



MEMO

To: Kymberly Marcos Pine, Chair, Committee on Zoning and Housing
Honolulu City Council

CC: Harrison Rue, Honolulu Department of Planning and Permitting

From: Rick Jacobus, Street Level Advisors *RJ*

Re: Affordable Housing Requirements, Bill 58 CD2

Date: January 16, 2018

At the request of the Department of Planning and Permitting, I have reviewed the draft revised Affordable Housing Requirements ordinance (Bill 58 CD2). Overall, I continue to be impressed by the thoughtful approach that Honolulu is taking to this legislation and I think you have a very strong proposal. As you know, I work with many similar programs throughout the United States and, for the most part, what is proposed here is well in line with the established practices of other jurisdictions. However, I want to point out a few details where the proposed ordinance differs significantly from the best practices established in other communities in ways that may cause problems down the road.

Affordability Period

The draft ordinance wisely plans for the risk that affordable homes could sometimes remain unsold for longer periods of time. Relaxing the income limits can help with some common marketing problems and many comparable programs allow this remedy. However the bill also offers to reduce the affordability period, in addition to allowing the higher income limits. This is not a common approach and it seems likely to reduce the impact of the program without solving the most common marketing problems.

Below Market Rate (BMR) homes are almost always in very high demand. New York and San Francisco routinely have thousands of applicants for every available home. However, there are exceptions and it is unfair to require developers to hold units vacant when eligible buyers truly cannot be found.

By a large margin, the most common reason for difficulty selling BMR units is that they were priced and restricted at too *high* an income level. Units that are targeted to

lower incomes sell for prices that are more highly discounted below market. It is this large discount that makes it possible to serve buyers who are otherwise priced out of the market. That generally leads to a large pool of interested buyers.

When we increase the income target (say from 100% of Area Median Income to 120% or 140%) we increase the 'affordable' price that these units will sell for. At some point this price approaches the market price. In some cases, we have seen programs impose 'affordable' prices that are above the market price for a comparable unit. When this happens it is not surprising that homes are nearly impossible to sell. This seems to be what happened in Maui where the program required homes affordable to incomes as high as 160% of AMI. The restricted prices of these homes were not far enough below market to reach buyers who were otherwise priced out of the market.

It is important to note that shortening the period of affordability does nothing to solve this most common problem. Buyers who can purchase an unrestricted home can and should choose that option over a restricted home whether the restriction lasts 10 years or 30. A home with restrictions simply can't ethically be sold at a market price to any buyer.

The most effective way to address this problem is to set the pricing and income targeting initially at a level that results in prices that are comfortably below the market prices in the areas where projects are likely to be built. Some cities address the risk that they might get that initial targeting wrong by requiring developers to always ensure that the BMR units are priced at least 20% below the market value of the unit – though this can significantly increase a developer's cost. Others allow developers who are unable to sell homes after an extended marketing period to instead pay an in-lieu fee. Both approaches avoid creating units that cannot be sold without misleading potential buyers.

Another potential marketing problem relates to financing. There are some situations where no buyers (or very few) in the target income group are able to obtain financing. This is most often a challenge for programs that target buyers earning less than 60% of AMI. In these cases, allowing developers to sell to higher income buyers at the same price after a good faith effort to find lower income buyers, ensures that homes don't sit empty. The draft CD2 is consistent with national best practice in allowing this kind of relaxation of income limits after a period of marketing. Like the bulk of other similar programs it ensures that the price remains set at the initial level which avoids creating an incentive for developers to fail at the initial marketing in order to later receive a higher sale price.

There is sometimes a concern that the price restrictions themselves will make financing difficult to obtain. I have heard it suggested that reducing the affordability period to only 10 years might reduce this risk but I can't see any reason to believe that this would be the case.

I have personally worked in dozens of communities with these programs; I ran a national network that reached hundreds more, and I am not aware of one community

that has been unable to find willing lenders for price restricted homes. All but 7% of Inclusionary housing programs impose restrictions that last 30 years or longer – many as long as 99 years. Both Fannie Mae and Freddie Mac are actively seeking to finance restricted homes. While financing a price restricted home may be more challenging than financing a home with no restrictions, the period of restriction will make no difference in this challenge. And in fact, beginning in 2018, the Federal Duty to Serve Rule gives Fannie Mae and Freddie Mac incentives to finance price restricted affordable homes with restrictions that last 30 years or longer. Homes with 10-year restrictions would not be Duty-to-serve eligible.

Income Targeting

While planning for the possibility that some units may be hard to sell is appropriate, it would be better to design the program in a way that avoids those problems in the first place. I am concerned that the higher income targets in the current draft may increase the risk of marketing challenges.

The draft CD2 adds an option that sets the income targeting for the program at the highest conceivable level, well above the norm among comparable cities and above the levels that Honolulu's economic research suggested.

There are over 500 programs in the United States that require new developments to include affordable housing units. The majority target households earning less than the median income (100% of AMI or less). Generally this is where the housing affordability needs are most pressing. But lower income units are more 'expensive' for a developer because their prices are lower. Some cities have chosen policies that target median income or above median income buyers in order to impose less burden on developers. Bill 58 as originally proposed follows this approach by targeting buyers at 100% and 120% of AMI. I understand that the requirement to sell at 80% of AMI (under current unilateral agreements) was not included in Bill 58, to make the requirement less of a burden on developers. These above-median programs can work so long as they are still serving an income group that is not well served by the market. But there is a natural upper limit.

When the affordable price approaches the market price, in addition to the marketing challenges discussed above, there is also a change in the public benefit. The closer to market prices, the more likely the buyers are to be people who would have purchased a market rate unit in any event. These programs are difficult and costly to administer and to monitor over decades. Most cities are only willing to undertake that burden because they hope to make homes affordable to families that would not otherwise be able to purchase them.

It is possible that, even if the homes are close to market initially, over time, if the market rises quickly they could become relatively more affordable. In this case, even if the units provide little immediate benefit, the program creates a stock of homes that are protected from future increases. But, if the program allows a reduction of the term of affordability to only 10 years whenever there is some difficulty in marketing,

there is a real risk that just as the market is high enough for units restricted to 140% AMI to really be needed, they will no longer be affordable.

If Council is concerned that the proposed requirements create too high a financial burden on development (a real and appropriate concern), rather than reducing the burden by increasing the income targets, the more common and likely effective alternative is to reduce the *number* of required affordable units. Both approaches reduce the net cost to a project but, somewhat counter intuitively, requiring fewer more deeply affordable units can often generate more public benefit than a greater number of units that are very close to market prices.

Third Party Administration

I am encouraged to see Honolulu pursuing the goal of contracting with an outside third party administrator for ongoing monitoring and support. I have seen many examples where this approach has resulted in a stronger program with better outcomes than when a city manages all aspects of the program internally. However I would caution against requiring this at all times as the current draft CD2 does. I have been meeting with city staff and outside partners over the last year to explore how to improve administration, monitoring, and compliance procedures, including the potential for third party administration.

In every city that has implemented this strategy, city staff retains some key responsibilities and outsources others. The specific mix of roles differs based on the capacities of available outside administrators. And, importantly, this mix changes over time as that capacity changes. Because Honolulu does not currently have an entity playing this kind of role, it may take several years to build partnerships, identify funding, hire staff and develop the systems necessary to successfully monitor these units. In the best case, the city will necessarily have to do some monitoring while this process is occurring. But there is also no guarantee that there will be a third party willing and able to play the necessary role. Even after this start up phase, there may well be points in the future where a change will need to be made. If Council requires a third party administrator at all times, I worry that that will reduce accountability on that third party and make it difficult for staff to ensure that the program remains well run at all times. Instead I would recommend that Council encourage but not require the used of a third party administrator.

Thank you for the opportunity to comment.