

THE SPACE BETWEEN

Realities and Possibilities in Preserving
Unsubsidized Affordable Rental Housing

Executive Summary



Introduction

Minnesota Preservation Plus Initiative (MPPI)

The Minnesota Preservation Plus Initiative is about proactive, sustainable housing policy and practice and reflects Minnesota’s longstanding commitment to systemic, long-term approaches to stabilization/preservation needs. This initiative is a community-wide approach to stewardship, focused not only on real estate but also on ownership and management. Every project that is capitalized properly, maintained, and operated capably—thereby avoiding costly preservation interventions—stretches existing resources further.

Preservation responses fall along a continuum, ranging from a passive system (limited ability to intervene) to a responsive system (response after opt-out notice is received or deterioration is at a critical point) to a preventive system (policies and resources support pre-emptive prevention).



Unsubsidized Affordable Housing; Its Place in Preservation Efforts

Just as preservation activity falls along a continuum of differing responses, the *type* of affordable housing addressed also varies. Typically, jurisdictions start by developing policies/resources to target properties with federal subsidies. Later, properties with local investment are a focus, and finally unsubsidized yet affordable properties can be addressed.



In Minnesota, the current system addresses federally and locally subsidized properties, but a comparatively less systemic response exists to address unsubsidized properties that are affordable to lower-income households. These properties, however, provide more affordable housing than the aggregate of all privately owned subsidized rental properties, and constitute valuable resources that merit preservation consideration. Included in this group are properties that have affordable rents and are currently occupied by lower-income households, as well as those that have affordable rents but are occupied by higher-income households.

The following report details the findings of a study conducted through MPPI to explore the nature and challenges inherent in this stock, and make recommendations for specific policies and strategies to identify and preserve these units. It was developed over several months of intensive research conducted by a Project Team, with valuable input from the Strategic Partners. However, the opinions expressed here are that of the Project Team and should not be viewed as a formal opinion or endorsement from any particular Strategic Partner agency.



Strategic Partners



Project Team



Definitions for This Discussion**SUBSIDIZED**

Units with project-based rent assistance or recipients of capital funding (with income and rent restrictions).

UNSUBSIDIZED

Units without project-based rent assistance or capital funding (may include tenant-based assistance).

LIGHT-TOUCH

New, highly-tailored interventions with customized affordability, compliance.

Minnesota policy makers have focused worthwhile and appropriate attention on preserving and increasing the state's supply of subsidized rental housing. However, most low-income renters do not live in subsidized housing, but instead, rely on the larger market of unsubsidized—yet affordable—rental for their housing. For this reason, optimizing this unsubsidized housing stock is also in the public interest and policy makers should seize select opportunities to maximize this important resource.

The majority of the unsubsidized rental market functions just fine without further governmental or nonprofit involvement. However, there are specific circumstances where a light-touch intervention can address a threat to this supply or an underutilized opportunity. This research focused on those limited, but important circumstances.

Ultimately, we believe that there is potential for limited, light-touch interventions in the unsubsidized rental housing market that could result in the preservation, creation, or better matching of existing affordable housing opportunities to those who need these resources most.

Interventions in the unsubsidized housing space, however, will look less like the highly-standardized programs often used in the subsidized housing industry; where resources, regulations, and structures are prescribed at federal and state levels with very little variation in their implementation. These standardized programs are operated largely outside of the influence of market dynamics and depend on consistently applied—if somewhat arbitrary—requirements. This strategy may be appropriate given the nature of subsidized affordable rental housing as a production backbone, where deep capital subsidies buy long-term affordability and where strict compliance and monitoring ensure the soundness of that investment.

By contrast, any light-touch interventions should be targeted toward only certain limited areas of the unsubsidized rental market, and need to be:

- responsive to a clearly identified reason to intervene;
- designed for the specific situations at hand; and
- re-engineered with changes in the local rental market over time.

Intervention Outcomes

Preservation. Prevent the loss of units to deterioration, demolition, or rent increases that would move the unit “up-market.” These may not necessarily decrease rent burden for existing residents or new residents.

Creation. Create new affordable rental housing opportunities by lowering otherwise out of reach rents. For instance, cost reduction programs might help drop rents to new/greater affordability levels.

Matching. Ensure that those who need affordable rental housing are getting access to it; matching rent and incomes to lessen or avoid rent burden. Examples include providing incentives for landlords to dedicate units upon turnover to lower-income households, or a voucher program that might help residents gain affordable access to units for which they could not otherwise compete.

The Nature of Opportunity (continued)

To effectively engage in this work, philanthropic and public entities will need to leave behind the comfort of strict program guidelines and seize the opportunity and responsibility to act in real time and in the context of market fluctuations. Prudent public or philanthropic interventions in this segment of the market require a tailored approach, taking into account local market dynamics (even to a micro-market level) while simultaneously keeping the regional context in view. Any intervention will require a nuanced understanding of what is needed in the local market, a knowledge of changing market dynamics, and consideration of the cost and benefit of any action against others.

Rather than being the core or primary response to housing need, intervention in the unsubsidized rental market may play a complementary role to that of deep-subsidy programs and might allow our communities to respond more fluidly and nimbly than possible through these existing programs. Much of the investigation leading to this report focused on distinguishing the difference between the unsubsidized affordable rental housing space and that of subsidized affordable housing.

Our Charge

This investigation was undertaken at the request of three Strategic Partners; the Family Housing Fund (FHF), the Greater Minnesota Housing Fund (GMHF) and the Minnesota Housing Finance Agency (Minnesota Housing) and is one component of a multi-year grant under the Minnesota Preservation Plus Initiative (MPPI) funded by the MacArthur Foundation. The vast majority of MPPI efforts focused on preserving existing subsidized affordable rental housing. This study is a complement to that work and does not indicate a wavering in the Strategic Partners' commitment to the preservation of subsidized units.

A Project Team was led by One Roof Global Consulting (One Roof) with instrumental participation of the Housing Preservation Project (HPP) and Urban Land Institute of Minnesota (ULI MN). This team combined significant technical expertise and a broad perspective on the importance of and issues surrounding affordable housing.

Our charge was to explore ways in which the Strategic Partners might support the continued affordability of rental housing that does not currently receive direct public subsidy.¹ This was envisioned to include the following light-touch intervention possibilities:

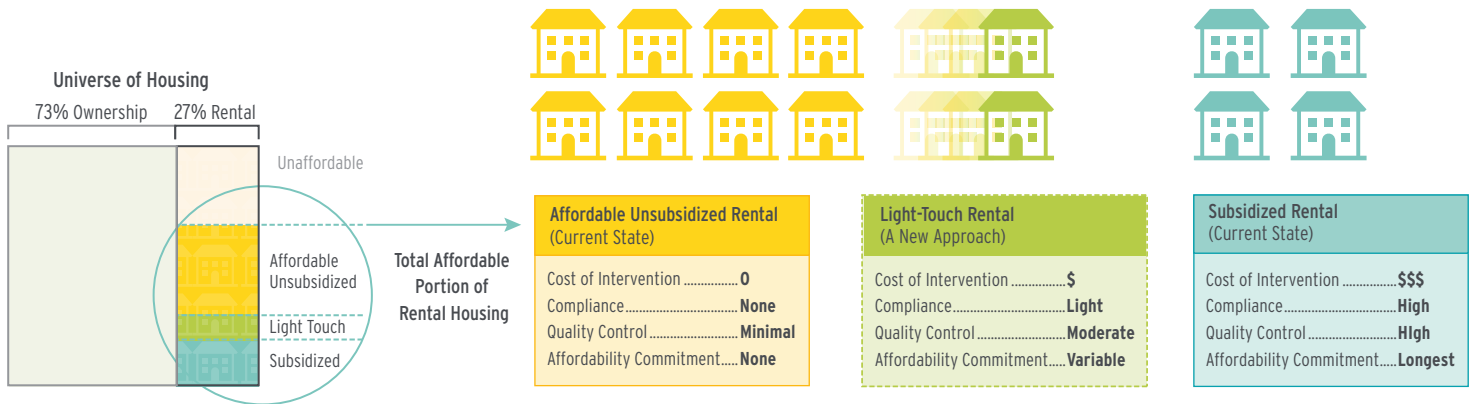
- Shallow, direct financial incentives
- Operating cost reduction efforts
- Technical assistance
- Regulatory options

The intent was not to simply convert unsubsidized rental housing into subsidized rental housing, which would create greater competition for already oversubscribed subsidy funds. Rather, it was to think of new ways to influence select portions of the unsubsidized market to bring these properties closer to the characteristics that provide public benefit (depth and durability of affordability, quality assurance, etc.).

1. This refers to deep capital subsidies like LIHTC, HOME, etc. Properties that accept Section 8 vouchers from individual tenants would not be considered subsidized for the purposes of this study.

Creating Light-Touch Rental Housing

Light-touch rental housing is a new approach to ensure housing affordability in the unsubsidized affordable market. It should be highly-tailored to respond to specific market conditions and local community needs.



Our Charge (continued)

We sought to define and understand the existing unsubsidized rental housing market and identify what could be done if the Strategic Partners were to decide to take action. This was an open and practically-oriented investigation of the current realities and possibilities in Minnesota, with a focus on the Twin Cities Metropolitan Area. The following is a summary of our findings regarding the dynamics of this housing market, the categorical interventions possible in this space, and our recommendations to the Strategic Partners to pursue specific steps to enact particular interventions.

The Unsubsidized Affordable Rental Housing Market in Minnesota

The Importance of Unsubsidized Rental

In the Twin Cities Metropolitan Area unsubsidized rental comprises at least 57% of all units with rents affordable to households at or below 50% of area median income (AMI); equating to as many as 120,000 units of housing.² The continued affordability of this unsubsidized housing—and its occupancy by those with corresponding need—cannot be taken for granted. There are neither controls to ensure the enduring affordability of these unsubsidized units, nor are there forces in the unsubsidized market to place low-income households, rather than high-income households, in the most affordable units.

2. Housing Preservation Project (HPP) calculation based on HUD's 2005-2009 CHAS data and HousingLink's Streams data. Depending on whether unsubsidized affordable units currently occupied by Section 8 voucher holders are counted in this supply or not, the share of the affordable rental market that is unsubsidized is either 57% or two-thirds. As noted elsewhere herein, a good argument can be made either way.

The Importance of Unsubsidized Rental (continued)

Over the past decade, statewide rents have increased a seemingly modest 6%. However, incomes over the same period have dropped by 16%.³ As a result, the percentage of very low-income households⁴ who are cost burdened increased by over 30%.⁵ Moreover, Minnesota Housing Partnership reports that from 2000-2010, Minnesota had the fastest increase in households paying more than half their income for housing of any state.⁶ Most recent reports and our discussions with stakeholders indicate that Metro Area landlords are currently making up for an extended period of rent stagnation, with continued plans to raise rents. Furthermore, new units being constructed in the unsubsidized market necessitate charging the highest rents (particularly on a per square foot basis) in order to cover development costs. Dependence on unsubsidized market self-regulation or adjustment is unlikely to benefit low-income people. The trickling down of any benefit of new construction currently underway is likely a very long-term, if not dubious proposition.

Unsubsidized Owners: Motivations and Challenges

Most, but not all, possible interventions in this space are simply different ways to influence the behavior of owners. In order to entertain the full spectrum of these possibilities we sought to understand the types of owners, their existing motivations, and the challenges they face in operating unsubsidized rental property by talking to them directly. Our observations are outlined here.

Types of Owners

While these owners are diverse, we have categorized them into three broad types:

- **Do-It-Yourself (DIY)/Part-time.** Owners with small portfolios consisting primarily of four-plexes, duplexes, and single-family homes that are self-managed and considered secondary sources of personal income or investment. These owners are most often employed in another industry with rental property as a side business.
- **Small-scale Professional.** Owners with portfolios that are less than 100 units that may or may not have professional management, but view property ownership and/or management as their full-time occupation.
- **Large-scale Professional.** Owners with portfolios of 100+ units that provide professional management as a related business line or through a fee-for-service arrangement. These are mostly formal business organizations that operate as an on-going concern, rather than individuals or partnerships.

In Greater Minnesota this typology exists, but is also greatly influenced by the size, economic growth, and demographics of the communities in which they work. It is worth noting that, across the board, nonprofit organizations are largely absent from ownership in the unsubsidized rental housing market.

3. Minnesota Housing Partnership. *Slides for Housing Advocates*. January 2013.

4. Households earning 50% or less of AMI.

5. HPP calculation based on HUD's 2000 & 2009 CHAS data. This figure also includes housing deficits of overcrowding and lack of basic services, which are thought to be de minimis.

6. Minnesota Housing Partnership. *Slides for Housing Advocates*. January 2013.

Owner Motivations

- **Cash flow.** The main motivator for each group is cash flow, with the DIY/part-time owners being more acutely affected by property cash flow disruptions.
- **Long-term investment.** Virtually all owners claimed to acquire properties with the intent to hold them for the “long-term,” defined variously, but always reported as longer than 10 years. Admittedly, our focus groups were more likely to attract conscientious and committed owners willing to discuss their business and its relationship to affordability; thus, we may not have been exposed to those involved in speculation.
- **Asset building.** Large-scale owners were the most concerned with and best equipped to maintain or build value in the real estate, meaning they are motivated to plan for and methodically address the capital improvement needs of their housing. DIY/part-time owners’ motivation in this regard is more varied, and the distance the owner must travel to the housing is a key factor in such improvements over time. Appreciation is a secondary factor to cash flow in buying decisions and return expectations.
- **Interaction with government.** Generally speaking, the DIY/part-time owners were more likely to want to avoid any involvement in government programs; thus, making intervention there much more challenging.

Owner Challenges

- **Management.** Property management can be particularly challenging for DIY/part-time owners, but even large-scale professional owners detail the challenges presented by marketing, tenant screening, maintenance, and rules enforcement. Management challenges/shortcomings can become community concerns in the case of problem tenants and exterior maintenance.
- **Operating costs.** Operating costs are continuously rising, often independently from an owner’s ability to recoup them in rents. The two most frequently mentioned/troublesome operating costs were:
 - Property taxes—both pace and unpredictability of increases; and
 - Utilities—particularly the variability of publicly-provided ones.
- **Financing.** Access to and terms of financing for acquisition, rehabilitation/improvements, and refinance of existing debt varies greatly. Large-scale professional owners appear to be in a very liquid market for capital. Several lenders described a frenzy driven by low rates. Access to finance continues to be difficult for DIY/part-time owners, inexperienced owners, and any small-scale professional owners who lack strong banking relationships. The short-term nature of the financing currently available in the market is of concern when considering long-term affordability or even stability of properties.

Identifying and Exploring Possible Interventions

Throughout interviews and focus groups with over 150 Minnesota stakeholders and national experts, we solicited ideas on possible interventions that might preserve, create, or match affordability in unsubsidized rental housing.

Through this process we identified nearly 50 intervention ideas, sought existing examples or parallels, and cataloged them. We then selected a few of these ideas, which appeared to have promise, but needed more investigation in order to understand their potential. The Strategic Partners, as the state's policy makers and affordable housing administrators, guided the selection of five promising ideas. These selections became the subject of deep-dive work groups with local technical experts. The Project Team then revisited all the suggested interventions (those that were the subject of deep-dives and others) to make recommendations to the Strategic Partners.

Guiding Principles for Action

We suggest that any action that the Strategic Partners consider taking in the unsubsidized affordable rental space be guided by the following principles:

- Recognize that this is different than subsidized affordable rental.
- Capitalize on the lack of rules/dictates.
- Use local touch/knowledge.
- Pay attention to regional context.
- Choose partners/targets wisely.
- Monitor, evaluate, and actively manage.

A Suggested Strategy to Test Key Interventions

The Project Team recommends that the Strategic Partners engage in a demonstration program(s) with select cities to more fully understand if the identified interventions, and in what combinations, would achieve the goals of preserving or creating affordable housing within the unsubsidized rental market. The demonstration(s) would test the political, financial, and administrative viability of such interventions. It would also allow for the Strategic Partners to tailor interventions based on local dynamics in a demonstration context where financial and reputational risk can be minimized. These should be phased and managed by the Strategic Partners, or their designee, as follows:

Phase 1: Determine the scope of the demonstration program

Phase 2: Test intervention(s)

Phase 3: Evaluate and adjust

Recommendations

We have made four different types of recommendations.

1. **First Order Recommendations**—recommendations that we advise even if no other actions are taken.
2. **Direct Interventions**—project or program level interventions that are designed to impact a subset of properties, and/or provide a direct incentive to a property owner in exchange for an affordability pledge.
3. **System-wide Interventions**—interventions that provide benefit on many levels to all property owners and property types.
4. **Long-term Recommendations**—ideas to monitor as the market changes.

1. First Order Recommendations

We recommend that the Strategic Partners take these steps, even if no other interventions are contemplated.

- **Communication.** Promote understanding of the importance of the unsubsidized inventory as part of the affordable housing delivery system. Communicate the issues explored in this work with other important public, private, and philanthropic audiences that could be implementation partners.
- **Data.** Determine when and what kind of data is important enough to justify the resources to collect it. Establish a data protocol for the gathering and analysis of this useful and practical data. Start first with existing data. The protocol could provide for better tracking of unsubsidized properties, rent levels, etc. Highlight successful city inventories and encourage other cities to do similar work.
- **Metropolitan Council Regional Housing Policy Planning.** The Metropolitan Council has a unique function and influence that ranges beyond that of the subsidized housing realm. For that reason, we highly recommend involving this agency in any efforts. Their involvement would enhance the ability of the region to recognize the value that unsubsidized rental housing contributes to our communities. Recommendations relating to this organization include:
 - Increase the understanding of their process for determining regional affordable housing goals.
 - Encourage a new formula for calculating affordable housing goals including a more nuanced definition for what counts as credit towards the Livable Communities housing goals.⁷
 - Create incentives for local governments to test identified interventions.
 - Build this work into the Metropolitan Council Regional Housing Policy Plan.
- **Support mission-driven owners' entry into the unsubsidized space.** Continue to explore and understand the barriers and hesitations of mission-driven actors (both nonprofit and for-profit) and assist those who are interested in doing so to become involved.

7. The Livable Communities Act is a grant program operated by Metropolitan Council in which Cities elect to participate by agreeing to work towards providing their share of affordable housing needed, as calculated by Metropolitan Council, for the metropolitan region. Participant cities also agree to invest annually towards building or preserving affordable housing within their communities.

2. Direct Interventions

Consistent with the spirit of this investigation, our suggested interventions focus on light-touch approaches; a much lower level of financial incentive than existing deep-subsidy sources, with fewer requirements and more flexibility.

- **Local government rent subsidy.** This is a potentially cost efficient method for creating or retaining affordable housing opportunities through a locally-funded and administered rent subsidy program(s). Cities that have limited opportunities to invest in the development of new affordable units could use local funds to create new affordable opportunities by writing down rents on existing units. This could also help to ensure that there is a match of lower-income households to the existing unsubsidized affordable housing supply. We recommend the Strategic Partners take the following steps:
 - Solicit interest from cities and property owners and include within a demonstration program administered by the Strategic Partners.
 - Encourage Metropolitan Council to recognize a rent subsidy program as contributing toward the local Livable Communities affordable housing goals.
- **Second mortgage/mezzanine debt/loan participation.** A second mortgage, mezzanine debt, or loan participation product might increase the availability of long-term, private sector debt for acquisition, rehabilitation, and/or refinance of properties that are currently offering some level of de-facto affordability. We recommend the Strategic Partners take the following next steps:
 - Solicit interest on the part of existing CDFI or funding intermediary to implement such a lending program and determine the parameters under which they would consider participation.
 - Provide resources (existing or through new program-related investment sources) to use alongside commercial debt.
- **Property tax incentives.** Through our research, it was revealed that Minnesota's Low Income Rental Classification Program (LIRC) or Section 4(d) program allows a local government to qualify properties for tax property breaks if some form of local financial assistance is provided and the owner agrees to income and rent restrictions. This underutilized provision creates the possibility for local governments to address housing goals by foregoing tax revenue in addition to offering cash incentives or regulation. We recommend that the Strategic Partners take these next steps:
 - Track any modifications to the Section 4(d) legislative authority through the upcoming legislative session and understand how a rewrite of the property tax laws would alter or eliminate Section 4(d).
 - Convene a broader conversation with a wide range of local governments (specifically targeting cities along emerging transit corridors), including counties, and perhaps the Metropolitan Council to discuss this tool and attempt to garner support for its prudent use.

3. System-wide Interventions

The Strategic Partners should consider enacting these interventions themselves or enlisting the right implementation partners to do so.

- **Encourage cities to:**
 - Use rental licensing programs to communicate with owners regarding interventions for maintaining quality and value in their investment.
 - Link educational and regulatory approaches. There are examples of cities that promote training by lowering licensing fees for participants.
 - Enact rental licensing regulations that include the stick and carrot approach, incentivizing and rewarding good behavior, and penalizing poor performance.
- **Reward cities that adopt rental licensing programs by:**
 - Providing added points within funding applications.
 - Favoring cities that require rental licensing in a newly weighted formula for determining contribution to regional affordable housing goals by Metropolitan Council.
- **Maximize the usefulness of the MN Housing Policy Toolbox to support unsubsidized rental housing efforts by:**
 - Promoting use of the Toolbox through Metropolitan Council, Minnesota Housing Partnership, Minnesota Multi Housing Association, ULI-MN/RCM, etc.
 - Incorporating strategies and recommendations from this report into the Toolbox where appropriate.
 - Developing a navigational tool within the Toolbox that can make accessing information on unsubsidized rental resources easier.
 - Identifying an ombudsman to help connect educational resources with technical and financial expertise depending upon the issue.
 - Creating a section specifically for rental property owners: “Help Rental Owners Succeed.”
- **Promote existing landlord/owner educational efforts.** Work through the Minnesota Multi Housing Association, Lutheran Social Services, local city property owners associations, the Crime Free Multi-Housing program, etc. Consider models for a single point of contact for information, technical assistance, and training similar to Chicago’s Preservation Compact.

4. Long-term Recommendations

The Project Team identified specific ideas that should be monitored in the future by the Strategic Partners as the market changes. The market conditions could impact the opportunity to intervene.

- **Short-term debt refinance.** Many properties taking advantage of the very low rates currently being offered in the market will need to find new financing in the next three to five years. This may provide an opportunity for intervention by public or philanthropic entities—exchanging debt for affordability commitments.
- **Use of Variable Rate Demand Notes (VRDN) or “low-floaters.”** While this financing option has been altered—possibly permanently—by changes in bank regulation and is currently not competitive with federally insured debt mechanisms, we recommend that the Strategic Partners monitor the changes in capital markets as this tool could lend itself well to acquisition of unsubsidized affordable rental housing.

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