NEW AFFORDABLE RENTAL HOUSING FOR NEW YORK CITY
A Program for Large Numbers of Small Buildings
February 11, 2014

By Michael Lappin and Mark Willis[1]

Now that Bill de Blasio has taken the reins of government, one of his most daunting challenges will be reaching his goal to build and preserve 200,000 units of affordable housing. Both the scale and cost of such effort seem monumental, but a page from past successes, plus today's low interest rates, may help confront these challenges.

A proposal for a moderate-income rental housing program.

An often overlooked resource of the City is the virtual army of small builders who have developed many of the small apartment houses that have sprung up across the City over the past decades. Mayor Koch's 10-year housing plan of the late 1980s, continued by Mayor Dinkins, used such builders to rebuild a high volume of abandoned city-owned buildings at low costs under the plan's "vacant building" program. A similar program, focused on developing small sites, can take advantage of the talents, expertise and cost efficiencies of these owner/builders, to create a new generation of low-cost affordable rental housing. The program can also offer an excellent opportunity for owners of small, underused sites (e.g., religious organizations) to develop their holdings in a productive and socially useful way.

While the City currently owns few vacant buildings or lots it can sell for a dollar as in the Koch/Dinkins era (1986-1992), there are numerous small privately owned lots found in many City neighborhoods, and many opportunities to create new sites through rezoning and repurposing publicly owned lands. Today's low interest rates – 30-year mortgage rates are 300 to 600 basis points lower than the Koch era -- makes room for the acquisition of these sites. The challenge is how to weave these market place advantages (low rates, low cost builders) into a robust production program for affordable housing.

A key to attracting small and mid-sized owner/builders—essential for the program to be successful—is minimizing its complexity. Simplified processing and requirements, as detailed below, is crucial to building large numbers of modestly sized buildings. More complexity will undoubtedly narrow the universe of builders/owners willing and able to participate, as the process becomes more costly and time consuming, and less financially feasible.

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Here's how the program can work:

1. With a focus on the redevelopment of the many small sites (say up to about 20,000 square feet with suitable street frontage) scattered across the City, the City would offer pre-qualified builder/owners an opportunity to build and own moderate-income rental housing on such sites. The City would provide a one-percent, subordinate mortgage to supplement a construction loan from a private lender. This low cost loan from the City would allow for the rents to initially be set at levels that ensure affordability suitable to the site. The City and State pension funds would purchase the private lender's construction loan and convert it to a 30-year fixed rate permanent loan insured by the State of New York Mortgage Agency (SONYMA). The rate on the pension fund loan would be set at the start of construction (see paragraph 3 below).[2] To fill out the financing package, the builder/owner would need to put up at least 10% of the total development cost.

2. In determining the underwriting for the public and private loans, there are several considerations:

    a. The City's share of the financing package would be sufficient to enable the projects to rent at an affordability level determined by the City for the particular sites. If even lower rents are desired for a given site, the City's Department of Housing Preservation and Development (HPD) would adjust the financing to allow for these lower rents.[3]

    b. The first year cash-on-cash return on the builder's investment would target about 8% -- an attractive return in today's market. Thus, the ratio of net operating income to the cost of public and private debt ("debt service coverage") would be about 120%.

    c. The pension fund mortgage, as well as the City's subordinate mortgage, would be fixed for 30 years. While the former will fully amortize over the 30 years, the City loan may be interest only, with the full loan payable at the end

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[2] The Pension fund program of economically targeted investments for affordable housing in the City and State has provided over $1.3 billion of 30-year fixed rate mortgages insured by (SONYMA and a City insurance program -REMIC) since the program's inception in 1983. The investments have suffered virtually no losses of principle or interest – the insurers have absorbed losses of about $6 million – with the City funds reporting its one of its highest yielding fixed income investments. The City may have to work with the City and State funds to expand that program to support this initiative.

[3] It should be noted that this program might not be suitable for the lowest income households, where limited rents may barely support operating costs, let alone debt costs. Overcoming this with internal cross-subsidizing strategies may be unworkable given the small building focus of the program.

of the term. (To limit over mortgaging of the property in future years, the City would maintain its current practice whereby any excess refinancing proceeds would first go to repay the City subordinate mortgage.)

d. The project would be eligible for 25 years of real estate tax abatement/exemption under the City's 421a program. (Legislative consideration may be given to extend 421a term to 30 years to match the financing term.)

e. In order not to over pay for land or create an artificial market for the program, HPD would set price caps by neighborhood for site acquisitions. In setting such caps, consideration will be given to existing values in the neighborhood, as well as realistic affordability levels the program wishes to achieve in the area. The acquisition cost recognized by the City for financing purposes would be the lesser of the HPD cap or its market valuation. Purchases above such caps would increase the amount of cash the owner/builder invests, thus reducing their returns. Given today's low capitalization rates that properties are selling, owners might willingly invest more equity to buy land at higher prices than the program will finance. The workability of such caps will be tested over time, and will undoubtedly be adjusted periodically.

3. This combination of fixed rate 30-year financing (with the long term rate set at the beginning of construction – an important feature of the pension fund program) and minimal taxes, should provide long-term financial stability to the project. It will provide protection from spikes in interest rates, both during construction and afterwards, and virtually eliminate real estate taxes for most of the term of the financing.

4. The high ratio of fixed costs to variable costs provides both a cushion against unexpected increases in operating costs and the potential for growing investment returns. This provides long-term financial incentives for owners to properly manage and maintain the property.

5. The initial residents of the building would be income qualified in accordance with the affordability standard set by the City. Thereafter, the rents would be regulated under the current rent stabilization system. The building would be committed to remain under that system for a fixed, say, 30-year period.

6. Development costs should be lower, reflecting the efficiencies of the builder/owners and the relative simplicity of the program.[4]

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[4] The program assumes the existing wage scale for the owner/builders. If prevailing wages become an issue, two outcomes may occur. First, construction costs may increase by up to 25%. Second, many small builders may be reluctant to participate, as it is difficult to run a business where workers get different wages for the same work at different sites. See

a. Construction prices are expected to be lower for owner/builders since they will be building for themselves, earning a healthy return on their investment through rental income. As an example, about 50 in-fill walk-up buildings were developed by CPC over the past 10 years using third party contractors. The most recent "hard" construction cost of these properties was between $170 and $185 a foot, which includes typical profit margins of about fifteen to twenty percent. With builder/owners in effect trading up-front profits for long-term earnings, the program's lenders should be able to underwrite some portion of such lower costs with appropriate completion guarantees.

b. Transaction costs are expected to be lower, replicating the relative simplicity of the long-established "Participation Loan Program" whereby City subordinate mortgage funds are combined with the City's pension funds. These costs compare favorably with complex publicly issued bond programs.

7. The program can also help existing owners develop their small sites. For these owners the program defines a practical way to both understand the potential of their holdings and provide a straightforward method to develop them. This may be particularly relevant to small religious institutions, etc. who increasingly look to assist their congregations who need affordable housing. Furthermore, if de Blasio's reported plan to increase tax rates on vacant residentially zoned land is enacted, the proposed program might prove an attractive complement to spur their development.[5]

8. Given the scarcity of the City's inventory of vacant land and/or buildings and rising prices of private sites, additional measures should be taken. Along with a reasonable cap on land values as proposed in paragraph 1(e) above, the Administration could aggressively rezone underutilized private sites as well as rezone and/or utilize available publicly owned land.

    a. There exist many unused or underused sites that may be suitable for rezoning. Consideration may be given to up zone other areas appropriate in the context of the existing neighborhood, particularly near transportation hubs. Land prices in these areas may fit the affordability parameters of the program.

Citizens Housing & Planning Council's December 2008 paper "Prevailing Wisdom – The Potential Impact of Prevailing Wages on Affordable Housing."

[5] See Crain's November 24 article "DeBlasio tells vacant lot owners to put up or pay up" http://www.crainsnewyork.com/article/20131124/REAL_ESTATE/311249973

b. Utilize and/or rezone publicly owned sites. A study done by Michael Kwartler in 1991 outlines the potential of this approach for public housing sites.[6] Similar studies should focus on other publicly owned lands.

c. To lower costs on rezoned sites used for this program, there might be consideration to reducing parking requirements.

9. Standardized documents, loan underwriting standards and procedures should be created in concert with construction lender(s) who have access to the public pension funds. **Such simplification is crucial to reducing administrative barriers to enable the participation of small builder/owners.**

   a. Other helpful program enhancements include fast tracking the projects through Building Department reviews; and expedited processing through HPD for both subsidized loans and real estate tax benefits.

   b. The construction lender must be thoroughly familiar with the public programs and experienced in dealing with small builder/owners.

10. Construction standards for a variety of zoning sites should also be developed. The CPC walk-up in-fill model is one example that works in "R-6" zoned sites with minimum widths of 30 to 40 feet, and was used to fill in the "missing teeth" in such areas.[7] The ability to maximize the usable FAR on a site-specific basis will be a constant design challenge. Other models should be developed for "R-7" and other residential zoning densities.

Table I below provides an example of how the program might work to develop a version of the above-mentioned walk-up buildings. It shows how much subsidy per unit would be required for the building to be affordable to households at various income levels. The example assumes: residents pay 30% of their gross income for rent; land costs at $50/buildable foot; construction costs of $170/SF (includes normal contingency) plus funds for parking (may be waived); permanent loan interest rate 5.25%; first year cash-on-cash return for low to higher median income housing, 7.50% – 11.87% respectively (120% debt service coverage); financing of 90% of recognized development costs; no unusual site problems. The model also assumes 83.5% efficiency of the site's FAR, an outcome dependent on the actual configuration of the individual sites. As the need for subsidy diminishes, as illustrated in Table I for housing built for households at 110% of median income, the need for a subsidized revolving pool of construction financing may be necessary, as the percentage of loan to development costs may exceed conventional lending standards. See the recommendation in 1b below.

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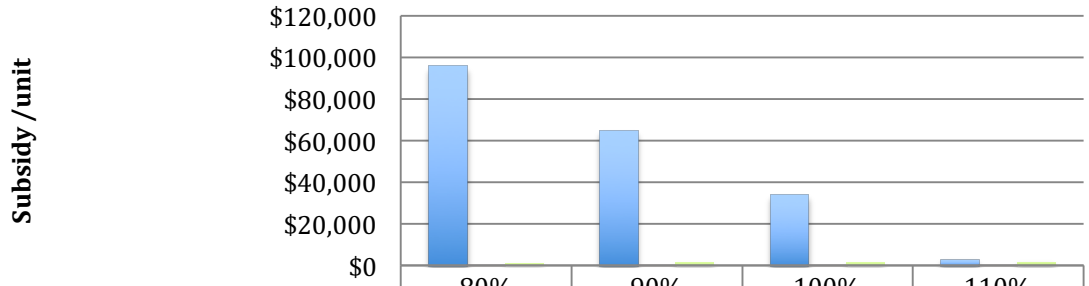
[6] "Building in Your Own Backyard: Affordable Land for Affordable Housing, *A Program for Affordable Housing on Public Housing Authority Estates.* Michael Kwartler and Associates, February 1991.

[7] See appendix

Table I. Subsidy and Returns for New Moderate Income Rental Program



	80% median income	90% median income	100% median income	110% median income
public subsidy/unit	$95,559	$64,703	$33,846	$2,990
1st year cash-on cash returns	7.43%	8.88%	10.34%	11.79%
2 bedroom rent/month	$1,548	$1,742	$1,935	$2,129

Footnote: Table I values assume the following:
2013 median area income (HDC); room size HPD standard

income	household size	# of rooms	square feet
$85,900	Family of four	3 BR	1000
$77,400	Family of three	2 BR	800
$68,800	Family of two	1 BR	650
$60,200	Individual	0 BR	500

A Variation: Rental Housing that is Affordable to Middle Income Households but without the City's Low-cost Loan – a Small Building Version of Mitchel-Lama

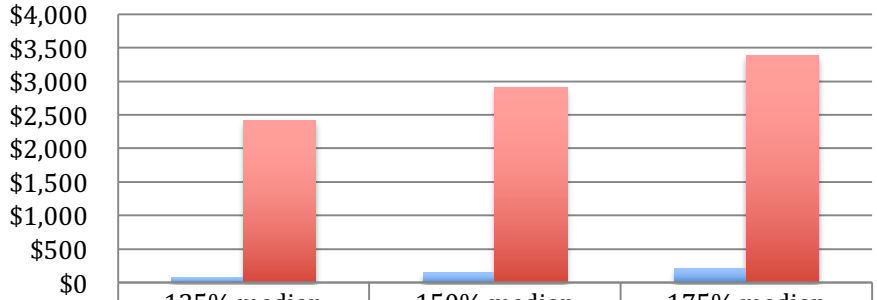
1. Some Privately-Owned Sites could produce affordable middle-income housing without any city subordinate loan. For certain well located sites it may be sufficient just to offer both 90% fixed rate financing coupled with 25 (or 30) years of 421a real estate abatement/exemption, with little or no additional subsidy, to attract builders for higher income rental developments (See Table II below). This might be viewed as a successor to the Mitchel-Lama program for smaller sites. Three innovations in current programs might be considered to accomplish this.

    a. Benefits under the 421a tax abatement/exemption program might be extended to 30 years to match the financing term.

b. In the absence of subsidy to help finance the building of the properties, many construction lenders may not be willing to fund 90% of development costs, as it may exceed its underwriting standards which today are generally limited to around 75% of costs. In these situations the City might make available a revolving credit line at market rates to fill the gap, with that line being paid down upon the completion of construction and the rent up of the building ("stabilization") on project completion.

c. SONYMA will have to find insuring investments for higher income "workforce" housing without direct public subsidy is consonant with their mission. Its current underwriting standards should accommodate such financing as the program model assumes a sufficient cushion (debt service coverage of 120%), which is in excess of their minimum standard. Such insured mortgages would be eligible for purchase by the City and State pension funds under their existing programs.

Table II. Land Price and Affordability Levels with no Public Subsidy



	125% median income	150% median income	175% median income
land price/FAR	$90	$160	$230
2 Bedroom rent/month	$2,419	$2,903	$3,386

(Footnote to Table II: Table II illustrates how much could be paid for land to develop the in-fill model for the various affordability levels. In this example there is no public subsidy other than 25 years (possibly 30 years) of 421a real estate abatement and exemption with financing for 90% of the recognized total development costs. Table II assumes the same values for construction costs, rate, etc. as Table I. The first year cash on cash return to the owner/builder when the building is fully rented is about 11.5%. It also assumes that residents will pay 30% of their gross income to rent.

2. To the extent the above affordable middle-income housing are built on publicly owned land, (whether such sites become available through rezoning or are currently unused) there may be an opportunity to reduce rents and/or use the sale proceeds to cross-subsidize other affordable housing. Table III gives an example of

the potential funds that might become available from the sale of these sites to developers of middle income housing at the affordability levels outlined in Table II.

Table III. Potential Funds from Sale of Public Land to Produce Middle Income Housing[8]

Target Market Rents	125% median income	150% median income	175% median income
Funds Generated	$60,000 per apartment	$110,000 per apartment	$160,000 per apartment

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The viability of this type of program was amply demonstrated during the Koch "vacant building" program. That program was noteworthy for both its low cost and scale. Under that program, thousands of apartments in abandoned city owned apartment buildings were rebuilt for moderate-income residents by small private owner/builders. Cost wise, the program was the least expensive of the different approaches tried by more than half the most expensive. The average development cost, with free land, was around $85 thousand a unit. The volume of the program was the largest – over 20,000 apartments were renovated during the Koch and Dinkins years. J-51 benefits eliminated real estate taxes for 20 years; the public employee pension funds provided a fixed rate 30-year mortgage, insured by the State of New York Mortgage Agency.

The need to build and preserve affordable housing is vast and public funds to support this are scarce. This approach is one such proven method to build low cost housing on a large scale, efficiently using public subsidy and potentially produce surplus funds when used to create middle-income housing on public lands. It can, and did build and rebuild neighborhoods. And, it produces a treasure trove of good paying construction and management jobs.

The knowledge of the program is in the bones of the City's housing agency (HPD). It is a flame to be reignited to help reach our new mayor's housing goals.

[8] The dollar amounts of funds generated have been discounted by 20% to allow for transaction costs.

APPENDIX: EXAMPLES OF INFILL WALKUP PROJECTS ON R-6 ZONED LAND