



## MEMO

To: Harrison Rue, Department of Planning and Permitting  
From: Rick Jacobus, Street Level Advisors  
RE: Policy Options related to Affordable Housing Requirements  
Date: December 23, 2016

The City and County of Honolulu is considering adoption of affordable housing requirements (AHR) which would ensure that new residential development includes a portion of homes that would remain affordable to lower and moderate income residents over the long term. The requirements were proposed in the Mayor's Affordable Housing Strategy, as revised in September 2015. The City engaged Street Level Advisors to help refine the AHR strategy and plan for the implementation of such a program. Over the course of a two-day site visit we met with housing developers, housing advocates, state agency partners, and key City staff from several departments in order to better understand the City's needs and current capacity to implement this program. Our discussions focused on two distinct issues:

1. Given the uneven market conditions in communities across the island, should requirements be scaled (different percentages) or phased in over time geographically?
2. How should the City plan for long term monitoring, administration, and stewardship of affordable homes created through the program?

### **A. Geographic Phasing**

There are over 500 communities in the United States that impose affordable housing requirements either on all new residential development or on development that takes advantage of certain planning incentives<sup>1</sup>. For the most part, these programs, which are commonly referred to as "inclusionary housing" or "inclusionary zoning" programs, impose a single requirement across an entire city or county. However, as communities have become more adept at evaluating the economic feasibility of these requirements, there has been a trend toward requirements that recognize the uneven market strength of different neighborhoods within a jurisdiction.

Most communities include neighborhoods where the housing market is very strong as well as neighborhoods where there is far less development pressure. If affordable housing requirements

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<sup>1</sup> Achieving Lasting Affordability through Inclusionary Housing, Robert Hickey, Lisa Sturtevant, and Emily Thaden, Lincoln Institute of Land Policy, 2014.

are set too high in an area, they can be perceived as a barrier to new development, and if they are set too low, they produce less affordable housing than they otherwise could.

The City commissioned Strategic Economics to complete an economic feasibility analysis of the potential affordable housing requirements<sup>2</sup>. Strategic Economics followed the national established best practice for these studies. They identified several of the most common local residential development prototypes and evaluated their profitability in several different locations across the city. They found that the rents and condo sales prices were too low in many parts of the island for new housing development to be economically feasible (with or without any affordable housing requirements)<sup>3</sup>. At the same time, they found that in Ala Moana the rents and prices were significantly higher and development would be not only feasible but highly profitable. Table 1 summarizes Strategic Economics’ assessment of the financial feasibility of the proposed requirements. In short, they found that, of the four geographic areas they studied, development was only likely to happen in Ala Moana, considering current market conditions. They only studied a few locations, but it is likely that there is similar market strength in Downtown and Kakaako due to similar characteristics. They further found that within Ala Moana, development was profitable enough that the proposed affordable housing requirement, combined with the proposed set of incentives, would reduce profitability but not by enough to deter development. Projects that were profitable without the requirement would still be more than profitable enough to proceed even with the new requirements. In other areas, the requirements would make unprofitable projects even less feasible at this time.

**Table 1: Strategic Economics Return on Cost for Condominium Prototypes**

		Low-rise, Kapolei	Low-rise, Pearlridge	Mid-rise A, Kapalama	Mid-rise B, Kapalama	High-rise A, Ala Moana	High-rise B, Ala Moana
<b>Baseline (No AHR)</b>		-13%	10%	-7%	5%	1%	25%
<b>On-Site Affordable Housing Requirement</b>	Before Incentives	-16%	5%	-12%	0%	-5%	16%
	With all Incentives	-15%	7%	-10%	2%	-2%	19%
<b>Off-Site Affordable Housing Requirement</b>	Before Incentives	-16%	5%	-12%	0%	-5%	16%
	With all Incentives	-15%	7%	-10%	2%	-2%	19%
<b>In-lieu Fee</b>	Before Incentives	-20%	0%	-13%	-2%	-4%	17%
	With all Incentives	n/a	n/a	n/a	n/a	n/a	n/a

\* Projects with greater than 18% return on cost are considered feasible (Shaded green)

While Honolulu’s market is extreme in many ways, this pattern is not unusual. Even in the strongest market cities, new development tends to be concentrated in a handful of neighborhoods where rents/prices are high enough to justify the high cost of new construction.

Note that this finding does not mean that a simple islandwide requirement would be problematic. If the market remained as it appears in Strategic Economics analysis, an islandwide requirement would generate significant amounts of affordable housing in Ala Moana with little impact in other areas where development was unlikely even without the requirements. However, the challenge comes from the fact that markets change. Some areas where development is infeasible today are

<sup>2</sup> Affordable Housing Requirements Financial Analysis, Strategic Economics, 2016.

<sup>3</sup> SE’s analysis assumed that developers had to pay market rate for land, and did not receive subsidies other than some fee waivers. Therefore, development on public lands, with public subsidies, or by long-term landowners who choose to discount land value is more feasible in softer market areas.

likely to reach a point where development becomes feasible in the near future, and the risk is that affordable housing requirements could delay the point when that transition happens.

This is particularly a concern in communities like Honolulu where transit or other public investment is intended to generate new real estate investment. While unsubsidized larger scale residential development is not currently feasible in most of the planned transit station areas, the history of similar transit investment suggests that higher density development will become feasible in many of these areas as the opening of the rail line approaches in concert with TOD upzoning. The pioneering real estate projects in these emerging areas will be more economically marginal and the risk is that the strong affordable housing requirements that work financially in Ala Moana could be enough to prevent those marginal projects from proceeding and, thus, delay development of those station areas. At the same time, it is important that these station areas develop in a way that is equitable and includes affordable housing. An ideal policy would impose reduced requirements on pioneering projects in emerging areas but increase the requirement as the market was established. Unfortunately, most cities have concluded that timing the market in this way is not entirely practical.

This problem is common and there are a number of different strategies that other cities have used to address it.

1. **Target only high growth areas:** Some cities limit their affordable requirements to only neighborhoods that have strong market conditions at the time that the program is adopted. Both Seattle and New York limit inclusionary requirements to areas zoned for higher density development.
2. **Vary requirements by zone:** Others impose requirements jurisdiction-wide, but vary the level of requirements so that strong market locations provide more affordable housing while other areas face less of a burden. Boston adopted different requirements for three different zones, based on the average market price for new condo units in each area.
3. **Project-by-project underwriting:** Some communities negotiate different requirements for each project in order to ensure that they impose the maximum feasible requirement without over burdening projects. This is, of course, a very staff-intensive process and it can be difficult to get a clear picture of the real economics of every project. Vancouver, BC negotiates the specific requirements for each project independently.
4. **Vary requirements by rents/prices:** Some communities try to achieve the same result in a simpler manner by imposing requirements that vary based on each project's proposed rent or sales price. Projects with higher market rate prices are required to provide more affordable units than projects with more modest prices. Burlington, VT has three tiers of inclusionary requirement with the lowest tier for projects with market rents or prices that are relatively affordable and the highest requirement for projects with luxury units.
5. **Hardship waivers/appeals:** Many programs allow any developer to request a full or partial waiver of requirements if they can show that the requirements would make their project infeasible. It can be very difficult to determine which projects should truly be eligible for this kind of waiver and some communities have had problems drawing a clear enough line. New York, NY provides for an appeals process for

developments that believe the affordable housing requirements render a project financially infeasible. The Board of Standards and Appeals may modify the requirements on a case by case basis.

6. **Vary requirements by project size:** Some communities impose higher requirements on large projects (measured either by land area or number of units). Toronto only requires affordable housing for projects on very large sites.
7. **Scheduled phase in of requirements:** A growing trend has been to phase requirements in over time and to vary the phasing between different areas in order to allow softer market areas more time to adapt to the new requirements. Oakland, CA identified 3 distinct zones based on project financial feasibility and phased requirements in at different rates in each area. In King County, WA, several cities adopted affordable housing requirements that were waived in areas that were targeted for growth until the number of units permitted exceeded a specific threshold.

There are advantages and disadvantages to each of these approaches, and it seems likely that more than one of these approaches could be adapted to meet Honolulu’s needs. The last option, phasing in requirements in a geographically targeted way, seems to best meet the city’s current needs and administrative capacity. Note that all options will require some degree of additional staff resources, as described in Section B of this memo.

**Recommendations:**

<b>Zone</b>	<b>Ultimate Requirement</b>	<b>Phase in schedule</b>																		
Ala Moana and Downtown	Ownership: 20% Rental: 15%	Immediate (on adoption)																		
Transit Corridor (as defined in Neighborhood TOD Plans)	Ownership: 20% Rental: 15%	5 year phase in (from date of adoption)  <table border="1"> <thead> <tr> <th><u>Year</u></th> <th><u>Ownership</u></th> <th><u>Rental</u></th> </tr> </thead> <tbody> <tr> <td>1</td> <td>0%</td> <td>0%</td> </tr> <tr> <td>2</td> <td>5%</td> <td>3%</td> </tr> <tr> <td>3</td> <td>10%</td> <td>7%</td> </tr> <tr> <td>4</td> <td>15%</td> <td>10%</td> </tr> <tr> <td>5</td> <td>20%</td> <td>15%</td> </tr> </tbody> </table>	<u>Year</u>	<u>Ownership</u>	<u>Rental</u>	1	0%	0%	2	5%	3%	3	10%	7%	4	15%	10%	5	20%	15%
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Remainder of island	Ownership: 10% Rental: 5%	12 months after adoption																		

***Ala Moana and Downtown***

In the strongest market locations, a 20% requirement should take effect immediately after passage of the ordinance establishing the program. Projects in Ala Moana all essentially face this requirement already under the Interim Planned Development – Transit Permit (IPD-T) rules. While Strategic Economics did not analyze projects in Downtown and Kakaako, the economics of

development appear similar. We recommend that the City include Downtown in the zone with immediate requirements. We understand that the Hawaii Community Development Authority is considering revising their Reserve Housing Requirements to generally align with similar numbers. It makes sense to keep any requirements in Kakaako parallel with Ala Moana.

### ***Transit Corridor***

In the remaining transit station areas, the economic analysis suggests that market conditions are not strong enough to support multi-family development today (unless land is contributed or discounted, or other subsidies provided). Our recommendation is to phase in the requirements so that these areas have strong affordable housing requirements clearly established before the opening of the rail line, but allow a transition period where pioneering projects can benefit from lower requirements. It is important to recognize that it is impossible to predict the exact timing of market changes related to rail. At some point, it is likely that the coming of rail will result in rising rents and prices in many of these station areas, which will prompt new development, but the exact timing will likely differ by area.

One response to this uncertainty would be to exempt the first 100 or 200 units in each station area, as suggested in the draft Affordable Housing Strategy. While this approach is appealing and has been implemented with some success in King County, WA, it adds significant uncertainty for the initial projects. Individual developers in a particular neighborhood will find it difficult to know which project will make it through the building permit application phase first, and whether they can actually count on the exemption. A phasing schedule with specific trigger dates identified clearly in advance allows developers to more readily forecast the impact of the requirements on their project independent of the timing of other projects. It is unlikely that this scheduled phase in will result in exactly the optimal timing in each district, but the additional certainty that it provides may be more important.

For areas where the requirements are scheduled to change, we recommend that the requirement be set at the time that a complete building permit application is submitted, and that a project be allowed a set period of time (say, 3 years) to complete construction without any adjustment in the required percentage. For example, a project in a station area that applied for a permit in year 2 would have a 5% requirement even if they completed construction in year 4 (when any new projects would need to provide 15% affordable units). Projects that took too long would reset to the higher rate.

### ***Remainder of the Island***

It appears unlikely that large numbers of other projects would be developed outside of the station areas, but a lower requirement for those that do occur would minimize the risk of the program standing in the way of new investment in underserved areas. Delaying implementation of the requirement in the remaining area for 12 months ensures that any potential developers in these areas have ample warning before new requirements are imposed.

Outside of the transit station areas, the majority of larger scale development projects are likely to require rezoning, which would make these projects subject to the existing Unilateral Agreement (UA) policy. Currently the UA policy requires 30% affordable housing for projects executing UAs. The affordability period for these units is only 10 years. After adoption of an islandwide affordable housing requirements policy it would make sense to update the UA policy to ensure consistent requirements including a 20% requirement and 30-year affordability period.

## **B. Administration**

Successful implementation of an islandwide Affordable Housing Requirement (AHR) policy will require a significant expansion of local administrative capacity. Honolulu has meaningful experience administering this type of program, but the proposed AHR will be more administratively demanding than the current Unilateral Agreements (UA) process.

Currently, the UAs are administered within the City Department of Planning and Permitting by a staff of 4 people, each of whom have significant responsibilities in addition to this program. The current program design relies very heavily on project developers to perform most functions, including all marketing and resident selection and nearly all monitoring and enforcement.

While we did not conduct a formal evaluation of the current program administration, it seems likely, based on our conversations with staff and observations in other cities, that the program is currently understaffed relative to the need. There are a number of practices which are common among similar programs in other states which are not being implemented in Honolulu due to limited staffing capacity. Grounded Solutions Network developed the attached set of ***Stewardship Standards for Affordable Homeownership Programs*** based on detailed feedback from dozens of program administrators and other stakeholders. The Standards, which are designed to protect long-term affordability and ensure fair treatment of homebuyers, include common practices such as providing homebuyer orientations to ensure that buyers understand their restrictions before purchase, and annual monitoring to ensure owner occupancy of affordable homes.

The proposed islandwide AHR policy will require significantly greater local administrative capacity. The AHR will likely involve a higher volume of activity, as a greater number of projects will be expected to provide affordable housing units. At the same time, the AHR will rely on restrictions lasting at least 30 years (ideally even longer if the period of affordability is reset after each sale), while the current UA policy only restricts affordability for 10 years. This change means that the portfolio being monitored will ultimately grow much larger as units added each year will not leave the portfolio.

Longer-term restrictions will also create some additional administrative responsibilities including more directly supporting the resale of affordable ownership units, and more upfront education for homebuyers who will face longer-lasting restrictions. Under the UA program, if the owner of a restricted unit moves within the 10 year affordability period, the project developer is expected to identify a new eligible buyer. This approach is unlikely to work with 30 year restrictions as the initial project developers may no longer be around and/or the city may have no leverage to incentivize them to perform this role so long after the initial sale.

The attached report ***Delivering On The Promise Of Inclusionary Housing Policies: Best Practices In Administration And Monitoring*** provides detailed descriptions of the key administrative functions necessary to successfully implement a program like the proposed AHR.

Key administrative functions include:

**Supporting the development process**

- Communicating program requirements to developers and property managers
- Reviewing development proposals for compliance with rules
- Negotiating certain requirements to maximize production
- Ensuring that affordable units meet appropriate design and location standards
- Ensuring timely payment of in-lieu fees (if any)
- Planning and implementing reinvestment of fee revenue to produce affordable units

**Monitoring Rental Units**

- Setting affordable rents
- Working with property managers to ensure fair marketing of units
- Monitoring eligibility screening for new tenants
- Re-certifying annual incomes of tenants
- Enforcing requirements (as necessary)

**Stewarding Homeownership Units**

- Setting initial prices at an affordable level
- Marketing homes to eligible buyers
- Ensuring that potential buyers receive homebuyer education
- Verifying that applicants understand program requirements and resale restrictions
- Screening applicants against eligibility requirements
- Working with lenders to ensure access to appropriate financing
- Monitoring homes for owner occupancy over time
- Managing resales to future income eligible buyers at formula price
- Enforcing program requirements when necessary

**Tracking Results**

- Tracking program outcomes
- Refining program design over time

**Recommendations:**

**Expand City Capacity**

Whether through a newly created Housing Department or elsewhere, the City will need to add dedicated staff with sole responsibility for oversight of the AHR and UA programs. Even if the City contracts with a nonprofit partner, additional in-house capacity will be necessary to effectively support the development of new projects, including the development of Affordable Housing Agreements, and to manage the contract with the nonprofit partner.

In addition to expanded staffing capacity, the likely volume of new affordable housing units under the proposed AHR policy suggests the need for investment in data systems to manage information about the growing portfolio of restricted units. Both New York and San Francisco have both recently built web-based data systems that allow applicants to apply online. They can also track applicant eligibility and maintain data after a sale to enable ongoing monitoring. Grounded Solutions Network sells a software tool called HomeKeeper (MyHomeKeeper.org) that a number of cities are using to manage inclusionary housing portfolios. A modest initial

investment in this kind of infrastructure can greatly reduce the ongoing staffing requirements for a program while simultaneously improving long-term outcomes.

### **Partner with the State of Hawaii**

Both Hawaii Community Development Authority (HCDA) and Hawaii Housing Finance and Development Corporation (HHFDC) have administrative responsibilities for affordable housing units which mirror the City's likely requirements under the proposed AHR. Managing these functions separately in three separate government agencies is inefficient and likely to frustrate both developers and potential residents. There are very significant economies of scale which could be realized through a partnership among these agencies. One agency could provide services to the other two, or all three could partner to contract with a single nonprofit agency to support all three programs, as outlined below.

### **Explore the feasibility of contracting with a local nonprofit organization for selected administrative functions**

A number of cities have invested in the capacity of local nonprofit partner organizations (Particularly Community Land Trusts) to help oversee and support inclusionary housing programs, particularly for affordable homeownership units. This approach provides greater flexibility relative to expanding city staff capacity and offers some additional benefits as well. Homeowners appear to be more willing to reach out to nonprofit partner staff for assistance when they are facing financial difficulty, for example.

The key challenge with this approach is that most cities do not have existing nonprofits with all of the necessary skills and experience. Before relying on a nonprofit partner, Honolulu (ideally together with the State agencies) would need to invest in building the capacity of a local agency.

One approach would be to issue a Request for Qualifications (RFQ) for potential partners. The RFQ would outline the particular set of administrative functions anticipated and provide some sense of the scale of effort and the likely resources over the initial three years. Applicants should be asked to provide background on their organization, including staffing and governance, and detail the extent of their existing capacity to provide services similar to the anticipated services. There are significant advantages to working with a 501(c)3 nonprofit, but there is no reason not to allow for-profit organizations to respond to the RFQ.

Once a potential partner is selected, the first step could be to provide a small planning grant to enable the organization to complete a simple business plan that would outline the roles that they would play in implementing the City and State programs, project likely volume of activity for an initial three year period, identify the staffing levels necessary to succeed, and propose a revenue model to support the necessary staffing and overhead. Two sample business plans for similar nonprofits are attached. The *Irvine Community Land Trust* was a startup formed by the City of Irvine, CA to administer their inclusionary units. The *Workforce Housing Association of Truckee Tahoe* was an existing nonprofit which the Town of Truckee contracted with to build out entirely new administrative capacity to oversee inclusionary housing units.

### ***Sample division of labor***

While the specific roles assigned to any contractor would be determined after considerable discussion and business planning, the matrix below provides a single example of a division of labor that might be appropriate in Honolulu.

Developer	City	Nonprofit
<b>Supporting the development process</b>		
Develop Affordable Housing Agreement	Negotiate and Approve AHA Evaluate alternative options, approve offsite proposals Review design, monitor development Collect Fees Manage investment of in lieu fee revenue	
<b>Monitoring Rental Units</b>		
Market units to tenants	Publish table of affordable rents annually Review and approve developer marketing plans Review tenant application material to certify eligibility	Maintain central waiting list
Pre-screen tenants for eligibility		
Collect annual income recertification documentation	Review annual income recertification	
Evict/relocate tenants who are no longer eligible		
<b>Stewarding Homeownership Units</b>		
Market homes, refer lower income buyers to nonprofit partner	Publish table of affordable prices annually Review Marketing Plans	Maintain central waiting list Provide pre-purchase homebuyer counseling/education Provide pre-purchase program orientation
Sell to eligible buyers only.	Certify eligibility Set rules for appropriate financing Take any necessary legal action Final approval of each sale	Collect and review homebuyer income eligibility documentation Manage lottery or other fair selection process Work with Lenders to ensure appropriate financing Annually monitor each unit for owner occupancy Refer enforcement to city Work with sellers to ensure that homes resell only to eligible buyers
<b>Tracking Results</b>		
	Receive annual performance reports Refine program rules as needed	Manage program database Produce annual performance reports

### Plan for scalable revenue

While most of the details of ongoing administration can be developed as the AHR program is implemented, the financial aspect should be planned carefully before an AHR ordinance is finalized. The program needs a scalable source of revenue if it is to successfully administer a portfolio of homes that is likely to grow over decades. Many cities have struggled to adequately budget for ongoing administration. The best practice is to rely as much as possible on fee revenue which would increase along with the administrative workload. But any fee structure that the program will impose on developers or homeowners must be clearly identified in the

ordinance creating the program and incorporated in any evaluation of the economic burdens of the program. There are two common fee types that Honolulu should consider at this point:

**Administrative monitoring fees:** Some programs charge administrative fees for each rental or ownership unit each month. For example Honolulu might charge \$50 per unit per month. For rental properties, the property owner would pay the fee for all units (likely on an annual basis). For ownership units, each homeowner would pay the fee individually (though often these fees can be included in escrow payments to mortgage lenders). In addition to helping offset the cost of administration, these regular fees help homeowners remember that their home is part of a special program with restrictions on resale. It is important to identify these fees in advance because adding a monthly expense will lower the mortgage amount that a buyer can support. This fee should be included along with other likely housing costs in the formula used to determine the maximum affordable price.

**Resale Fees:** Most programs also charge homeowners a fee at the time that the homeowner sells their affordable home. The level of this fee depends on the level of service provided. In many places, where demand for affordable housing is high, the program maintains a waiting list of eligible buyers, and sellers are able to resell their homes without support from a realtor (or with only limited support). In these areas, the program would manage all aspects of the sale and might charge a resale fee of 2-3% of the restricted sale price of the home. In other areas, where sellers are likely to be paying 5-6% realtor commission, the program would only monitor the sale to ensure that it conforms with program rules and charge a resale fee of .5 – 1% of the price.

## Conclusion

Honolulu is well positioned to successfully implement a new AHR program. The economics of development on Oahu are somewhat extreme, but not fundamentally different from high cost markets on the mainland. With careful attention to the market, there is no reason to expect that Honolulu could not successfully require that a significant share of new units be affordable to lower income residents without overburdening development. Existing staff and community partners have a clear understanding of both the potential benefit and the challenges that are likely to be encountered and are likely to be successful in building the additional local capacity that will be necessary to administer the new program.

## Attachments

- Stewardship Standards for Affordable Homeownership Programs
- Delivering On The Promise Of Inclusionary Housing Policies: Best Practices In Administration And Monitoring
- City-CLT Partnerships
- Irvine Community Land Trust Business Plan
- WHATT Business Plan