21 Elements

AFFORDABLE HOUSING FINANCE 101

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This overview of how affordable housing is financed and developed is provided for jurisdiction staff to help inform your decisions and policymaking. Sections of this document may be pulled and used in your housing element or may help you talk about affordable housing with your community.

Key considerations for developing subsidized affordable housing:

- Local policies to support affordable housing
  - Generate and dedicate funding for affordable housing
  - Reduce the cost to develop affordable housing
  - Utilize planning and zoning strategies to give affordable housing a boost
  - Identify public and private land opportunities for affordable housing
- Typical local (city and/or county) gap funding: $100,000-$150,000 per unit
  Note that the county is a key local source of funding for affordable housing
- Typical project size: 50-120 units

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How are affordable units financed?

Deed-restricted affordable housing is primarily created in two ways: by market-rate developers who are required or incentivized to include affordable units within their projects ("inclusionary housing") or by developers who specialize in the development of subsidized affordable housing.

Market-rate housing projects, including those that have inclusionary units, are typically financed with a construction loan, a mortgage supported by rents, and equity from private investors. They do not or cannot typically access government subsidies to cover the funding gap for the inclusionary units, so they rely on the market-rate rents to cross-subsidize the operations of the affordable units.

Affordable housing projects – also known as subsidized housing projects -- are financed differently. Because rents are restricted to be affordable for people with lower incomes, affordable housing developments can only support a small mortgage (the rental income determines the amount of the mortgage). Developers that specialize in building affordable communities where all or most of the units are designated for people with low- and very-low incomes must use tools beyond the typical debt and equity products offered and utilized by the private real estate market. They must assemble multiple sources of government and other funding to make these developments possible.

What local government can do to help create affordable housing

While there are many challenges to financing and developing affordable housing that local jurisdictions cannot control, cities and counties can create conditions that are more conducive to the development of affordable housing.[1]

- **Revenue Generation:** Create or grow funding sources through inclusionary housing requirements (alternative methods of compliance like in-lieu fees and land contributions) and commercial linkage fees, and identify new tax/fee opportunities
- **Cost Reduction:** Reduce the cost of development (and time) for affordable housing through expedited approvals and permitting, reduced or waived fees,[2] reduced parking requirements, tax abatements or exemptions, additional flexibility on meeting development standards, and free public land
- **Zoning/Planning Strategies:**
    - Incentivize the creation of affordable housing through density bonuses, affordable housing overlays
    - Allow affordable housing in all zones other than heavy industrial zones, even where other housing is not currently allowed
    - Make affordable housing by-right (not subject to case-by-case project approvals or CEQA)
    - Proactively designate and zone appropriate sites or areas for multifamily housing to smooth the way for affordable housing
- **Land Opportunities:**
    - Identify opportunities to add housing to publicly owned sites (underutilized sites, parking lots, etc.)
    - Proactively work with private landowners, major employers, nonprofits/religious institutions to use their land for affordable housing

Common Funding Sources for Subsidized Affordable Housing

For projects other than inclusionary housing, developers must pull together a set of government and/or philanthropic subsidies to cover the "gap" between the cost of developing the project and the amount of market financing that is available. In addition to a typical bank construction loan, sized according to the value of the project, and a mortgage that is supported by the rents residents will pay, affordable housing developments require grants or "soft" loans

[1] More ideas can be found here: http://www.21elements.com/policies-and-programs (click on link to PBot to download), https://www.midpen-housing.org/housing-element-best-practices/

[2] Jurisdictions should plan to waive their impact fee requirements imposed on affordable housing development. Other gap funding sources will not look favorably on a larger funding request that enables the local government to collect a larger parks fee. Note that deed-restricted affordable housing will be a small percent of overall development so the foregone funds should have limited financial impact for jurisdictions.

from governmental and/or philanthropic sources.[3] Projects providing supportive services for persons with disabilities and/or homeless individuals and families also need an additional subsidy, such as Project-based Section 8 vouchers, to support ongoing operations and cover the cost of the supportive services.

Common sources of funding include:

- **Tax credit equity:** The biggest affordable housing program in the country is run by the federal Internal Revenue Service (IRS), which offers a credit against federal income taxes in exchange for investments in affordable housing. States, including California, also offer a state housing tax credit. Corporations or banks with federal tax liability put upfront cash into a project in return for 10 years of credits against their taxes. This program can fund about 30 to 70 percent of a project's development costs. In California the California Tax Credit Allocation Committee (CTCAC) is responsible for allocating federal and state tax credits to projects.
- **Tax-exempt bonds:** Affordable housing projects can be financed in part by the issuance of tax-exempt bonds, which provide funds in the form of a loan to the project, resulting in less expensive debt and larger loans for projects. A local government agency usually acts as the bond issuer. In California, the California Debt Limit Allocation Committee (CDLAC) is responsible for granting the ability to issue these bonds.
- **Loans and grants from the federal government:** The US Department of Housing and Urban Development (HUD) provides block grants (HOME, CDBG and others) that are distributed to states, counties and cities to support affordable housing and community development. HUD was once the primary funder for the development and subsequent redevelopment of public housing. However, in recent years, HUD funds have generally only been a minor source of funding for affordable housing.
- **Loans and grants from state government:** The State of California has been a longtime major funder of affordable housing through the Multifamily Housing Program (MHP), which is primarily supported by periodic statewide housing bonds. In recent years, several other major state programs have been key funding sources for transit-oriented development, infill development, housing for veterans, housing for people experiencing or at risk of homelessness, housing for people with mental health challenges, and other groups of people with special needs.[4] These programs, primarily administered by HCD,

[3] Government almost never expects its loans to affordable housing projects to be repaid, although sometimes a small interest payment may be collected. Their loans are investments in the community (they structured as loans rather than grants for technical financing reasons). They protect their investment in affordability with loan agreements and deed restrictions that run with the land, regulating resident incomes and setting other requirements to ensure the property remains affordable over time.

[4] Some well-known state financing programs include: Affordable Housing and Sustainable Communities (AHSC, pronounced "ay-sick"), Transit-Oriented Development (TOD), Infill Infrastructure Grant (IIG), Mental Health Services Act (MHSA), HomeKey, and others.

have been a critical source of gap financing, as the loans are of significant size, but they can only fund a limited number of projects and are often very competitive.

- **Loans and grants from regional government:** Until now, MTC and ABAG have had a somewhat limited role in funding affordable housing. The Transit-Oriented Affordable Housing Fund (TOAH) was one exception. However, in 2019, state legislation created the Bay Area Housing Finance Authority (BAHFA), which intends to put a revenue measure on the ballot to fund affordable housing across the Bay Area. The COVID-19 pandemic led to the decision to delay a planned November 2020 ballot measure.
- **Loans and grants from local government:** Local government also provides important gap funding to affordable housing. Sources include housing bonds issued primarily at the county level, sales tax measures, inclusionary in-lieu fees paid by market-rate development and jobs-housing linkage fees that new commercial development may pay. Other taxes are being explored by many local jurisdictions. The end of this section includes more on County funding.
- **Project-based Section 8:** Housing authorities have the ability to allocate Section 8 or Housing Choice Vouchers to projects, rather than to individual households. This can be an important source of stable rental revenue for affordable housing developments. Furthermore, these projects can borrow against that anticipated income, increasing the amount of upfront capital available during the development process.
- **Private loans and grants:** Community-minded banks, community development financial institutions (CDFIs), philanthropy and other private sources are a potential source of funding for affordable housing. In recent years, technology companies based in the Bay Area have been particularly encouraged to participate in solutions to the region's housing crisis and have made commitments to support affordable housing through both loans and grants.

Each project usually requires multiple subsidy sources to close the funding gap between the cost to develop and the size of the mortgage based on affordable rents. As a result, the process of assembling financing for affordable housing development is lengthy, challenging and expensive, involving multiple competitive applications (and their respective deadlines) and negotiations with lenders, investors, and other funding partners. Affordable housing projects typically take 4-6 years to complete, from the initial identification of a site, partner or funding opportunity, through the process to assemble funding, get local approvals, work with the community and design and construct the building, to leasing the building to residents.

The County is a key affordable housing partner for cities in San Mateo County. The County of San Mateo Department of Housing includes both Housing & Community Development (HCD) and the Housing Authority of the County of San Mateo (HACSM). The department issues two annual Notices of Funding Availability (NOFAs) – a HUD program NOFA in the winter and one local funding NOFA in the summer. The County's local funds NOFA (the Affordable Housing Fund (AHF)) is the larger of the two NOFAs and makes funds available from several state and county sources, including Measure K, County's 2016 ½ cent sales tax measure, for the construction and rehabilitation of affordable housing. Cities should reach out to the County early and often to understand whether the AHF, housing authority vouchers, or other county resources may be appropriate for affordable housing projects in their jurisdictions. The HUD programs NOFA and the AHF NOFA are regularly oversubscribed. As a result, the County has developed funding priorities to inform the selection of projects to fund through its NOFAs.

A few of County's funding priorities for its latest round of the AHF NOFA included the following: target AHF funds to Supportive Housing Projects that serve homeless households and those at imminent risk of homelessness and other clients of County services in need of affordable and supportive housing; target AHF funds to very low- and extremely low-income affordable housing units; create more housing within close proximity of services, amenities, employment opportunities, and transit; and leverage local, state, federal, philanthropic, private, and other subsidy funding for affordable housing.

What it costs to build an affordable unit[5]

Building affordable housing is just as costly as building market-rate housing in California, if not more expensive in some cases. LIHTC data show that altogether, these cost drivers have led to affordable housing total development costs reaching $480,000/unit and $700/square foot across California in 2019. Affordable housing projects are subject to the same trends and volatility in construction costs, which often account for more than 60% of a project's costs.

Rising costs have been particularly pronounced in the Bay Area, where the **average total development cost was closer to $600,000/unit as of 2020**. In the 10-year period between 2008 and 2018, hard costs increased 119% in the Bay Area compared to 25% statewide when accounting for inflation. Materials and labor are two of the primary drivers of these increases due to shortages in both markets. Material costs – particularly in wood, insulation, roofing, and appliances – have escalated in recent years due to COVID-19, climate change, global trade patterns and federal macroeconomic policy decisions. The labor market in the Bay Area has also tightened, as the high cost of living has led some to relocate outside the Bay Area, resulting in increased transportation costs, a general shortage of labor, fewer specialists in the multifamily sector, and substantially higher wages overall.

Beyond construction costs, local development fees, long entitlement processes, parking requirements, and heightened design scrutiny can contribute to inflated hard and soft costs. State and local regulations and requirements may aim to achieve important policy goals, but also load up projects with considerable costs. For example, 60% of LIHTC projects between

[5] Sources: https://ternercenter.berkeley.edu/research-and-policy/hard-construction-costs-apartments-california/ https://ternercenter.berkeley.edu/research-and-policy/development-costs-lihtc-9-percent-california/

2008 and 2019 were subject to prevailing wage requirements, which led to projects that were 10% and 35% more expensive than non-prevailing wage projects, depending on location.

Moreover, while "deep affordability" in income targeting (targeting extremely low- and very low-income households) has become more of a public policy priority, the fact is that costs of new construction do not change under this scenario, requiring an even greater subsidy from public sources to offset the financing gap created by the lower rents. With less income available to a project and escalating development costs, the puzzle of securing project financing becomes increasingly challenging.

Typical local gap financing required

After accounting for a mortgage, Low Income Housing Tax Credits, and possible state financing, the gap that typically must be filled with local subsidy (city and/or county sources) is usually in the **range of $100,000-150,000 per unit** and can sometimes grow larger, especially if projects include supportive housing units and/or units for extremely low-income households. However, tax credit and state financing programs often require or prioritize projects that have obtained local financing. This demonstrates leverage and feasibility, and is an essential component of a dynamic competitive landscape. Developers will typically need to secure local sources early on in the project life cycle, concurrent or prior to entitlements to the extent possible.

As noted earlier, cities should speak with the county about whether potential affordable housing projects may be a good fit for county resources.

Typical size of an affordable housing project

Typically, affordable housing developers seek **projects with a minimum of 50-60 units, with the ideal project size settling around 80-120 units**. The publicly owned sites offered for affordable housing opportunities are sometimes small or awkwardly-shaped; while these sites can sometimes be made to work, it's often not financially feasible.

Many of the costs associated with affordable housing are fixed and do not change with the size of the project (or have a minimum threshold), so economies of scale are important. This includes development costs, including the project manager's time, consultant costs, such as the cost of bond counsel, and operating costs, including an on-site property manager. On the other hand, tax credit regulations limit the size of a given project allocation and limit the size of the developer fee, so there are upper bounds of what may be feasible. Very large opportunities are often broken down into multiple projects for funding purposes.

Minimum trust fund balance before releasing a NOFA

Many local jurisdictions collect funding on an ongoing basis to fund future affordable housing. The sources may include inclusionary in-lieu fees that market-rate residential developers pay instead of providing required affordable housing on-site, commercial linkage fees that developers of office, industrial or R&D space may pay to offset the impacts of employees who will want to live in the community, sales tax revenue that may be dedicated to affordable housing, or other local fees and taxes. These amounts may be small and will need to accrue over time to be a worthwhile amount of funding to contribute to a project or other affordable housing purpose.

A jurisdiction can use a competitive Notice of Funding Availability (NOFA) process to be transparent about its funding priorities and solicit projects for funding awards. It is recommended that a jurisdiction have **at least $2-3 million available in its housing trust fund** before releasing a NOFA. If the trust fund balance is lower, an affordable housing project might need multiple allocations to assemble sufficient financing to start construction, but it is a good practice for local government to establish its priorities and then issue NOFAs either on a regular schedule or on a rolling, open-ended basis. When setting up a NOFA, jurisdictions should also consider the timing and compatibility of its funding requirements with other funding sources' priorities and calendars.

A note on preservation projects

Preservation of so-called "naturally occurring" affordable housing (NOAH), which means existing rental housing that is not rent-restricted but is serving lower-income households at affordable rents, is a focus of growing interest in the Bay Area. These are important but challenging projects to complete. They may require less gap financing per unit overall, but there may be fewer funding sources available for preservation uses. They don't help to grow the housing stock, but they may provide stability to the people who are already living in the community. Additional development challenges also exist with the unknowns of existing construction quality and working with residents who already live there.

On the financing side, preservation projects often try to utilize the same sources as new construction affordable housing, but it can be challenging to align funding deadlines with the nature of market competition for acquisitions. Acquisitions move much faster than the affordable housing development process. Financing institutions like LISC, Housing Trust Silicon Valley and the San Francisco Housing Accelerator Fund, or sources like the Partnership for the Bay's Future Fund are sometimes able to move faster and provide interim financing to enable an acquisition, but longer-term gap financing is still needed, and preservations projects may not always compete well.

In addition, the property tax exemption for units that house households with incomes under 80% of AMI is critical to project feasibility, but sometimes developers may want or need preservation projects to house moderate- or middle-income households (by definition *above* 80% of AMI) which are not eligible.

Given the many issues and complexities surrounding potential preservation opportunities, jurisdictions where a preservation project is proposed may want to consult a technical expert such as California Housing Partnership Corporation (CHPC) or similar firm with extensive affordable housing financial expertise before committing any funding.