ratio for the private rehabilitation loan. In most instances, the existence of the public subsidy (whether it is a low-interest loan, a deferred-payment loan, or a grant) will reduce the lender's actual exposure to less than 50 percent of the after-rehab value. If it does not, or if the lender is still uncomfortable, an arrangement whereby the agency assists the lender with delinquencies may be considered. (Nevertheless, public agencies need not assume the lender's responsibility for debt collection.)

Construction loans may be needed for larger rehab projects, e.g., those which exceed 7 or 8 units, whether they involve refinancing or not. And construction lending introduces a different series of lender concerns about risk. It also introduces complications with computing loan subsidies. If separate construction loans cannot be avoided, and if the lender's terms are considered excessive, public agencies may consider establishing a "construction loan pool" with their funds.

If a lender expresses such concern about risk as to request a separate deposit of public funds for loan guarantees, another institution should probably be approached—unless the lender is being asked to depart from "normal" institutional practices. If a comparable arrangement cannot be negotiated with a second lender, then a loan guarantee fund may have to be considered.

3. How can public agencies assure that they are not providing too great a subsidy vis-a-vis the lender and/or the borrower?

The design of rehab programs and the assembly of individual loan packages is not an exact science. Both activities are based on judgments and may be subject to abuse. Nonetheless, certain safeguards may reassure public officials that their financing plans are attractive, but not excessive opportunities for private investment. The control point occurs with loan underwriting.

Programs that are designed for high-volume production tend to offer a prescribed subsidy, whether it is a fixed percentage of costs or based on a gap financing formula. As such, the design involves a pre-loan underwriting decision. It assumes certain commonalities among the properties to be rehabilitated and consistencies in the loan terms to be offered from private sources. While such designs are usually necessary to achieve broad impact with narrow staff resources, they are somewhat vulnerable to case-by-case abuse. Some tolerance (say, 10 percent of all projects) for over-funding should be assumed.

More intimate (but time-consuming) control may be assured if the design retains flexibility and agency staff underwrite all loans prior to their submission to a participating lender. In this way, the lender can perform a separate underwriting function in accord with previously-negotiated loan terms. Alternatively, this process may be reversed: the lender reviews the package first, indicates the amount and terms of the private loan, and submits it back to the agency for its public subsidy commitment. Whereas this alternative may create a "bouncing application" and a protracted loan review process, it will tend to ventilate the funding process.

4. What do public officials need to know about the secondary mortgage market to negotiate effectively with local lenders?

From nothing to a lot. Depending upon the lender response, it may be necessary for public officials to contact and become partners with FNMA, FHLMC, or private institutional investors to develop a workable program. And the lender response will be influenced predominantly by its liquidity position and on-going relationship with secondary market operations.

If the secondary market is a prerequisite, or if it offers opportunities not otherwise available for the financing arrangement, overtures by public officials will be more effective if made in conjunction with one or more primary lenders.

5. In what ways is local experience with owner-occupied rehab financing appropriate and useful to rental program leveraging arrangements?

Any previous experience with private lending and loan officers should benefit public officials who are embarking on a rental rehab leveraging program. The only detriment occurs when the differences between owner-occupied and rental property underwriting are blurred.

In brief, there are three principal underwriting criteria for any loan:

Income: Is there sufficient cash-flow to support the repayment obligations, presently and in the future?

Loan-to-Value Ratio: If the borrower defaults on repayments, is there sufficient value in the property to recover the principal loan?

Credit Worthiness: Has the borrower shown a history of responsible debt-repayment?

The criterion relating to income is the one most frequently blurred—primarily by public officials, but occasionally by private lenders as well. The primary source of income for rental rehab loan repayments is the property and the rents which they generate. For this reason, the structure of the proforma and the income analysis begins with the after-rehab rents. The borrower's personal income (and credit-worthiness) are important secondary sources of loan repayments. However, the design of programs and the approach to local lenders should emphasize these underwriting differences.

6. Is it better to enter into a formal leveraging arrangement with a single lender or to leave the source of private funds open to the investor-owner?

The absence of a formal relationship between the agency and a private lender *may* result in less expensive and more available sources of private loan funds. Personal savings of the property owner, for example, may be used for all or a portion of the private funds needed. Because they involve no loan transaction, savings or "mattress money" requires neither interest rates nor terms of repayment to draw on the income generated from the rental property.

There may also be comparatively inexpensive sources of credit that are available to certain owners that are not available to others. Credit unions or favorable relationships with particular lending institutions may provide some investors with a reduced cost of borrowing as compared with conventional terms that are more broadly applied.

If a significant number of owners indicate that they have access to their own sources of private funds, then a financial design that offers a fixed subsidy (based on a set percentage of the rehabilitation costs) may prove effective. As a back-up, however, it will be prudent to acquaint a selection of local lenders with the program's guidelines and operations and make referrals of applicants to them.

Such informal relationships with conventional lenders need not involve a *quid pro quo*—"we'll do this if you do that." No commitments of loan funds are sought from lenders, and no special deposits or other services are provided by the agency. Nonetheless, for the relationships to be useful, certain items of information must be exchanged with regard to underwriting criteria and procedures. Lenders will want to know how and when the public subsidy will be funded, and the agency will want to know the types and terms of loans that will be available. In some communities, informal relationships will stimulate competition among lenders on interest rates and terms of repayment.

Such relationships, however, are still speculative. Lacking formal commitments, it is possible that private loan funds will not be available at the time they are needed—or that they will be too costly to make projects feasible. Formal leveraging agreements remove the guesswork and provide a measure of security that funds will be available under specified underwriting criteria. Such agreements identify the *volume* and *terms* of the private funds that are committed to the program, as well as the public subsidy *technique* and *amounts*.

If the financial design involves below-market interest rate financing that is stated up-front, i.e., "second mortgage loans at an effective 6 percent rate," then a pre-negotiated leveraging arrangement becomes paramount for consistent operation. In addition, certain concessions may be negotiated with a lender in the form of interest rate reductions, extension of repayment terms, liberalized loan-to-value ratios, etc., if it is assured a volume of business through the program.

7. Can lumpsum deposits of public funds be used to enhance private lender commitments?

In the Community Development Block Grant (CDBG) program, funds cannot generally be drawn down from the U.S. Treasury until they are needed for specific cost items. These regulations become more permissive, however, where housing rehabilitation programs are concerned. In the event of a *formal leveraging agreement* and certain specific concessions on the part of the lender, the entire CDBG amount budgeted for loan subsidies may be drawn down and deposited. Interest on the deposit may be paid by the lender to produce "program income;" alternatively, all or part of the interest may be foregone by the agency in exchange for specific, quantifiable concessions or free services by the lender.[6]

[6]The "Lumpsum Drawdown" Regulations as promulgated by HUD should be carefully reviewed prior to undertaking a deposit of this type.

8. Can less-expensive sources of private loan funds be developed through tax-exempt leveraging agreements?

The interest rate which conventional lenders charge on loans they make represents their *income* from the transaction. Part of this income is used to pay for costs of providing the funds (the "cost of funds"); part covers their administrative expenses; and part is profit, on which Federal and state taxes must be paid. If the lender is exempted from paying taxes on the income it receives from the loan transaction, then the interest charge may be lower.

Units of government, both state and local, enjoy a *tax-exempt status.* When they borrow money, the lender pays neither Federal nor state taxes on the loan proceeds, and the interest rate charged is at a "tax-exempt rate." Accordingly, certain state housing agencies and units of local government have sold bonds or otherwise borrowed money to create a pool of funds which may be reloaned at rates that are 60-70 percent below those charged by conventional lending institutions.

To date, there has been limited involvement by public agencies in tax-exempt financing for rental rehabilitation programs, though there are indications of increasing interest. A number of state housing finance agencies are working with local governments in the field of small property rehabilitation in conjunction with the Rental Rehab Demonstration Program.

A real obstacle to increased use of tax-exempt financing, however, is found in the Federal legislation that governs this type of activity. The Mortgage Subsidy Bond Act of 1980—or the so-called "Ullman Bill"—and related rules that have been promulgated by the Treasury Department through the Internal Revenue Service contain certain restrictions. Principal among these pertain to "targeting" (most structures must be located in certified "low income neighborhoods") and "tenancy" (owners must certify that at least 20 percent of the units will be rented to low- and moderate-income tenants.)[7]

9. What must rehabilitation agencies know about the tax advantages involved with real estate ownership?

The proforma or operating statement on an investment property shows the cash-flow or profit that is left to the owner after expenses and debt service have been paid. The benefits of property ownership, however, do not stop at this "bottom line." They include as well *appreciation* in the value of the property over time (which will be realized at the time of sale) and *deductions* of interest charges, property taxes, and depreciation from the owner's personal income for tax purposes.

Appreciation and the deduction of interest charges and property taxes apply as well to homeownership; so these concepts are commonly understood. It is the computation of *depreciation* that is peculiar to investor-ownership. Conceptually, the value of the structure (the "improvements," as distinct from the land) depreciates over time and will require full replacement at some point in the future. In anticipation of the owner's need to fully replace the structure, the IRS permits the owner to deduct a percentage of its value (at the time of acquisition) during each year of ownership.

There are two key elements to depreciation: (1) the *period* over which the structure will depreciate, and (2) the *percentage* of the value at acquisition which may be deducted per year. The shorter the period, the higher the amount which is depreciated per year. The higher the percentage in the early years of ownership, the greater the initial tax advantages.

If a property were purchased for $125,000, and 20 percent were assigned to the value of the land, then $100,000 would be the value of the structure and available for depreciation. If its useful life were considered to be 25 years, and it would depreciate evenly, then 1/25th or $4,000 could be deducted per year. If, however, the depreciation period were reduced to 15 years, then 1/15th or $6,666 could be deducted per year and this amount would be subtracted from an individual owner's taxable income.

This example has assumed an even depreciation schedule: that the same amount is deducted each year. Accelerated depreciation schedules front-load the deductions, permitting more substantial tax benefits during the intitial years. For example, a schedule that permits a "200 percent declining balance" over 15 years would provide $13,333 (200 percent of $6,666) as the first year's depreciation. For the second year, the depreciated value of the property would be reduced by $13,333 (to $86,666), and the deduction would be recomputed on the new basis.

Certain tax laws allow certain choices for owners of investment properties that provide low-income housing. They may select an Accelerated Cost Recovery System (ACRS) that permits a 200 percent declining balance over 15 years, or the straight-line schedule over 5 years that is provided through the Section 167(k) of the IRS code. Furthermore, certain tax *credits* may be taken for rehabilitation of older commercial buildings and certified historic properties.

[7]The Mortgage Subsidy Bond Act is up for reconsideration by Congress and certain changes may result. Agencies contemplating the use of tax-exempt sources of funds should stay current on the regulations that affect it.

10. What is involved in a real estate syndication, and how might such a financing be used in rental rehabilitation programs?

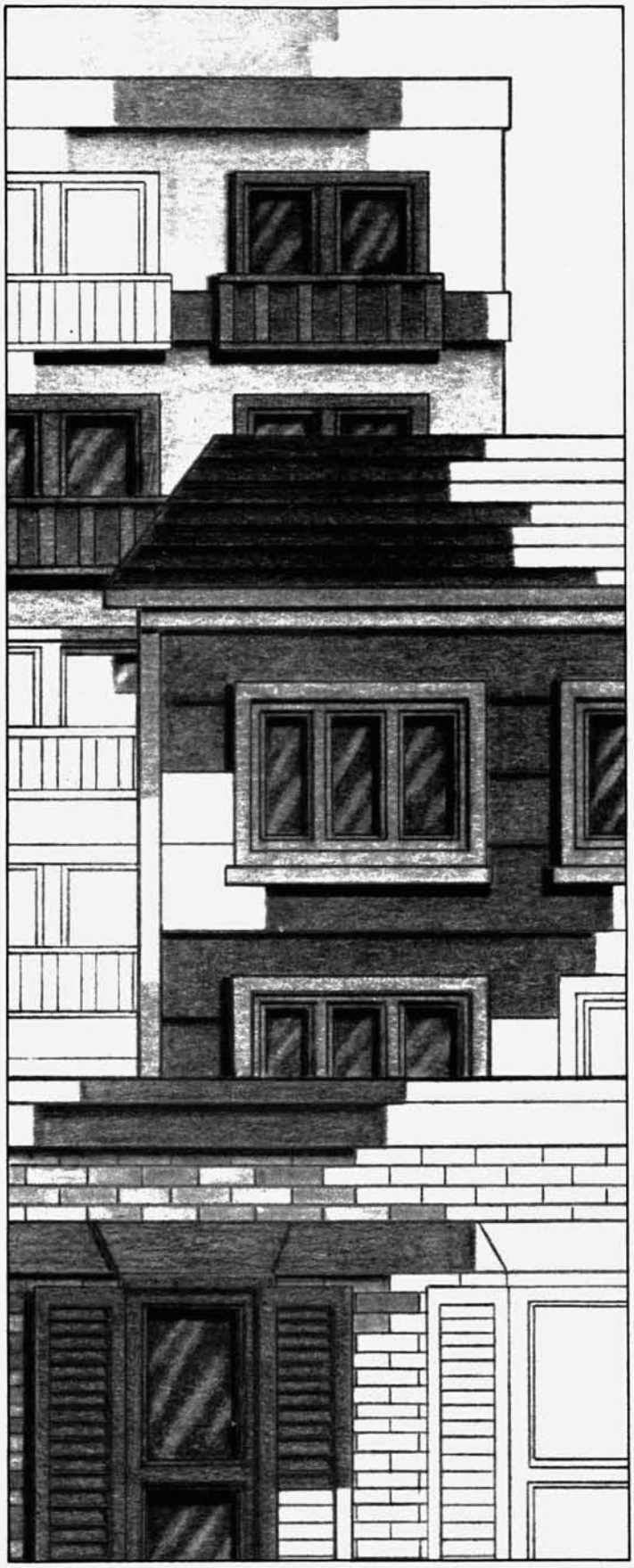
The tax consequences of real estate ownership are sometimes too great for a single individual to take full advantage of. Similarly, the costs of acquiring a property may exceed an individual's financial capacities. As a means to spread out the tax advantages and accumulate the downpayment necessary for acquisition, real estate sydications are formed to involve multiple investors.

The most common form of ownership under a syndication is the limited partnership. In this instance, the general partner will assume responsibility for the acquisition and management of the property for a fee, and the limited partners will put up cash and receive proportionate tax benefits. One key to a syndication deal is that ownership of the property must change hands; then it is typically held by the limited partnership until the time that the tax advantages have been exhausted. A second key is that the mortgage(s) on the property must be a "non-recourse" loan. In event of default, the only recourse that a lender has is to the property itself; the lender cannot go after the limited partners to recoup any losses.

Financing a rehabilitation project through formation of a real estate syndication may be an appropriate tool for a rental program that is encountering certain difficult projects. The current owners must be willing to sell, and a general partner must be willing to put in the time, effort, and front-end expenses necessary to form the venture. There may still be a need for subsidized financing even after the funds are raised by the syndicator for property acquisition.

What Are The Next Steps?

Having explored subsidy techniques, program design options, and the participation of private lending institutions, the task ahead of program planners is to develop an adminsitrative and marketing system. As alternative systems are considered, public attention should always be paid to the question: "Can someone else perform this task better and at a lower cost than a staff member of the agency?"



Chapter 4

Administration and Marketing

How many staff does it take to run a million-dollar-a-year program? Well. . .

. . .We get neighborhood groups to promote the program and contact the property owners.

. . .An investment banker analyzes the before- and after-rehab Operating Statements before they're brought in for $150.

. . .A fee appraiser gives us an appraisal based on comparable sales. It's the same one our lender uses.

. . .A construction management firm looks at the property and costs out all items based on our standards for $50 to $100 per unit, depending upon the size.

. . .Our lender assembles the package, underwrites the loan, and computes the amount of the public subsidy.

. . .Attorney's Title Company handles the loan closing for a fixed fee. They also function as escrow agents and process all construction draws.

How many staff? Just me and my secretary.

Sometimes when local officials embark on new program initiatives, they instinctively construct elaborate administrative systems. Their intentions are to assure accountability. The results are labyrinthine bureaucracies. ". . .And everyone works a 12-hour day."

Staff *are* frequently overworked. They act on and record numerable items on a daily basis, catalog them weekly, consolidate them monthly, and summarize them quarterly. If the system moves a bit slowly, that's better than moving precipitously. Precipitous movements always end up creating problems, and someone must be held accountable for problems.

In the administration of rental rehabilitation programs, traditional public sector instincts to overlay the process with checks and counter-checks must be resisted. They can quickly nullify an otherwise promising program design. Promising designs are those which use public resources to intervene in an otherwise private real estate process to accomplish certain public purposes. Similarly, administrative systems should be established to reflect—and use—private procedures to the extent they are feasible, while retaining essential public controls.

Whether a system is being designed from scratch or being modified within an ongoing operation, i.e., a single-family program, the key steps in the process must first be identified. Then they should be analyzed using the question: "Who is more appropriate to perform this function than the public agency?"

What Are The Key Steps?

Amid all the tasks and functions that must be performed in a rental rehabilitation program, they may be grouped into seven key steps. They are:

1. Marketing
2. Determining Eligibility/Feasibility
3. Determining the Scope of Work
4. Loan Packaging
5. Loan Closing
6. Disbursement of Funds
7. Management/Maintenance/Close-Out.

Step 1: Marketing

Real estate loans don't sell themselves. That's why banks, savings and loan associations, and other financial institutions spend a lot of money advertising their rates and terms. . . and toasters. Loans don't even sell themselves when they're much cheaper than other loans that are available in the marketplace. . . or even free! An investment decision requires certain actions on the part of potential or actual property owners, and decisions to rehabilitate declining structures must be induced through marketing efforts.

The first step to developing a marketing plan is to understand and define the *product* which is being sold to the consumer. In the case of rental rehabilitation programs, the dominant product is a financing vehicle, or perhaps a financing package, which is unavailable elsewhere. But there are also other benefits which may accrue as a result of the rehabilitation investment, and they should be identified. Finally, there may also be some liabilities which the alert consumer (the investor) will either be aware of or will discover in the process of considering the product. The development of a marketing plan should begin by identifying certain benefits and liabilities, such as:

Benefits	Liabilities
Profits: Increased cash-flow Increased property values Favorable tax advantages	Property taxes may increase; May require additional cash investment by owner
Below-market rate financing	Possible reduction in overall equity position due to increased debt
Lower maintenance costs/ problems; improved neighborhood environment	Time and energy to see rehabilitation through
May raise rents and retain tenants if tenant subsidies are available.	Possible complaints from tenants
Etc.	Etc.

Having compiled a promotable, but honest list that defines the product, the characteristics of the potential consumer must be similarly identified. Who are the program's clients?

What are their motivations? Much of the needed information should have emerged through the neighborhood analysis process, and a profile of investors and developers might include:

- ☐ Length of ownership;
- ☐ Size and types of structures;
- ☐ Financial capacity;
- ☐ Management experience; and
- ☐ Financial objectives (cash/depreciation/both).

By cross-referencing the listing of program benefits and liabilities with the client characteristics, the focus of a marketing strategy will appear. For example, long-time owners with limited financial capacity who are living on the cash-flow generated from a few small properties may be attracted to an investment that will increase their rate of return and permit them to retain existing tenants. Alternatively, sophisticated investors interested in the tax advantages of real estate ownership and the potential for appreciation in property values may be drawn by the opportunity for below-market rate financing. It is possible that more than one strategy will need to be pursued.

Outlets for promoting the product should then be considered. If appropriate, these may include the traditional media: press releases, advertisements in city-wide and neighborhood-based newspapers, feature articles for trade publications, etc. Depending upon the scope and capacity of the program, local radio and television stations may provide community service time to promote the program. Meetings and speaking engagements before realtor associations, civic groups, community organizations, and property managers can stimulate interest. Finally, marketing materials may be disseminated as brochures, posters, and flyers in the neighborhood and with lending institutions, or mailed directly to known investor-owners.

With regard to marketing materials, it may be useful for public staff to purchase assistance from professionals in the field to assist with the preparation of brochures and flyers. There is a difference between a "program description" and "promotional materials" which is frequently overlooked. Program descriptions typically provide more information than is needed for marketing purposes, and they usually sound dry and bureaucratic and look unappealing. Professionals involved with marketing are trained to use only that information which is needed to entice a potential client to "come to the door," and to present it effectively.

Before deciding on the specifics of a marketing campaign, certain questions should be asked. These include:

Resources: How much money can be budgeted for marketing purposes? Are there others, i.e., participating lenders, who would be willing to assist for free?

Costs: How much will it cost to produce items for various outlets?

Impact: As it relates to costs, would a presentation to a local realtor association (free) reach as many potential consumers as a glossy brochure (expensive)?

Timing: How should the various efforts be staged? A newspaper article followed by a mailing? Vice versa? And if real demand is generated, is the program ready to respond?

Accessibility: What is the most direct route to reaching potential clients? Do investor-owners read the neighborhood-based newspapers?

Credibility: Is the promoter credible? Would a lender be better to carry the message to owners than a community leader? Vice versa?

Replicability: Can the marketing technique be replicated, or is it a one-shot effort? What are the cost/impact considerations?

Having considered these questions, a marketing strategy may be assembled that is appropriate and sensitive to local conditions. At the beginning of a new program, it may be necessary for a staff member of the administering agency to be concerned full-time with marketing the product.

Step 2: Determining Eligibility and Feasibility

There is frequently confusion in the administrative process of determining which projects are *eligible* to receive assistance, which are *feasible* for subsidized financing, and which will receive *priority for selection* in the approval process. Each of these three issues requires establishment of certain criteria for evaluation purposes. The eligibility, feasibility, and selection criteria should relate directly to the public purposes for which the program has been designed.

Taken individually, these criteria should be established to answer the following questions:

Eligibility: Does the property meet the basic qualifications for program assistance?

Feasibility: Considering the public subsidy and other program requirements, will the financing package meet underwriting standards?

Selection: With limited financial resources, which applications will receive priority consideration for funding?

It will be helpful if there is a Preliminary Application that is filled out by property owners. It should be designed to elicit sufficient information for agency staff to determine eligibility—and perhaps basic feasibility. Selection criteria should be thought through, but they need not be applied to individual applications until a competitive number have been received.

Eligibility Criteria

Eligibility criteria should be clearly stated and easy for potential applicants to understand. They should involve a minimum of time and effort to determine compliance, both by applicants and agency staff. Applicants are apt to lose interest if they cannot determine quickly whether or not they are eligible for program assistance. Similarly, staff time and energy will be wasted on assisting owners in the process if the properties are later determined to be ineligible.

The fundamental eligibility criterion deals with *location:* Is the property located in the geographic area defined as the target neighborhood? The precise location will be shown in the deed or title to the property. If there are any questions, agency staff should pay a visit to the site.

Other eligibility criteria deal with the elements of the particular program design, so they cannot be generalized. They may include the following:

Ownership: Is the applicant the bonafide owner of the property? If there is multiple ownership, has each owner of interest signed the Preliminary Application? If the design accommodates purchase/rehabilitation, is there evidence of control of the property through an executed option agreement, an agreement of sale, or a letter of intent to sell? Are limited partnerships eligible for non-recourse loans according to the design?

Longevity: How long has the current owner(s) owned the property? Does the design contain any anti-speculation features that would make ineligible those who have made recent acquisitions in the neighborhood?

Occupancy: Is the structure fully occupied, partially occupied, or vacant? Are vacant properties eligible for assistance, or must they be at least partially occupied to be considered? Are existing tenants low- and moderate-income? Must they be?

Size: How many rental units are currently contained in the property? Is there a minimum and/or maximum number of units which must be in existence? Are conversions of larger to smaller units permitted? Smaller to larger?

Condition/Cost of Repairs: What does the owner estimate the average cost of rehabilitation per unit to be? Is there a minimum and/or a maximum cost per unit that is part of the program design? What is the total projected cost of rehabilitation? Does it exceed program maximum/minimum costs per project?

If applicants can respond "yes" to the various eligibility questions to the satisfaction of agency staff—providing documentation where necessary—then the basic cost factors may be established and feasibility criteria may be evaluated.

Feasibility Criteria

Feasibility criteria relate to the economics of the property and to the loan underwriting concerns of private lenders. Economically, a project is feasible if it shows sufficient revenue (a) to pay all operating expenses; (b) to cover all debt service costs; and (c) to return an "acceptable" profit to the owner. From an underwriting standpoint, a project is feasible if the principal amount of all loans after rehabilitation does not exceed a fixed percentage of the property's value.

A well-considered financial design is based on certain feasibility considerations. The question that should be asked during the program design process is the following: "With the type of subsidized financing proposed, is it likely that most (or perhaps specific) projects will be feasible?" There is thus a *prediction* of the economic results of the rehabilitation and a degree of pre-underwriting in the design concept.

The feasibility of individual projects must nevertheless be determined individually. Such a determination will involve the owner, the lender, and the agency. Administrative issues that attend to feasibility criteria will vary with the type of financial design that has been adopted by the agency. Generically, design types may be distinguished as either fixed subsidies or "gap" financing,[1] and each involves different administrative systems.

If the subsidy is essentially *fixed,* i.e., an amount or a percentage of the rehabilitation cost per unit, then there is a minimal role for the agency to play in determining feasibility. The owner must first decide whether the investment is feasible. (Does it provide sufficient tax and/or cash-flow benefits?) Subsequently, the lender must underwrite the loan package, assuming that the subsidy amount will be available. (Will there be enough cash to pay all costs, and are loan-to-value requirements met?)

[1]The Financial Design Continuum described in Chapter 2 illustrated a broader range of options. There may be elements of fixed subsidies and more flexible "gap" financing in the design that is chosen. It is the extremes that are described here.

If, on the other hand, the subsidized financing is *flexible,* i.e., that the "gap" that exists between private financing and rehabilitation cost requirement will be filled through some public loan, then the agency must assume a fuller role in determining feasibility. Normally, the agency and the owner will work together to determine that the project is feasible prior to sending the package to the lender. Alternatively, the lender could review the application first, determine the extent of private financing which will be available, and compute the amount of the public subsidy that is required for the package to be underwritten.

Regardless of the administrative process, feasibility criteria should be developed on the front-end to guide the owner, the lender, and the agency through the process. These may include:

Operating Expenses: Will they be the same in both before- and after-rehabilitation condition? Or, will certain cost savings result from energy-related improvements that are required or voluntary? Will management be more or less costly? Will property taxes remain the same or go up? *(In a flexible design, a sample proforma should be developed that requires the owner to show both before- and after-rehabilitation operating expenses.)*

Debt Service Costs: Will a rehabilitation loan(s) be added to an existing mortgage on the property? Or, is refinancing of existing debt contemplated? What is an acceptable "debt-coverage ratio" for the agency and for the private lender? *(A debt-coverage ratio is a feasibility criterion commonly used by private lenders. It is an expression of the net income from the property after expenses have been paid for operation, but prior to debt service. A debt-coverage ratio of "1.15" means that the net income is 1.15 times the amount needed for debt service costs, and that 15 percent is available to the owner as cash flow to cover unexpected costs (or provide profit).)*

Cash Flow or Profit: What is the maximum/minimum profit which should be realized by the owner? How should it be expressed? As a percentage of the owner's cash equity in the property, i.e., "cash on cash return"? As a percentage of the owner's "paper equity"? In the debt-coverage ratio? Is the owner required to put cash into the rehabilitation cost, or will it be possible for the work to be "financed out"? *(Public guidelines tend to discourage profit-making while private lenders like to see as much cash-flow as possible in a project. Both would like to see owners put additional cash into the property so that the owners will be at risk as well. Risk encourages timely repayment of loans and property maintenance.)*

Loan-to-Value Ratios: What is the maximum debt that the project can hold? Should the public subsidy be counted in the total amount of the loan(s)? On what basis will the property's value be established? Through an "economic appraisal?" Comparable sales? A combination of both? *(Lenders prefer low loan-to-value ratios so that they are protected in event of default. If a property is highly "leveraged"—carrying debt that approaches value—then the owner may "walk" if the project runs into financial trouble. Some lenders will include the amount of the public subsidy when considering loan-to-value ratios for this reason.)*

Having delineated the public criteria from those required for private lender underwriting, feasible projects will be ready for funding. If more projects qualify than there are public subsidies available, then certain selection criteria must come into play.

Selection Criteria

Selection criteria are a means to *target* certain potential projects for rehabilitation and/or to *set priorities* for approving applications that have been submitted. Among other items, they will typically deal with *cost* issues:

- ☐ Should projects that require the *least* public subsidy—per unit, per project—receive priority? Or,
- ☐ Should projects that improve the *worst* structures, and thus require higher subsidies, be treated first?

Depending upon the length of ownership, the amount of existing debt on the property, and the cash available for debt service, these two cost settings may not be mutually exclusive. In most instances, however, the worse structural conditions will require higher public subsidies to make the project feasible, and a decision may be made on a "worst-first" basis or on some other cost consideration.

Additional selection criteria may deal with location of properties, occupancy, displacement potential, owner's cash in the financing, the type of improvements contemplated, and a number of other public concerns. For example:

Location: A program that wishes to establish physical impact in a sub-market area of the target neighborhood may give priority treatment to applications on certain streets or blocks. Alternatively, if wider influence is sought within a neighborhood, then dispersed properties may be favored.

Occupancy: If the program is designed to assist properties with existing low- and moderate-income tenants, priority points may go to such occupied projects.

Displacement Potential: If rehabilitation will cause substantial rent increases without some form of rental assistance for existing tenants, displacement will occur. To avoid the human and financial costs of relocating existing tenants, such projects may get lower priority. (If the agency determines that displacement will disqualify an application, then this criterion should be treated under Eligibility.)

Owner's Cash: There may be a specific requirement for the owner to put a minimum amount of cash into the financing arrangement. This amount may be expressed as a percentage of the rehab cost. Even if there is not a cash requirement, more owner cash may improve a project's standing on a list of priority applications.

Type of Improvements: A project that qualifies under minimum program standards but includes additional amenities may get higher priority treatment than one which involves only the minimum. (This criterion assumes that both competing projects are feasible and require a similar public subsidy.)

Some selection criteria involve judgment and qualitative concerns. Nonetheless, the structure and administration of the program will be enhanced by the extent to which selection criteria are *described* and *quantified.* For example, a "point system" (which assigns 10 points for this factor and 25 for that one out of a total of 100 points) will enable both agency staff and property owners to understand and operate within the competitive nature of the program.

Step 3: Determining the Scope of Work

The first element to determining the scope of work is to establish minimum rehabilitation standards. These should be tied to local and state housing codes and should take into account Housing Quality Standards (HQSs) as set by HUD. Minimum rehabilitation standards should answer the question: What is the *minimum* amount of work which must be done on the property to make it acceptable for the public subsidy? In most programs, this threshold is crossed only when all hazardous code violations have been abated.

Beyond these minimum standards, there will be "incipient" code problems that should be treated if feasibility permits. There are also "general property improvements" (GPIs) that are not code related, but which contribute to the livability—and marketability—of the structure. Programs should consider each of these three categories of improvements in determining the scope of work:

Category A: Those items that threaten the health and safety of tenants, i.e., basic electrical and plumbing systems. If the project is infeasible when the costs for all Category A are included, then the application will not be approved.

Category B: Those items that correct incipient code deficiencies, i.e., an operating water heater which has exceeded its normal life expectancy but is not health/safety threatening.

Category C: Those items that are not housing code related, but that improve the livability of the structure through installation of permanent fixtures. If the project is feasible after all Category A and B items have been included, then Category C improvements (GPIs) may be included in the application.

The extent of agency staff participation in the process of determining the scope of work is a key administrative issue. Staff inspectors may visit the property, perform a full inspection, and prepare a detailed work write-up that describes all the improvements that must be made by the owner. Alternatively, the initial inspection may produce a "deficiency list" that outlines the problems according to the categories noted, and then the owner must find a contractor to prepare the detailed scope of work. Agency staff must then review and approve the work so described. A more efficient and streamlined system normally results in the latter process.[2]

Regardless of the process used to determine the scope of work, the agency should always retain control by approving the write-up and authorizing the contract between the owner and the contractor. This document should make explicit that minimum program standards and specifications must be met to enable the use of subsidized financing. The contract should also specify that agency staff will make periodic inspections of the work in progress.

Step 4: Loan Packaging

The formal loan package will be assembled from information shown in the Preliminary Application (Step 2), the Scope of Work (Step 3), certain Market Analysis information (the planning phase), and other private lender requirements. It will normally include ownership and title reports; a management plan and operating budget; market rent and vacancy projections; and a commitment on the part of the agency to authorize the subsidy amount required.

[2]There is considerable debate among programs designed to assist owner-occupants on the prudence of a "streamlined" approach. Detractors argue that lower-income owners and rehabilitation contractors cannot adequately handle these responsibilities. However, investor-owners and contractors dealing with larger projects are generally more sophisticated.

It is at this step that the agency becomes a full partner in the project and begins acting as an agent of the owner to present a feasible application to the private lender. With the lender's approval, the process may move quickly to loan closing.

Step 5: Loan Closing

Loan closings will generally occur in the office of the lender. If the owner, the agency, and the lender are putting cash into the rehabilitation project, each will bring checks to the closing table, and they should be endorsed to an escrow agent.

The escrow agent should safeguard the funds during the construction process. Disbursements should be made only with appropriate approvals.

Step 6: Disbursement of Funds

The use of private escrow agents for disbursement of all loan funds enhances the administrative process. With regard to the mechanics of check-writing, a single agent can assure that the funds are available and the draws are processed in a timely fashion. With regard to agency and lender controls on the owner and the contractor, checks should be drawn only with the appropriate authorizations.

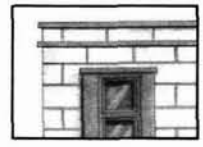
The primary role of the agency should be to inspect the property at the time construction draws are requested to assure that *minimum standards and specifications* are being met. The lender may also have an interest in these issues and wish to participate in the inspections. The lender's primary objective, however, is to assure that the *value of the improvements* is in place before funds are disbursed. In this way, sufficient loan funds will be available to complete the work if the contractor (or owner) cannot or refuses.

A hold-back of some percentage of the value-in-place is generally required so that the contractor is not paid-in-full until the job is complete. Concomitantly, there should be clear incentives (and penalties) to get the work done properly and on time. If the building is vacant prior to completion of the construction work, then marketing efforts to "rent up" should begin prior to completion.

Step 7: Management/Maintenance/Close-Out

It is in this step where the owner assumes ongoing responsibility for the property. Prior to closing out its involvement in the project, however, the agency must assure that the work has been completed in full compliance with the program standards; that the owner has implemented the management plan as described in the application package; and that any maintenance and tenant-occupancy agreements[3] are in place.

At the conclusion of this final step, the involvement of the agency in the rehabilitation project is over. Monitoring tenancy or lending agreements may continue for several years depending upon the program design. Most communities contract these functions to a housing authority and/or the lender.



Who Should Perform The Administrative Steps?

It is crucial that the public agency retain control of the administrative process. A well-conceived program design which articulates eligibility criteria, rehabilitation standards, financial feasibility, etc., is a primary means of establishing and maintaining control. But what about the administrative steps? Must public agency staff perform *all* the functions? To the contrary, experience has shown that individuals outside the agency may be better equipped to administer certain of the steps necessary.

To determine who is equipped to perform the various administrative steps, four basic criteria should be used. They are called the "4-C's" of the administrative process:

Capacity: Who has the capacity to perform the task? Who is most capable?

Cost: How much will it cost the agency in public dollars to purchase the service, either through in-house staff or through an individual or organization outside the agency?

Control: If the service is purchased through an outside source, how will the agency retain control of the process?

Clout: Who has the clout to make the task occur, or possibly prevent it from occuring?

Who does *what, when* and *how* will vary from one program to another. To get a handle on these issues, the administrative process should be laid out and dissected. Each

[3]If there are agreements to provide housing for Section 8 certificate holders, for example, the local housing authority must have performed certain inspections. If rent control agreements are part of the package, then they must be executed. And if certain maintenance standards must be met by the owner over time as a condition of the public subsidy, then such an understanding must be formalized.

Chart 5: The 4-C's Matrix

Step: Loan Packaging and Underwriting

Actor	Capacity	Cost	Control	Clout
Agency	Currently underwriting owner-occupied loans; no experience with multifamily	Hire and train new staff-person; base salary plus fringes	Make decision on subsidy amount and timing	Cannot control lender decision on private funds
Lender	Extensive experience with multifamily underwriting	Packaging and approval costs normally charged as 1% of loan amount	Makes decision on private loan funds	Can prevent project from being funded
Owner	N/A	N/A	Must provide documentation, credit	Can back out of deal
Attorneys	N/A	Some legal costs will be involved	N/A	N/A
Appraisers	N/A	Appraisal costs will be charged	N/A	N/A
Tenants	N/A	N/A	N/A	Could create negative publicity
Community Organizations	N/A	N/A	N/A	N/A
Others				

step should be broken down into the functions or tasks that are involved, and the following questions should be asked:

Who will be involved in the performance of each task?

What must occur for the task to be accomplished?

When will the task be performed in relation to other tasks within the particular administrative step?

How will the various individuals involved in the task be coordinated to assure that it is accomplished?

The Loan Packaging and Underwriting step provides a useful illustration for these questions.

Who will be involved? Certainly the Lender, who will make the loan underwriting decision; the Owner, whose responsibility it is to provide documentation; the Agency, which must approve the loan subsidy; Attorneys and Accountants, perhaps, to assist with document preparation and justification; the Contractor, indirectly, whose cost figures are the basis for computing the loan amount; and to some degree, the Appraiser, the Market Analyst, the Management Agent, and others who have provided information and structure to the loan package.

What must occur? The package must be endorsed by the Owner, authorized by the Agency, and approved by the Lender.

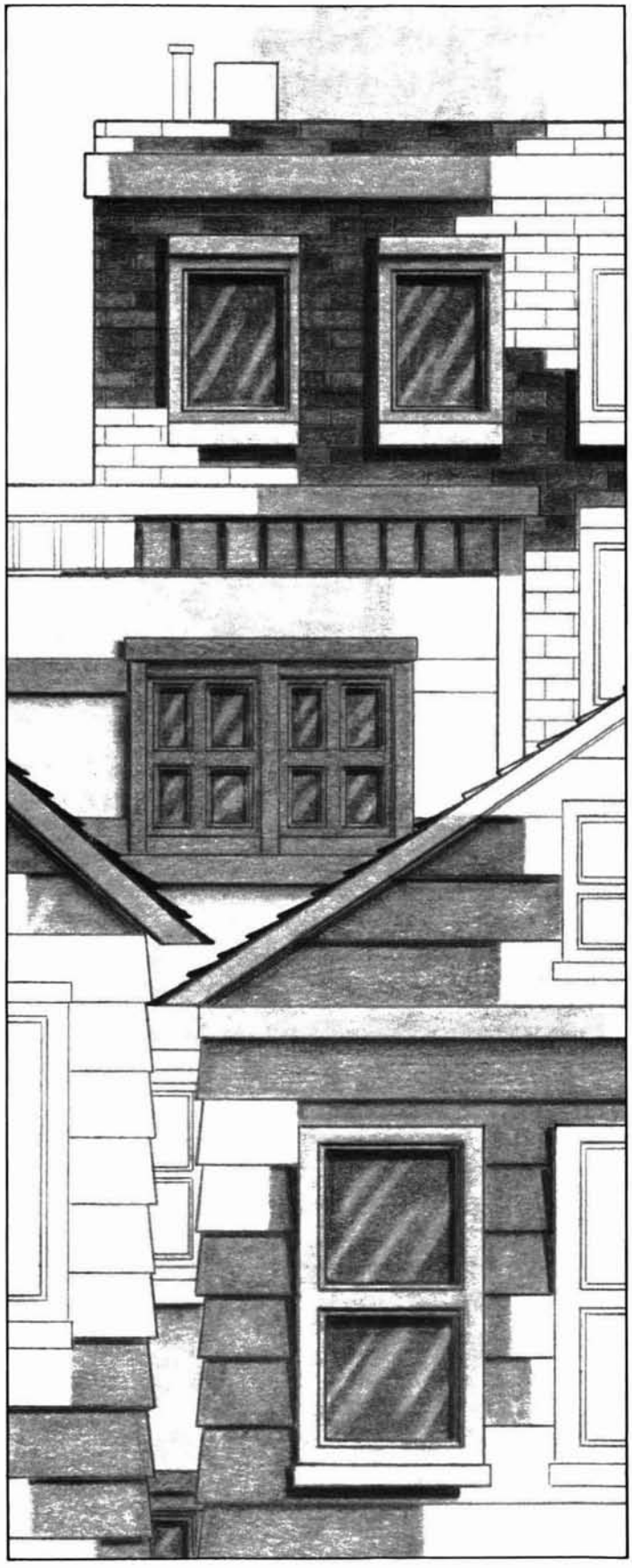
When will it be done? After the documents have been assembled, but before the funding for the loan is actually in place.

How will it be coordinated? By the individual who is given responsibility for accomplishing it.

The Loan Packaging and Underwriting step might now be analyzed through the perspective of the 4-C's, as shown in the matrix as Chart 5. Obviously, *degrees of involvement* from a number of actors has resulted, but the prime responsibility should rest with the Lender. The Lender already has the capacity; the cost is low (though figures are not shown); the agency retains control through approving the subsidy; and the Lender can prevent the project from being funded by disapproving the loan.

Conclusion

The same analytic system might suggest that the contractor (chosen by the owner) should prepare the work write-up based on the agency's deficiency list and standard set of specifications. In each step of the administrative process, consideration should be given to the use of capacities available in the private sector, and then test to see if costs are competitive, if control can be maintained, and who has the clout to make the final decision—or prevent it from being made.



Chapter 5

Tenant Strategies

They come into our neighborhood and fix up the buildings. The rents go up, so the poor families have to move out. Middle- and upper-income people move in.

The program doesn't help the community. It helps the landlords and other wealthy folks. That's why we tenants are filing a law suit to stop it!

The rehabilitation of rental properties *can* alter the financial and market economies of lower-income communities. The reasons are straighforward. First, *rehabiliation costs money*. And if part (or all) of the money needed is borrowed, then existing rents will usually have to be increased to pay off the loan. If the loan is made through conventional sources at prevailing interest rates, then the rent increases may need to be substantial to cover debt service. If public subsidies are involved in the financing, then less dramatic increases may be necessary.

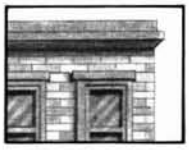
Second, *rehabilitation creates a more attractive product*. And improved rental units can usually command higher rents than those that are in substandard condition. If there is strong demand for improved units, then landlords may be able to charge substantially higher rents. Even if demand is soft, it is likely that some increase will be supported by market forces.

The combined effects of these *financial* and *market* economics of rehabilitation raise several fundamental public policy questions:

☐ Who can afford to live in the property after it has been rehabilitated?

☐ What income group(s) is the rehabilitation program intended to assist?

☐ If low- and moderate-income tenants are to be assisted, what techniques may be used to assure that the rehabilitated units are affordable to them?



Who Can Afford The After-Rehabilitation Rents?

Questions of *affordability* involve both the *income* of the tenants and the *rents* they are required to pay. In HUD's Section 8 and public housing programs, families whose incomes are below 80% of the median are considered needing rental assistance if they are paying more than 30% of their income for housing. If rehabilitation programs adopt this definition of "affordability," then a consistent means for analyzing the effects of rehabilitation will exist.

Assume that the 10-unit building described in Chapter 2—the one needing $50,000 in rehabilitation and containing one- and two-bedroom apartments—is located in an area where the median income is $18,000. Assume further that the program has adopted a policy stating that "after-rehab rents must be affordable to low- and moderate-income tenants whose income is between 50% and 80% of the median."

The market analysis that was conducted to determine the magnitude of the "gap financing" needed for project feasibility established the following after-rehabilitation rents:

One-bedroom units.....$190 per month
Two-bedroom units .....$230 per month

Since the two-bedroom units are suitable for families with three members, and the one-bedroom units are suitable for two-member families and elderly individuals,[1] the rehabilitation agency must extrapolate income levels between 50% and 80% of the median by family size. The data shown in Chart 6 was provided by the HUD Area Office.

Chart 6: Gross Income by Family Size

	Size of Family		
	1 Person	2 People	3 People
80% of Median	$10,080	$11,520	$12,960
50% of Median	$ 6,300	$ 7,200	$ 8,100

With this information, the agency computes "affordable" rent levels by dividing the gross annual income shown in Chart 6 by 12 months, and then multiplying the quotient by 30%. The maximum "affordable" rents for these low- and moderate-income families are shown in Chart 7.

Chart 7: "Affordable" Rents by Family Size

	Size of Family		
	1 Person	2 People	3 People
80% of Median	$252	$288	$324
50% of Median	$158	$180	$203

[1]These are the eligibility standards by unit and family sizes for HUD-assisted programs.

A comparison between the maximum affordable rent levels and the after-rehab rents will show those lower-income families who can afford to reside in the units and those who cannot. For those who *can* afford the rents, a "rent surplus" will exist, and the program will have met its affordability policy with no need for further subsidies. For those who *cannot* afford the rents, a "rent gap" will exist, necessitating some further public action to satisfy the affordability policy. Chart 8 shows the "rent surplus" or the "rent gap" that will result.

Chart 8: Rent Surplus/Gap by Family Size

	Size of Family		
	1 Person	2 People	3 People
80% of Median	+ $62	+ $98	+ $94
50% of Median	- $32	- $10	- $27

Having identified the existence of a rent gap for lower-income tenants, the program may address it through one of three approaches: (1) provision of rent subsidies (payments to the landlord in behalf of the tenants); (2) establishment of rent controls (requirements of the landlord to hold certain rents below market levels); or (3) a combination of subsidies and controls.

What Resources May Be Used For Rent Subsidies?

The use of public subsidies to fill rent gaps is the basis of the HUD Section 8 program, and Section 8 Existing Certificates may provide an appropriate resource for rental rehabilitation projects. Public housing authorities receive funds from HUD to pay the difference between 30% of an eligible tenant's monthly income and the contract rent for a particular unit. The contract rent must be within the allowable Fair Market Rent (FMR) for the locality.

Payments are made monthly by the housing authority to the landlord in behalf of the tenant. If the "real market rent" (as established in the market analysis) is *less than* the FMR (as set by HUD for a geographic area), then Section 8 Certificates may be used in those properties. The rent subsidy commitment to an eligible family may be assured for up to five years, and possibly for as long as 15 years if the family remains eligible.

Communities participating in HUD's Rental Rehabilitation Demonstration receive special allocations of Section 8 Existing Certificates to prevent displacement of tenants that may otherwise result from after-rehab rent increases. Furthermore, the "fair share" allocation of Section 8 units that are contracted by HUD with local housing authorities provide a possible resource. Arrangements may be negotiated between rehabilitation programs and housing authorities whereby existing, eligible tenants are assigned priority on waiting lists, classified as "about to be without housing through public action."

As an alternative to the rent subsidies available in the Section 8 program, Community Development Block Grant (CDBG) funds may provide rental assistance payments *if* they are administered through a neighborhood-based non-profit organization. (CDBG funds may not be used for rent subsidy purposes directly from a public agency, and they may not be used as a supplement to a Section 8 Existing Certificate.) Furthermore, the tenants who benefit from the CDBG subsidies must reside in the affected property *at the time* the rehabilitation is undertaken.

How long the CDBG subsidy will be available to individual tenants is a program option. The payment may be made to the landlord during the typical lease period for the area, or even over a longer period. Payments may be made on a regular monthly basis; alternatively, the "present value" of the incremental payments over time may be calculated and paid up front.

Additional sources of rent subsidy payments include the following:

Local General Funds, which may be administered through a public agency if an acceptable arrangement cannot be made with a neighborhood-based non-profit organization that involves CDBG funds;

Other local revenues, such as condominium conversion taxes, which may be earmarked to benefit lower-income renters;

Statewide rent subsidy programs, which are funded through state legislative action; and

Cash contributions from property owners or developers, which may be required as a *quid pro quo* for program assistance or approval of other development projects.

What Issues Are Involved With Rent Controls?

Rent control agreements require landlords to hold rents at levels which are (presumably) below those they could otherwise command. The below-market rent levels are set to assure and protect affordability by low- and moderate-income tenants.[2] Because landlords are deferring income which they would otherwise receive for their rehabilitated units, rent controls actually involve an *indirect* form of rent subsidy, provided by the owner.

Many communities have determined for both political and programmatic reasons that rent controls in some form are both appealing and necessary to maintain affordability over time. If demand for rental housing is high—or may become high during the foreseeable future—then explicit controls may provide the only means to assure long-term benefit for low- and moderate-income tenants.

Nevertheless, rent controls clearly create obstacles to the market conditions upon which project feasibility may have been based. A series of questions should be addressed before regulations are established as a condition for owners to receive subsidized financing:

1. If rents are controlled, over what period of time should the restrictions apply?

Localities with existing rent control ordinances need not address the question, "how long?" Most involve perpetual controls—or until the law is amended. With rehabilitation programs, however, policies must be adopted and requirements established that define the time period over which low- and moderate-income tenants will be assured affordability.

Some programs have adopted a three- to five-year control period and expressed it as an element of the lien securing the subsidized financing. There is concern, however, with the immediate gentrification that may result at the end of that period. For example, if the rent control is restricting rent increases and cash-flow that the owner would otherwise receive during a three- to five-year period, rents may jump when the controls are lifted, and the lower-income tenants will be forced to move out.

2. Should regulations be established that control the rents for the existing tenants only?

Rather than establishing control on the rents for all rehabilitated units, some communities feel obliged to protect affordability only for those low- and moderate-income tenants who reside in the units *prior* to rehabilitation. Any vacant units, and those which may become vacated after the rehabilitation has been completed, may be rented at market levels. Though this strategy may satisfy public policies designed to avert involuntary displacement, it may create an undercurrent of resentment with the landlord against existing tenants whose rents are being controlled, as compared with those who are paying market rents.

3. What will rent controls do to program marketing efforts?

In some communities, landlords are eager to participate in rehabilitation programs that provide subsidized financing and the opportunity to increase the value of their real estate. In most cases, however, programs must be aggressively marketed to attract and hold investors. Direct or indirect obstacles to economic benefits that are posed by rent controls may deflect participation by luke-warm property owners. Furthermore, such obstacles may discourage on-going maintenance of the property after the rehabilitation has been completed.

4. What are rent controls going to cost in the form of increased subsidies needed to make projects feasible for rehabilitation financing?

The financial design issues described in Chapter 2 began with the *income* generated by rental property and computed the "financing gap" that must be filled through some form of public subsidy. If the rents are controlled—or suppressed—the income will be restricted, and the financing gap will be increased. Enactment of rent controls will generally cost more in public dollars at the point of financing, and programs must be aware of this eventuality when considering tenant strategies.

5. How can future increases in operating costs (taxes, utilities, maintenance, etc.) be accommodated in a rent control contract?

Financing subsidies may create a feasible project based on operating costs projected over the short-term; but they will

[2]Some studies have questioned the relationship between the controlled rent levels and tenant affordability, noting that low- and moderate-income tenants may be unable to afford the monthly rents that have been established in rent control agreements.

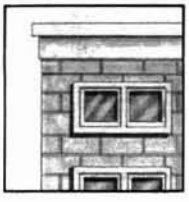
certainly increase, requiring either added subsidies or rent increases. Some rent agreements require landlords to petition to rent control boards for incremental increases based on actual and verifiable operating costs. Considerable time and expense are involved in such systems. Alternatively, some regulations provide for fixed increases, i.e., 6% per year, regardless of economic circumstances. Such indexed systems usually assure rent *increases* as much as they assure controls.

The caveats and quirks of rent controls notwithstanding, public purposes may be impeded—and public agencies may be embarrassed—if structures that are rehabilitated through the use of public funds are not affordable to lower-income tenants. If rent control agreements are employed, programs must consider:

☐ The costs involved;

☐ The term over which the controls will apply; and

☐ The administrative systems needed to monitor compliance.



Can Rent Subsidies And Controls Be Used In Tandem?

Combining techniques to assure affordability may reduce certain costs associated independently with rent subsidies and rent controls. Combinations may also muddy the water and create a less marketable financing package.

Some programs have developed creative tenant strategies by containing the owner's profit, and thereby controlling rents indirectly. For example, a limit on the owner's profit on the real estate investment, i.e., 10% of the annual cash-on-cash return, may cause rents to be stabilized, yet leave open the use of rent subsidies for eligible tenants. Similarly, the subsidized financing may involve an acceleration feature, i.e., a balloon payment, if units initially occupied by low- and moderate-income tenants do not remain so over time. Programs that are designed to maximize private resource and incentives, however, must be aware that tandem strategies (similar to direct controls) may discourage some owners from participating.

What Information And Other Tenant Services Should Be Provided?

Confusion and complaints occur quickly and loudly when tenants do not understand what is happening with their building. Early and personal notification should be provided to them about the extent of the rehabilitation contemplated, the construction schedule, and their options for remaining in the stucture during and after the work is completed. The property owner should be responsible for providing both verbal and written notice, and program staff should assure that the information is conveyed to tenants.

Beyond basic information about the facts and effects of the rehabilitation work, some tenants may need additional counseling and referral services whether or not they intend to remain in the building. Counseling might include:

☐ How and when is eligibility for the Section 8 program determined? Where is the public housing authority located?

☐ Will temporary relocation be necessary? Where can temporary facilities be found, and who pays for them?

☐ What are the terms and conditions of the leases that will be executed after the rehabilitation has been completed?

☐ If rent subsidies are available, who pays them and how do tenants apply?

☐ If tenants are forced to move, what relocation benefits will be provided?

☐ If moving expenses are available, who pays them and how do tenants qualify?

Administrative systems may also be needed for tracking and monitoring tenants two, three, or more years after the project has been completed. The length of time will vary with the commitment of the program to provide assistance.

The design and description of rental rehabilitation programs should include a *written* tenant assistance strategy that incorporates at least the following elements: (a) rent subsidy and/or rent control provisions; (b) relocation eligibility; (c) temporary and permanent relocation benefits; and (d) other tenant-related concerns that may be peculiar to localities. To enhance opportunities for successful program implementation, tenants should become an integral part of the property rehabilitation process.

Conclusion

Until a decade ago, many local officials were reluctant to spend public funds on single-family rehabilitation because private individuals were the direct beneficiaries. Since the benefits of programs have generally been contained to lower-income homeowners, however, and expenditures have helped to improve entire neighborhoods, such officials have mostly been persuaded that public purposes are met in single-family housing rehabilitation.

Until a few years ago, there was a similar reluctance to spend public funds on rental properties because slumlords were the direct beneficiaries. Since the benefits of programs are shared by lower-income tenants, however, and the expenditures have a neighborhood impact, officials are becoming persuaded that public purposes are met in rental rehabilitation.

The enthusiam of reluctant local officials for rental rehabilitation is growing as programs gain more experience and achieve production goals. In HUD's Rental Rehabilitation Demonstration, for example, the national goal was to have 1,000 units under construction or completed by September 30, 1983. This goal was exceeded by 50% three months prior. The national experience has shown that rental rehabilitation is not only worth trying, but it does succeed in producing improved, affordable housing for low- and moderate-income tenants.

The discussion of neighborhood analysis, project financing, program administration, and tenant strategies, as presented in this guidebook, should help local officials develop clear and marketable program designs. Once the key decisions have been made under these and other topics, however, specific regulations and standards must be articulated. These should take substance as application forms, rehabiliation standards, lending agreements, mortgages and notes, etc.

There is a tendency among some local officials to blur the sequence of designing the *program* and then designing the *forms and documents.* As the tail should not wag the dog, the forms should not wag the program. The documents used by other localities may prove helpful to understand the types of instruments that are needed; however, officials sometimes make the mistake of adopting forms just because they exist elsewhere.

In a well-articulated program design, the substance of the forms and documents needed for implementation becomes readily apparent. Because the transactions involve real estate matters and significant financial issues, lawyers will usually become involved from both the public and private sides. Program operators are cautioned, however, to resist the tide of legal documents that will surely rise to create a sea of papers and redtape. Provide adequate documentation, but don't drown in it!

A final point: since the economic conditions of neighborhoods will fluctuate regardless of the detailed data collected, and property owners will act individually regardless of efforts to predict their response to a finance plan, the results of the program design process should not be seen as static. Adjustments and modifications may well be needed during the operational phase based on unanticipated factors. Therefore, while resisting the tendency to overlay excessive forms and procedures on the program design, public officials should avoid becoming stalled in an *over-massaged planning process.* Design the program according to considered public objectives and sound information. But don't delay operations until everything is tucked in and tidy.

Get the program moving!

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Notes

Notes

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