



## MEMO

To: Harrison Rue, City and County of Honolulu

From: Rick Jacobus, Street Level Advisors 

Re: Affordable Housing Requirements

Date: July 19, 2017

I appreciated the opportunity to join you on June 29<sup>th</sup> for the City Council's Zoning and Housing Committee hearing on Bills 58 and 59, 2017. I remain impressed with the level of the discussion among your policymakers and local stakeholders. During the hearing there were a number of issues that were raised where it seemed possible that more information about the experience of other communities might be helpful to your decision makers. The key questions I identified:

1. Should requirements be phased in?
2. Should In lieu fees be allowed?
3. How long should affordability restrictions last?
4. How should the prices for affordable units be established?
5. Will long-term price restrictions make it difficult to secure mortgage financing?
6. What happens when no income eligible buyers can be found?

Please don't hesitate to contact me with any further questions.

### **1. Should requirements be phased in?**

The majority of inclusionary housing programs have been implemented uniformly throughout the jurisdiction and immediately after adoption. More recently many cities have conducted technical analysis like Honolulu's to make sure that their policy will work.

Special care may be warranted in Honolulu. Strategic Economics found a very large difference in the economics of projects in the different zones that they studied<sup>1</sup>.

While any economic study can provide only approximate answers, they found that

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<sup>1</sup> Affordable Housing Requirements Financial Analysis, Strategic Economics, 2016.

affordable housing requirements at the levels proposed would not currently be financially feasible in some areas. For the most part, these may be areas where limited development is likely to happen in any event. However, if the proposed requirements are implemented immediately islandwide, there is a meaningful risk that some otherwise feasible projects might not be built in lower demand locations.

In my memo to you dated January 9, 2017 I described seven different strategies that cities have adopted to address this challenge of the economics being different in different locations. The approach that seemed most appropriate to Honolulu's situation was to adopt the requirements immediately in the high demand locations and phase them in gradually to a lower level in outlying locations. This approach has been used with success in King County, Washington and Oakland, California.

The best available research suggests that in the long run, land markets adjust to reflect the cost of providing required affordable units<sup>2</sup>. However this kind of adjustment takes time and it may take more time in markets where there is less activity. When requirements are phased in gradually developers have time to negotiate appropriate land prices in anticipation of the requirements.

## **2. Should In lieu fees be allowed?**

The majority of inclusionary housing programs offer developers multiple options for satisfying their affordable housing requirements including the option to pay a fee. Researchers at NYU found that this kind of flexibility was a key reason why inclusionary programs in California produced more affordable units than comparable programs in Massachusetts<sup>3</sup>. Even if most projects can comfortably accommodate onsite affordable units, the financial and regulatory burden is greater on some projects than others. When developers have multiple options for compliance, the requirements are less likely to pose an insurmountable barrier to development. The more market rate development happens, the more affordable units are produced.

Fees that are collected can be invested in 100% affordable projects where they are able to 'leverage' state or federal housing funding in a way that results in a greater total number of affordable units being built. My study of Seattle found that the city was able to produce three times more low-income units through the fees than they would have received had their developers built onsite instead<sup>4</sup>. In addition, the fees can be spent to serve populations that might not benefit from onsite units. A number of jurisdictions collect fees from ownership projects and use them to subsidize much needed rental housing.

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<sup>2</sup> Schuetz, Jenny, Rachel Meltzer, and Vicki L. Been. The Effects of Inclusionary Zoning on Local Housing Markets: Lessons from the San Francisco, Washington DC and Suburban Boston Areas. Furman Center for Real Estate & Urban Policy, New York University, 2008. <http://nmhc.files.cms-plus.com/ContentFiles/ThirdPartyGuide/IZ%20Report.pdf>.

<sup>3</sup> Schuetz et al. 2008.

<sup>4</sup> Jacobus, Rick, and Joshua Abrams. "Policy Options for Refining Seattle's Incentive Zoning Program." Oakland, CA: Cornerstone Partnership, July 2014.

One of the appealing benefits of inclusionary housing is that it promotes economic integration by including affordable units in market rate developments. Research supports the idea that lower income residents benefit from healthier neighborhoods with better schools and access to jobs. However, there is no evidence to date that suggests that residents need to be integrated in the same buildings in order to realize these benefits<sup>5</sup>. Communities where economic integration is a high priority often require that a high percentage of their fee revenue be reinvested within the same neighborhoods as the market rate projects that pay the fees.

There is, however, a risk of setting the in lieu fee too low. A 2006 study of California Inclusionary Housing Programs found a number of programs that had produced very few affordable housing units because they had set very low fees which were the preferred option in all cases<sup>6</sup>. In lieu fees based on local market research (as in Bill 58) can ensure the greatest amount of affordable housing by providing an additional option which is not the preferred alternative in most cases.

### **3. How long should affordability restrictions last?**

The majority of inclusionary housing programs require affordability restrictions that last 30 years or longer. Less than a quarter of the 330 programs identified in one 2014 study had affordability periods of less than 30 years<sup>7</sup>. While shorter-term restrictions were common in the 1980s, many of the programs that began with 10 or 15-year restrictions have since revised their rules to require longer periods of affordability. The reason for this change seems to be that as housing prices have risen the discount that is necessary to make new units affordable to lower or moderate income buyers has grown so high that policymakers begin to feel that the subsidy level is too high for only one family to receive all of the benefit. Long-term restrictions allow a one-time reduction in price to create a unit that provides an affordable starter home opportunity to one lower-income family after another.

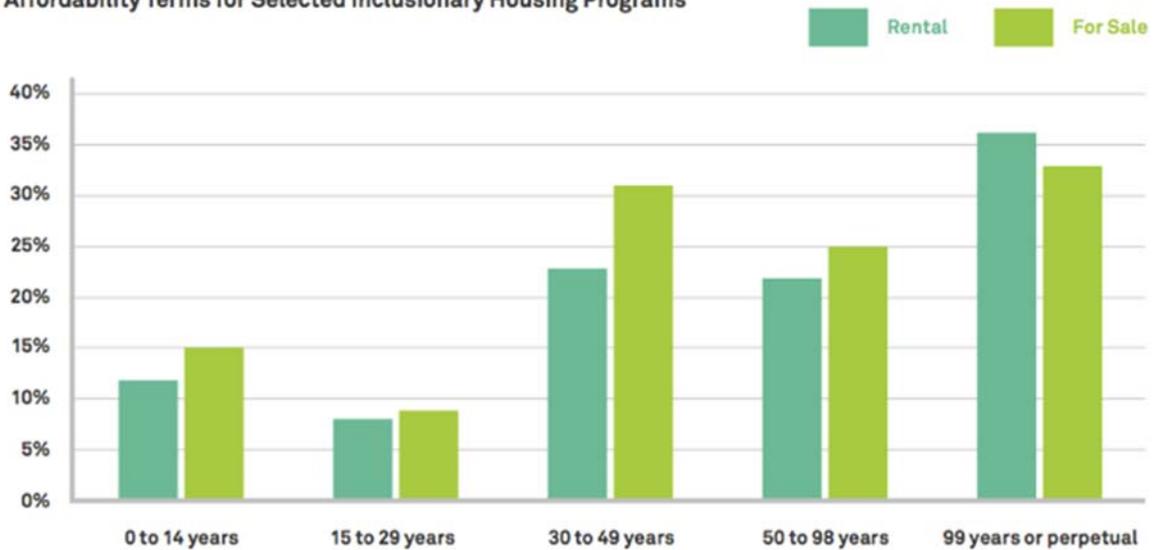
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<sup>5</sup> Levy, Diane K., Zach McDade, and Kassie Dumlao. "Effects from Living in Mixed-Income Communities for Low-Income Families: A Review of the Literature." Metropolitan Housing and Communities Center. Washington, DC: Urban Institute, 2011. <http://www.urban.org/url.cfm?ID=412292>.

<sup>6</sup> Nonprofit Housing Association of Northern CA. "Affordable by Choice: Trends in California Inclusionary Housing Programs." Nonprofit Housing Association of Northern CA, California Coalition for Rural Housing, San Diego Housing Federation and the Sacramento Housing Alliance, 2007. <http://www.rjacobus.com/resources/archives/NPHInclusionaryReport.pdf>.

<sup>7</sup> Hickey, Robert, Lisa Sturtevant, and Emily Thaden. "Achieving Lasting Affordability through Inclusionary Housing," 2014. <http://www.nhc.org/Achieving%20lasting%20Affordability%20through%20Inclusionary%20Housing.pdf>.

Affordability Terms for Selected Inclusionary Housing Programs



Includes 330 inclusionary housing programs for which affordability term data is available. Source: Hickey, Sturtevant, and Thoden (2014).

Some stakeholders in Honolulu seem to assume that 30-year restrictions are designed with the expectation that homeowners will remain in the units for 30 years. But the best data available suggests that homeowners with long-term price restrictions move with the same frequency and for the same reasons as unrestricted owners<sup>8</sup>. Regardless of the term of affordability, the majority of buyers move within 10 years.

If restrictions are to last a decade or more, it is important that homeowners have the opportunity to build meaningful wealth **during the term** of the restriction rather than expecting them to wait until restrictions expire. And, in fact, this is what most inclusionary housing programs offer. A study by the Urban Institute found that buyers of inclusionary homes in San Francisco gained an average of more than \$70,000 when they sold after a median length of ownership of only 4.2 years (an 11.3% annual rate of return) in spite of restrictions that ensured that these same homes remained affordable to new income qualified buyers<sup>9</sup>. Because of the long-term price restrictions, San Francisco is able to offer affordable units at resale to hundreds of additional families without any additional subsidy from the city or its developers. The researchers estimated that it would cost the City more than \$25 million annually to provide the same level of affordable housing if inclusionary units were not price restricted.

The key policy question is not *whether* to allow wealth building, but rather, how best to balance the opportunity to build wealth for the first owner against the affordability of the home to the next buyer. When restrictions expire after a short period, whoever is lucky enough to own the unit on the day the restrictions expire generally earns wealth

<sup>8</sup> Urban Institute, Shared Equity Homeownership Evaluation: Case Study of the San Francisco Citywide Inclusionary Affordable Housing Program, October 2010.

<sup>9</sup> Urban Institute, 2010.

that far exceeds what market rate owners can earn because they retain the initial subsidy as well as appreciation earned on that subsidy. Most inclusionary housing programs limit this gain to a more modest level in order to ensure that each successive owner has an affordable price and a chance to build meaningful wealth. Many programs attempt to offer owners enough wealth building that they are able to move out and into market rate ownership.

The evidence suggests that this is possible and that most programs are succeeding at this goal. Grounded Solutions Network collects real time data on the performance of price restricted units. Their dataset of more than 4,000 sales shows that more than two thirds of sellers are able to move on to unassisted market rate units when they sell thanks in large part to the wealth building that they experience even with restricted prices<sup>10</sup>.

#### **4. How should the prices for affordable units be established?**

One concern expressed by local developers is that 30-year resale restrictions will make it difficult to sell affordable units. It is unquestionably true that buyers would prefer to buy without any affordability restrictions, but there are over 500 inclusionary housing programs in the United States and in most cases their affordable homes are in high demand with long waiting lists or lottery pools. The reason for this is not that buyers prefer price restrictions; it is because these programs all sell homes significantly below their market price to people who would not qualify for higher priced market rate homes. If restricted homes are sold at the same price as comparable market rate homes, they may very well be impossible to sell. But most programs ensure that their homes are not only affordable to the target income group but also at least 20% below market price. This discount below market is a necessary condition for the success of long term affordability.

A number of cities have had problems marketing affordable homes when their policies have allowed developers to establish whatever price they wish so long as the buyers are income qualified. In theory if you have to sell to a buyer earning 120% of median income, for example, then you won't be able to sell for more than what someone at that income level can afford. However, if the developer assumes that buyers will use interest only, adjustable rate or other creative financing they may be able to assume a price much higher than what most eligible buyers would consider 'affordable.' While it is tempting to assume that the cost of holding unsold units would motivate developers to lower prices if marketing was difficult, developers are understandably reluctant to reduce the price of affordable units and unsold units (whatever the reason) can undermine public support for affordable housing requirements.

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<sup>10</sup> Grounded Solutions Network, HomeKeeper Social Impact Report, June 5, 2017. (<http://myhomekeeper.org/social-impact-dashboard>)

As a result, most cities, either in their ordinance or in administrative rules, provide a specific formula for determining the maximum initial price for required affordable units. Many cities publish a schedule listing the maximum prices annually.

Even if the City publishes the maximum price for affordable units, there can still be problems if the income targeting is too high. For example, if a program requires units priced to be affordable to buyers earning 120% of Area Median Income in a more moderate cost location, it sometimes happens that the market rate units in the same project sell at that same price or only slightly more. In that case, it may not be possible to sell the affordable units.

In order to avoid this problem some programs require that units be priced at the lesser of the price that is affordable to the target income group or 20% below the market price. This means that when the market rate units are lower cost the affordable units must be sold at a lower price than they otherwise would be.

Another response to this problem would be to change the income targeting requirements to avoid requiring units that might be priced at or above market levels. In Santa Barbara County, CA the inclusionary housing program requires developers to provide some affordable units at each of four income levels: very low, low, moderate, and workforce (50%, 80%, 120% and 200% of AMI). But in some parts of the county market prices are affordable to households earning 120% of AMI. The 120% and 200% unit requirements are waived, however, in any planning area where the prior year median condo sales price was affordable to buyers at those income levels. This policy has the effect of reducing the total inclusionary requirement in lower cost parts of the county and it does not protect the affordability of these moderate income units if prices later rise in these parts of the county.

## **5. Will long-term price restrictions make it difficult to secure mortgage financing?**

Affordable housing restrictions do create special lending needs and the programs need to be designed with appropriate care to ensure that the homes are easily financeable. It is not uncommon for new programs to struggle to support lenders in navigating unfamiliar program rules. However, I have worked with hundreds of local programs implementing these types of restrictions and I am not aware of any location where private lenders have ultimately been unable to finance eligible homebuyers because of the local affordable housing requirements. Fannie Mae, Freddie Mac and FHA all finance deed restricted units with resale price restrictions.

At the meeting you organized with several local developers and lenders on June 29<sup>th</sup> I was able to talk with them about their concerns related to accessing mortgage financing for units with long-term affordability restrictions. While your local stakeholders had the usual questions about how these programs work, no one raised any issues that suggested to me that buyers in Honolulu would have particular difficulty getting loan approvals due to the proposed price restrictions.

It will be important to include local lenders in the development of the administrative guidelines for the new program in order to minimize the burden placed on local lenders who are attempting to finance these units. Decisions such as how to protect the City's interest when homeowners experience foreclosure can make a big difference to lenders.

## **6. What happens when no income eligible buyers can be found?**

Even when the units have been priced appropriately there may still be situations where it is not possible to find qualified buyers for restricted units. Because many of these situations are beyond the control of the developer, it is common for programs to include some fall back provision to ensure homes don't sit empty indefinitely. In general these provisions require 'good faith marketing efforts' for a specified period of time. After good faith marketing has failed to find a buyer they allow some relaxation of the restrictions in order to expand the pool of potential buyers.

For example, a number of cities allow developers to sell to buyers in a higher income category but at the same below market price that they would offer to buyers in the original income category. San Francisco's program manual includes this exception:

In cases where, despite the Project Sponsor's good faith efforts, no eligible BMR Owner or BMR Renter has contracted to purchase or rent a BMR Unit within six (6) months after the lottery for the BMR Units, the Project Sponsor shall inform MOHCD, which may then increase the permissible income levels for prospective BMR Buyers or BMR Renters of that BMR Unit up to a maximum twenty (20) percent over the income percentage limit specified in Use Restrictions ... on a one-time basis only, but shall not increase any current or future permissible sales or rental price of that BMR Unit. Project Sponsors shall inform all BMR Buyers of the one-time nature of the qualifying income increase.

Some other cities only allow the payment of in lieu fees in cases where a developer has completed good faith marketing efforts and been unable to find a qualified buyer. La Plata County, Colorado allows developers who have been unable to sell restricted units after 120 days of marketing to sell at market price and pay a fee in lieu instead.