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State of the Market 45: Public housing's RAD-ical reinvention

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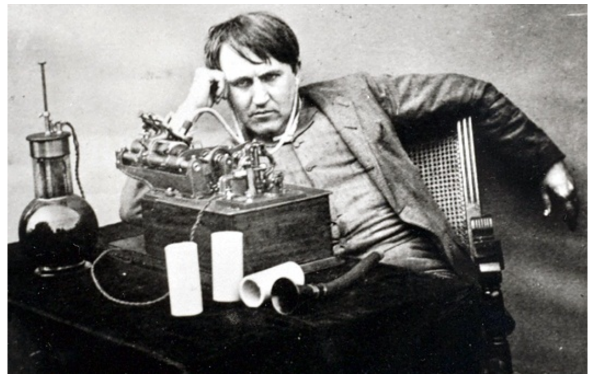
A critical piece of America's urban infrastructure is collapsing, a consequence of decades of underfunding stretching back over multiple Administrations. Unless something is done soon, the nation could lose an important resource: its public housing.

Fortunately, help may be on the way, in the form of HUD's Rental Assistance Demonstration (RAD) initiative, due to launch on a pilot basis. RAD has features drawn from recent experience with Mark-to-Market (M2M) and HUD's subsequent renewed-affordability initiatives.

RAD comes at a critical juncture for the public housing inventory, because a decades-old system is no longer viable, and dramatic reinvention is needed. This is an opportunity window similar to 1989's preservation and 1998's M2M and deserves a coordinated national response. If that happens, this could be the most exciting time in public housing in four decades.

Public housing, the irreplaceable yet long-neglected infrastructure asset

Public housing today is home to more than 1,300,000 American families of low and very low income. The inventory represents probably more than $100 billion worth of depreciated replacement cost, and faces a capital backlog conservatively estimated at more than $26 billion; personally, I think it's more in the range of $40-45 billion. The capital backlog is the result of chronic underfunding, tied to public housing's archaic and dysfunctional system of operating subsidy and modernization funds, where properties are:



Program-design genius is 1% innovation and 99% demonstration

- Legally prohibited from using collateralized financing or borrowing on their own
- Contractually locked in to zero Net Operating Income (NOI), with no replacement reserve, via the rent-setting requirements and federal operating subsidy structure
- Limited to periodic grants ('modernization funds') with minimal ability to forward-plan.

The properties themselves, though soundly built initially and often well located, are old, averaging more than fifty years. Few of them have had any major upgrading (modernization funds have tended to bring them back to basic functionality but not to rising market standards), and so have out-of-date bathrooms, kitchens, interior hallways, bedroom sizes, electrical wiring and circuitry, and interior plumbing. On a per-square-foot basis, public housing is the nation's least efficient to operate, according to a 2007 HUD study, due simply to age and obsolescence.

All this has been made worse by persistent under-funding. A succession of Administrations and Congresses has kicked the problem down the road until the inventory is literally falling apart.

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The radical reinvention plan: goals and procedures

Under authority granted in a previous Congress, in March HUD published proposed administrative guidance for its Rental Assistance Demonstration (RAD), a pilot that could spur the recapitalization of as many as 60,000 apartments nationwide. Though this will be nowhere enough for the whole inventory, other HUD pilots such as M2M has proven this is enough to experiment with the concepts and to create the early systems that can then be rolled out in a national program. As RAD goes, therefore, so goes the public housing inventory.

To recapitalize public housing we must move from the current system (entity-level financing with a crippling restrictive covenant) to an asset-based property-level ownership model that converts public housing authorities from into mission-motivated economic owners of their portfolio able to act upon it like any other. This change in ownership dynamics will enable newly enfranchised housing authorities to tap those capital resources available to every other type of mission-oriented owner and hence to compete for resources on a level playing field.

RAD has been designed to achieve the right three objectives:

1. *Enable new capital to flow into this inventory* so it can finance needed rehab, renovation, and upgrade.
2. *Liberate housing authorities from an overly regulated system* so that they can deploy entrepreneurial creativity in pursuit of ongoing affordability.
3. *Preserve primacy of the social mission* by having, as control entities, only bodies that are non-profit and publicly accountable.

Financial restructuring of this inventory is enormously complicated. The inventory is geographically diverse, widely varying in size and configuration, and obsolescent. New ownership and asset management of post-RAD properties are themselves challenging and complicated disciplines.

Many properties are not suitable for conversion to property-based assistance because of prior decisions concerning their location, layout, configuration, tenancy, and operations. Participation in the pilot must thus be entirely voluntary, with the housing authorities themselves choosing whether to participate and which properties to nominate as RAD candidates.

From HUD's perspective, RAD must be seen not only as a device for participating properties to recapitalize and reposition, but also as a laboratory to gather case-study experience, so that a larger-scale program can be designed with real knowledge. Hence enterprising Housing Authorities must be able to proceed on an expedited basis, with the explicit goal that these pilots will be accelerated (as was done in the M2M demonstration) all the way through to closing, so we can gain real-world case studies uncovering new issues, identifying risks and pitfalls, and developing underwriting and processes models that can be used in a wider program.

This will lead to recommendations of what existing armature must be suspended, waived, or abolished altogether if the inventory is to prosper and to fulfill its long-term missions.

Who plays, and with what results?

In simple terms, RAD converts a property *from* public housing *to* non-profit ownership with the housing authority as controlling party. The specific elements include these:

1. All public housing regulatory agreements are canceled and replaced with a single unified Use Agreement similar to that used in LIHTC or preservation transactions.
2. All current public housing assistance (operating subsidy and modernization funds) is converted to a property-based Section 8 contract at the same aggregate income levels.
3. At the closing, the property commits to do agreed-upon renovations or rehabilitation according to a scope worked out by the Housing Authority and approved by HUD.

4. Once so converted, the property is free to finance new debt immediately, and will need to do so to fund its required rehab.

Initial RAD rents are key. These vary dramatically across the country, even relative to local market rents or HUD FMRs, so some properties are not viable for RAD conversion, while others are quite viable. Hence voluntary participation is essential, lest unwilling Housing Authorities be forced into immediate insolvency.

To estimate the portfolio's impact, Recap was engaged jointly by the nation's public housing associations – NAHRO, the Council of Large Public Housing Authorities (CLPHA), and the Public Housing Authority Directors' Association (PHADA) – to prepare a comprehensive study. Using data from many participating Housing Authorities across the country, we analyzed the impact and overall financial feasibility of subsidy conversion, for a participant-selected cluster of over 125 properties totaling more than 25,000 public housing apartments nationwide. Our analysis, using data provided by the participating Housing Authorities themselves, showed an average capital backlog (physical components and building systems requiring immediate replacement, as reported by the housing authority) of $22,100 per apartment.

Based on the financing terms we believe these properties could obtain post-RAD in the debt marketplace, and assuming that 'current funding' corresponds to FY 2010 appropriated levels (the latest available data at the time of report issuance):

- 39% of the dataset properties can finance at least 100% of the reported capital backlog
- 25% more could fund some, but not all, of these needs.

However, even the FY 2010 funding is well below market, averaging only 72% of applicable HUD Fair Market Rents (FMRs). By contrast, if the funding were at 100% of FMR – the level the Department expects to pay for portable Housing Choice Vouchers – then 95% of the properties could fund some or all of their reported capital backlog.

Issues: affordability, rehab, and capital needs assessment

Permanent affordability and the double bottom line. Converting the structure of assistance and ownership must not be a cover for letting this inventory escape from public purpose; RAD-converted properties should be generally obligated to maintain public benefit. Maintaining a double bottom line is essential because public housing is part of a critical and underappreciated component of the urban fabric – it is where blue-collar jobs go to sleep at night, and where many of the people who make the city work are enabled to live in the city they work in.

If we were to lose this housing, through physical obsolescence or conversion to non-affordable uses, not only would the nation gratuitously write off more than $100 billion of previous public resources, we also would be unable to replicate the inventory prospectively, as many are located within urban infill and strategic locations within our cities and growing metropolitan areas.

To this end, HUD proposed that post-RAD properties execute a Use Agreement similar to preservation, which we expect will be senior to any new financing (as in preservation), not functionally junior in that it may be canceled in a foreclosure (as in LIHTC).

Appropriate rehab and the annual replacement reserve deposit (RRD). Rehab under RAD should be not just about correcting deferred maintenance but also upgrading and energy conservation. A properly planned renovation will reduce operating costs while improving resident health and satisfaction and reducing the environmental footprint of the property. The overall objective is adequate capital to fund physical needs, which capital can come from three sources:

1. The initial rehab loan coming from a financing.
2. Annual operations and maintenance, including potentially free cash flow.
3. The replacement reserve, as annually replenished by the RRD, which should be

level in real terms (i.e., rising annually with inflation).

Capital needs and a Green Capital Needs Assessment. With properties this old and this obsolescent, a normal capital needs assessment will not do. The proper standard is a Green Capital Needs Assessment (GCNA) that will identify the appropriate energy conservation measures and other environmental measures to integrate into the renovation plan. The Green CNA should include a replacement reserve analysis reaching forward twenty years).

Conclusion

RAD will arrive not a moment too soon. If it emerges as we expect, the program will be a significant success:

1. It will provide pilot properties that will allow Housing Authorities and their advisors to showcase how creativity can serve the ongoing mission of affordable housing.
2. It will generate innovative transactions and change the capital markets' perception of public housing, increasing capital availability and improving capital terms.
3. It should provide valuable input that will enable Congress and the Department to expand RAD from a small demonstration into a program that will transform and reinvigorate public housing throughout America.

RAD is due to go live soon. At Recap, we're keen to work with housing authorities and financing sources to launch the pioneers that will prove the concept and begin revitalizing this critical portfolio of assets.

Additional RAD Resources – available for the asking

Available upon request, we have (1) three articles I published in 2006-7 in NAHRO's *Journal of Housing and Community Development* envisioning how to restructure public housing, (2) Recap's conclusions from participating actively in the 1999 mark-to-market (M2M) demonstration, in many ways a RAD precursor, and (3) our detailed technical comments to HUD on how to make rent-setting and subsidy transfer work.

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