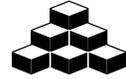


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Web Update 23

The El Dorado of Permanent Sustainable Affordability ... and how to pursue the endless quest

David A. Smith

Summary

Today's affordable housing production and preservation programs set a goal of 'permanent affordability'. But though this objective is laudable – indeed, it is the right programmatic design parameter – it is unattainable. Because the future is infinitely complex, with more things in heaven and earth than are dreamt of in our policymaking, programmatic cohorts experience steady attrition on the upside (conversion) and downside (default) – and those rates of attrition tend to increase over the years, as fickle reality diverges ever more from the original program-design environment.

The right goal, therefore, is *renewable sustainable* affordability achieved through three complementary strategies:

1. *Enduring sustainable affordability* to create a high degree of near-term stability in a fairly homogenous cohort of properties.
2. *Periodic property-specific interventions* because, no matter how homogenous properties may begin their lives, they are affected by individual circumstances that need individual solutions.
3. *Periodic program redesign* to adjust program parameters so as to accommodate previous unexpected major events.

Although too long neglected, in recent years sustainability has been recognized¹ as something to pursue. But its necessary preconditions – property-specific interventions and periodic program redesign – have been too little remarked. Understanding their *inevitability* – and their *desirability* – is key to effective long-term management of governmental resources and governmental powers.

¹ Mark-to-market and similar initiatives (such as the Millennial Housing Commission's report, www.mhc.gov) have emphasized sustainability as a goal.

What is 'sustainable affordability'?

What we call 'affordability' is one-word oversimplification for a condition that has two other features commonly overlooked:

- *Healthy properties.* Slums are cheap but they fail our standard. 'Affordability' carries the implicit warranty of property habitability and desirability.
- *The time dimension.* Affordability is a state achieved over time, not a snapshot at an instant – it is a long-running movie, not a single frame.

A property thus achieves *sustainable affordability* which it has not only the immediate indicia – good physical condition, affordable rents – but also the internal means to maintain that state over many years – sound operations, stable financing, a capable preservation entity owner, and a responsive structure. (These six dimensions are further articulated in the definition provided on Exhibit 1.)

These dimensions are inter-related, and to some degree they face inherent tensions among them. They are achievable *only if government makes meaningful commitments of financial resources*².

Fortunately, from time to time government does inaugurate a successful program that gives birth to a *property cohort*: hundreds or thousands of properties with a very high degree of similarity because they were all developed more or less contemporaneously under a standard production program. Creation of that successful cohort is the triumph of production. Almost immediately after its creation, that cohort starts to diversify. How and why it does creates profound challenges for enduring sustainable affordability.

Cohort evolution over time: entropic diffusion from homogeneity to diversity

In any portfolio, over time sameness degrades into difference, and from those differences of *attribute* arise differences of *outcome*.

Cohort evolution as a rubber duck race. Imagine a race of a thousand identical rubber ducks, utterly alike except in their numbering, all dumped into a slow-moving river at the same point and the same time. At first they move in a jostling mass, but inevitably a few are in front, catching the narrows and shooting ahead. Those to the sides may be caught in small eddies. Some may become entangled in shorebank branches. Bit by bit they separate from one another, until they are stretched the length and breadth of the river, some clustered in independent flotillas, others completely isolated.

Each affordable housing production program creates a cohort of properties that behave much like a rubber duck race. Properties that were all alike at inception – developed under the

² Getting more benefit from government financial resources is, of course, the complex challenge of program design and development. With ill-designed programs, government can put in vast resources and get little for its investment. For principles of program design, see [What Works and What Doesn't](http://www.recapadvisors.com) on Recap's Web site, www.recapadvisors.com.

same program, financed with the same loan vehicle, faced with precisely the same constraints and options – gradually become different. Location, tenancy, owner competency – indeed, every one of the program-specific variables – acts on each property a little differently. One has a construction problem, another faces a suddenly weak rental market. A third property has to replace a bankrupt general partner; a fourth accepts new financing to install sprinklers. Bit by bit, they separate, one from the other.

Now suppose that, as a policy maker, you want to corral all the rubber ducks. How do you do it?

The longer the properties have been on their own, the harder it is to generalize about them. Almost any statement you make has a counterexample property. Because they are at different places in the river, the properties respond differently to river-wide interventions. Dam the river at one point and you catch some, deflect others, and wave goodbye to still more.

In short, cohort differentiation is a *huge* challenge to policy makers, because over time:

- Difference overcomes similarity. Eventually, *any generalization you make is guaranteed to be wrong*. With the HUD inventory, we reached this state about ten years ago. The LIHTC inventory is reaching it now.
- Portfolio characteristics become harder to describe; behaviors are harder to predict.
- Any particular programmatic intervention works properly on a lower and lower percentage of the inventory and has a higher and higher percentage of unintended or undesirable consequences.

Cohort diffusion and its implications for sustainable affordability. Moving from metaphor into thought experiment, consider a portfolio's performance over time as being represented by a two-dimensional graph:

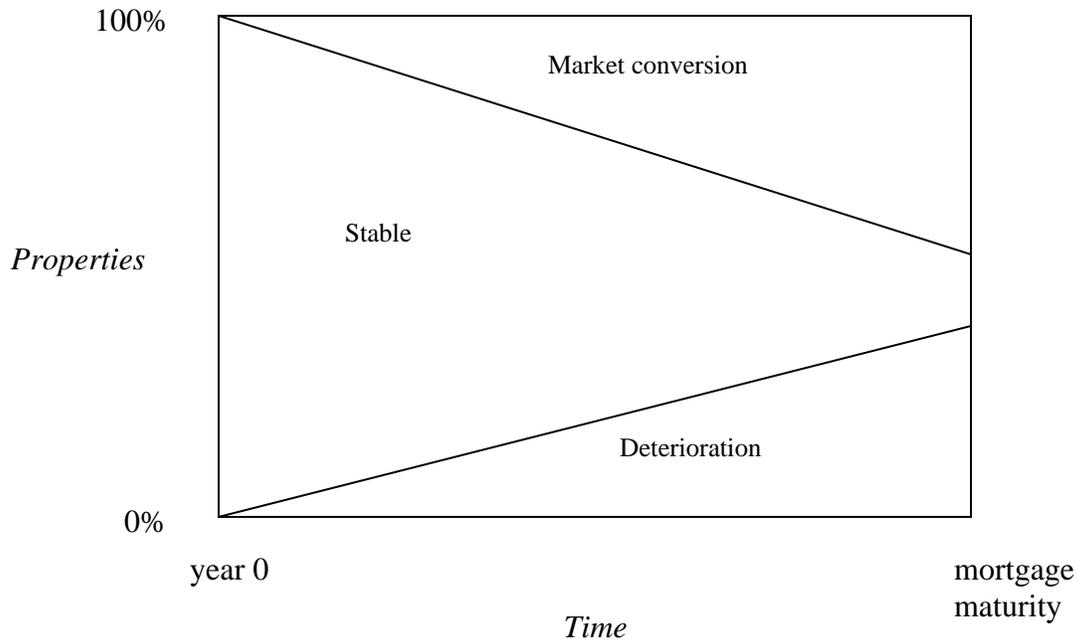
- The *vertical* axis ranks the properties from best (at the top) to worst (bottom).
- The *horizontal* axis measures time from original production.

Then we can draw two lines indicating property viability:

- *Conversion viable*: A top line heading down indicating that some properties become more valuable as conventional real estate than they are as affordable housing.
- *Affordable non-viable*: A bottom line heading up, indicating that some properties no longer work. They are headed for default and foreclosure.

We can illustrate this schematically as shown in Figure 1:

Figure 1 Cohort diffusion



Since this is a conceptual chart, actual numbers do not matter, only the overall shapes.

In reality, the lines may not be perfectly straight³, and their slope may vary based on program. But sooner or later, the original cohort will have divided into three basic groups:

- *Conversion*. Properties economically viable for market conversion.
- *Equilibrium*. Properties that are neither conversion nor non-viable.
- *Non-viable*. Properties that are no longer viable as affordable housing.

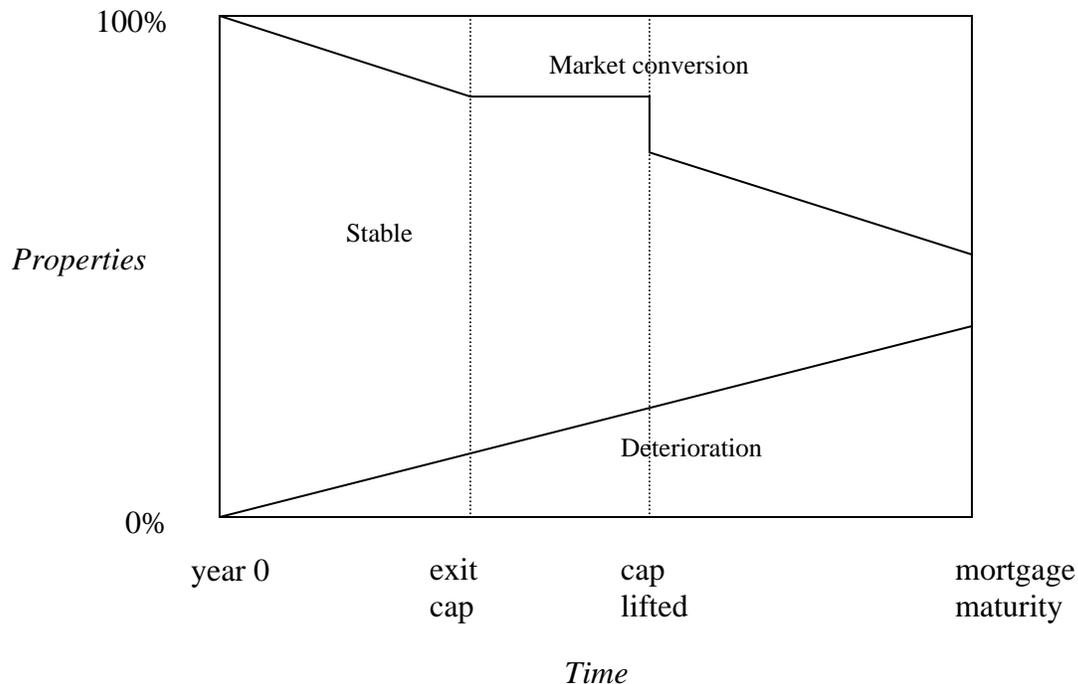
Policymakers, recognizing this, have in most programs sought to cap the exit of conversion-viable properties. Typically, the financing instrument requires the owner to waive the legal ability to convert for some (long) time⁴. In the short run, this is fine, because it

³ These are *real-dollar* (that is, inflation adjusted) curves, simplified. But in real life, inflation is moving both of them upward (also in curves). Thus a 'straight line' in our graph is equivalent to a curve whose upward slope matches underlying inflation. Further, the zone of affordability can widen and compress based on market factors. Unfortunately, these tend to pinch (e.g. recession and high interest rates can also trigger high inflation and unemployment and suddenly the affordability strait is narrowed). Such nasty pinches can happen suddenly – for instance, 1973-75 or 1986-89 – and destroy viability for a vast swath of properties.

⁴ Examples include 1 year (Section 8 renewal), 5 years (Mark Up to Market), 15 years (LIHTC before 1990), 20 years (HUD older assisted), 30 years (LIHTC after 1990), 50+ years (LIHPRHA), and perpetuity (some LIHTC variations).

suppresses conversion ... but the instant the lock disappears, there is a burst of pent-up demand that sometimes turns what would otherwise be acceptable conversion triage into a stampede, as shown conceptually in Figure 2:

Figure 2 Exit cap and removal

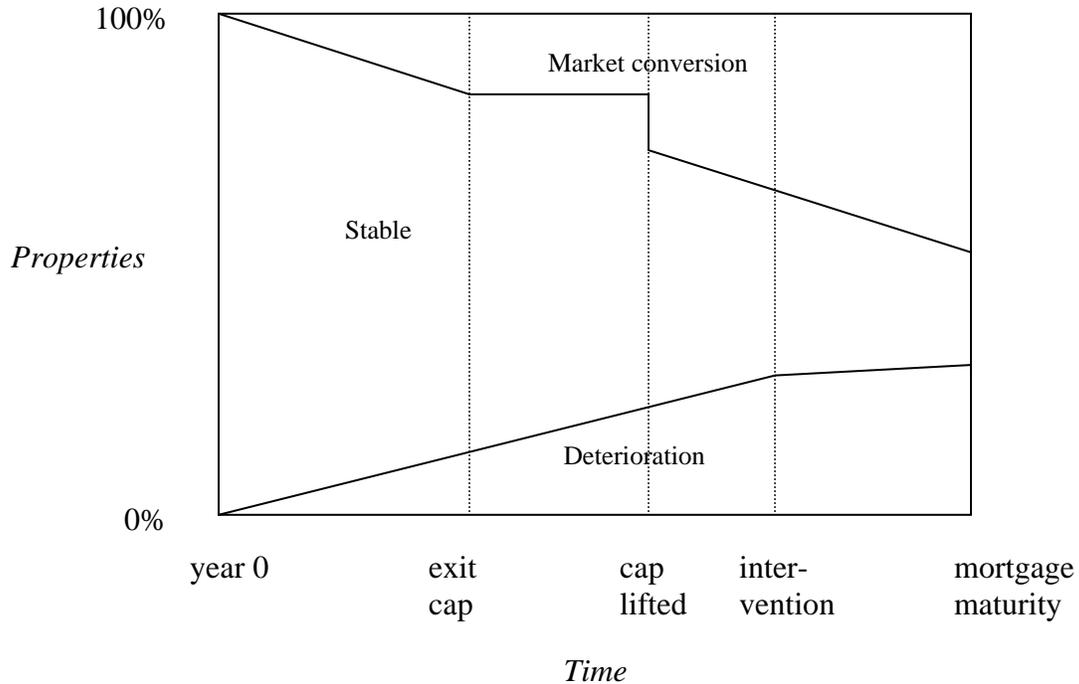


Even with programmatic designs to prevent or defer market conversion, programs cannot prevent individual property failure. These tend to be subject to individual interventions (see next section), but more commonly, a whole cohort of properties can be vulnerable to the same thing at the same time:

- Budget-based properties face sudden increases in costs (e.g. 1974 utility spike).
- Properties lacking income subsidy can face recession and vacancy problems (e.g. 1986 dip).
- Properties with short-term financing can find themselves unable to replace their debt (e.g. 1982 interest rate spike or 1990 credit crunch).

When a cohort hits a systemic problem (such as 1974's utility-cost spike), legislators often design a programmatic intervention. While this may be cold comfort to those properties already foreclosed, and irrelevant to those with conversion potential, most such interventions do mitigate the loss of viability, as shown in Figure 3:

Figure 3 Programmatic intervention slows deterioration



Each intervention⁵ is significant, usually sensible, and usually effective. Even with them, diversification increases. Properties migrate within the swarm: some that were good become bad, and vice versa. Accepting relief via a workout adds new conditions that divide a cohort. Workouts that add affordability covenants differ from those that do not. The number of adjectives needed to specify a property as similar to or distinct from others increases. Today, for instance, to define a cohort one needs to know:

1. Original program.
2. Workout or no?
3. Resyndication or no?
4. Preservation or no?
5. Change in general partner or no?
6. Investors original or successor via step-up?
7. Mark-to-market or no?
8. Mark-Up-to-Market or no?

⁵ Often workout or viability interventions extract a price – such as extension of affordability or renegotiation of previously established rights – so that interventions to change the bottom line slope also derivatively change the top line slope ... and sometimes in unexpected ways. It all gets very complicated very quickly ... which is the point of this article.

If we accept that these eight elements are independent⁶, this implies up to 256 different cohorts ... *before* we even distinguish by property market, original tenancy, or type of construction, or by general partner (capacity, organizational size, first or second generation, old-think or new).

Discontinuity, recapitalization and program change

Over time, what was once homogenous cohort diverges – sometimes in large flotillas, sometimes in isolated dinghies. This divergence is neither program failure nor extraordinary, it is inevitable. But it calls for both property and programmatic interventions.

Property interventions: the inevitability of recapitalization. Though presented as depictions of whole groups of property, the cohort diffusion diagrams we presented above can also be thought of as a probability display for an individual property. The day after a property is completed, it has virtually no chance of either going market or going into default⁷. As time passes, that property becomes increasingly likely to need something. What it needs, and when it needs it, will be specific to that property – but it is all but inevitable that a property *will*, sooner or later, need some aspect of its physical configuration, operations, financing or affordability changed, via a recapitalization.

Recapitalization demands thinking antithetical to the regulatory mindset. By definition it is unusual, and transitory – a property enters a recapitalization negotiation interval and then completes its recapitalization, returning once again to stability. Skills required are innovative and extemporaneous, the opposite of by-the-book administration. Solutions are negotiated and evaluated not by handbooks or protocols but by credibility of projected outcomes. It requires rule-breaking and rule-making, not slavish adherence to outdated rules.

By its nature, recapitalization is piecemeal that lends itself more to principles and talent than protocols and programs. Recapitalization is, however, either fueled by tools (e.g. §8 LMSA when we had it, Flexible Subsidy when we had *that*) or hindered by obstacles (e.g. contingent Federal exit taxes). Changes in the external environment can, therefore, have a huge impact in accelerating or decelerating the pace and volume of recapitalizations.

Programmatic interventions over the last thirty years. Experience over the last thirty years suggests that a major program intervention takes place every 4-5 years:

1970: Birth of modern era in US affordable housing.

1976: LMSA workouts.

1981: ERTA and resyndication.

1986: Tax reform and price collapse.

1989: Preservation (ELIHPA or LIHPRHA)

⁶ For those of you expert practitioners about to protest, "but *this* is incompatible with *that!*", suffice it to say that we have seen just about every combination imaginable, including some that ought to have been impossible ... but someone misread the documents or negotiated a property-specific exception.

⁷ I do personally recall, however, a property that was brought to final endorsement after construction and missed its first permanent mortgage payment, leading to a multi-year saga culminating in a long-overdue foreclosure.

1995: Mark to Market (demonstration; permanent legislation in 1997).
1996: Preservation repealed; prepayment and opt-outs.
1999: Mark Up to Market and renewed affordability.

Seven interventions in thirty years. And each intervention further subdivided the portfolio.

Cohort diversification as a governing reality. In short:

1. Cohort homogeneity is an illusion of program development that lasts, if it exists at all, for a tiny window of time.
2. Like entropy after the big bang, cohort diversification begins at program conception and continuously increases to an end point where it is impossible to generalize without so many caveats and qualifiers as to render generalities that are not wrong almost meaningless.
3. Because of cohort diversification, there will *always* be a fraction of the cohort – individual outlying properties – needing customized recapitalization outside a programmatic context. Conversely, every program will have properties that do not fit it and should be custom-restructured.
4. There is no such thing as the perfect program. Every so often, program rules have to be redesigned. Experience shows this can be as frequently as every five years, but if we assume they alternate between bad (workout) and good (conversion) interventions, the half-life of a typical stimulus is about ten years.

Policy implications

If there is no such thing as permanent sustainable affordability, what then should we pursue? And how should we pursue it?

Paraphrasing Robert Louis Stevenson, we should travel hopefully, but expect never to arrive, instead periodically making changes:

1. Policymakers should recognize and accept that no matter how robust, any program will need periodic adjustments as its property cohort ages and diversifies. This represents a huge challenge for government, because (a) government may be slow to recognize that what seem to be isolated failures are instead harbingers of the need for systemic change, (b) when the time comes to make changes, chances are it will be different individuals from those who created the original program, and they may lack historical context, and (c) often the key elements needing change are embedded in statute, and thus *very* hard to change.

2. Statutes should specify less, not more⁸: outcomes and boundaries, not processes or breakpoints. Statutes should allow regulations and administrative guidance room to make periodic tweaks in program parameters, consistent with the broader objectives. In effect, this principle reduces the cost of program modification, and thus increases a program's practical flexibility.
3. It is very hard – some would say impossible – to design good programs when the Congress and the Administration are fundamentally at odds⁹. Each distrusts the other's motives and thus tends to over-specify in statute, as a means of arrogating authority. This almost argues that housing advocates should seek legislative enactment only when they are likely to have a compatible Congress and Administration, and use periods when they are at odds as intervals to develop new ideas and shape the debate, but *not* to press for major and fundamental legislative change¹⁰.
4. Property interventions – recapitalizations and other property-specific restructurings – should not be seen as either extraordinary or as a program failure. Rather, they are more or less inescapable eventualities even though their timing and nature are unpredictable and uncontrollable. Robust programs should build in easy-replacement mechanisms or, if that is too much of a challenge or too loose a standard, programs should avoid overspecificity or over-defining operations. The fewer choices you have, the harder it is to design a property-specific recapitalization ... and absent a recapitalization, default and foreclosure follow, achieving only through failure what should be achievable through innovation and negotiation.
5. Since environments change, programs may actually be more robust if they embed one or more options for either the public or private sector¹¹. This is counterintuitive – how can creating a sunset make something more long-lasting? – but opening options raises public consciousness and creates the useful predictable turbulence that enables managed change.
6. It is easier to protect sustainable affordability against upside triage (market conversion) than downside triage. Better-designed programs require a minimum period of affordability before legal options open, allow for rising economic returns within the boundaries of affordability, and can even match market economics through increased government contribution. (Mark Up to Market does this.) This works better if the

⁸ Despite this sound principle, legislators sometimes consciously specify more than they should, as a deliberate insurance against a future change in controlling party or philosophy. While politically understandable, this is usually regrettable.

⁹ In other writings (see Web Update 22), we have characterized such environments as legislatively *turbulent* and contrasted them with *laminar* environments where executive and legislative branches are in synch. The distinction has profound significance for the type and viability of affordable housing programs that arise.

¹⁰ Of course, one-party or one-philosophy government is rare in American politics, so a party or philosophy that has long been out of power may have to be active, if only to advance alternatives to the prevailing wisdom. Similarly, there are often moments when the prevailing party is carrying a particular broad legislative concept that can, with a little pragmatic political creativity, be harmonized with the minority's goal and carried along in its wake.

¹¹ For instance, even with forty-year loans, Section 8 expiration after twenty years creates options that not only accommodate cohort diversification, they also compel policy makers to act. A very good case can be made that mark-to-market would not have happened without the looming cliff of Section 8 expirations, but its happening has been a boon to the inventory, even including many cohorts beyond those with expiring Section 8. See *Mark to Market, a Fundamental Shift in Affordable Housing Policy*, http://www.fanniemae.foundation.org/programs/hpd/pdf/hpd_1001_smith.pdf.

government delivers affordability through supplementing resident incomes¹² rather than buying down capital cost.

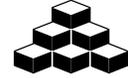
7. Even if legal restrictions inhibit upside triage (market conversion), as they do so they will create pent-up demand. The perceived agitation becomes disproportionately greater as time passes, so that policy can be driven by anecdote based on extreme cases rather than statistically representative understandings of the portfolio. Additionally, should a conversion window open, there may be a sudden rush of activity, so they should be preceded by appropriate notice provisions, to give preservation advocates a chance to create equitable proposals.
8. Triage on either end – upside or downside – is inevitable. Systems designed to eliminate triage are always way too complicated and way too expensive, over-rewarding the many to save the outlying few. Better is just-in-time intervention coupled with accepting that some amount of loss is par for the course.
9. Because some loss is inevitable, and given that the U. S. population continues to grow, there should always be a viable production program adding new stock.
10. To achieve continuous production, government must make a perpetual renewing moral commitment to affordable housing: this means both (a) continuous funding, and (b) periodic and timely program origination or modification.
11. Program tweaking should be seen not just as a chance to reduce triage but an opportunity to apply lessons learned and make future performance better. In the last thirty years, for instance, the U. S. has gone through four distinct generations (the LIHTC paradigm being the most recent), one of which (HUD older/newer assisted) included a radical conceptual shift halfway through (changing the government's contribution from capital cost buydown to resident income subsidy).
12. Though individual programs obsolesce – and should be allowed to obsolesce, ceasing production to be supplanted by new ones – policymakers should not regard that obsolescence as 'failure' but rather recognition that each program works well in a particular external environment, and as that environment changes – in ways we can never be smart enough to predict – we should take that change as a time to design a new program. In such fashion, affordable housing program design actually advances.

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¹² Of course, income supplements risk creating their own family dependency traps because properties become dependent on subsidy that government fears to cut, and residents become dependent on subsidy that penalizes them for improving their economic prospects. Neither choice is ideal; the tension is an ongoing challenge.

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Exhibit 1

Some useful concepts: Sustainable affordability, at-risk property, discontinuity, Conversion liquidity, and recapitalization

Sustainable
affordability

A property enjoys *sustainable affordability* if it is now and should be for many years affordable and desirable to low-income residents. This necessarily encompasses six components:

1. *Physical*. Represents quality housing with sound condition, attractive appearance, and no urgent capital needs.
2. *Operational*. The property has high occupancy, stable expenditures, and generates positive cash flow.
3. *Financial*. Long-term capitalization is in place, in balance, and not in danger of disruption; property maintains adequate working capital and cash reserves.
4. *Affordable*. Income-eligible residents can afford the rents either from their own resources or with resident income subsidy.
5. *Capable owner*. The property owner is a preservation entity with both mission commitment and business capacity.
6. *Responsive*. Regulatory and operational schemas allow flexibility to enable the property to cope with the unexpected.

See [Six Dimensions of Successful Affordable Housing](#) and see *Preservation Entities* in [Renewed Affordability: A Paradigm for Existing Affordable Housing](#).

'At-risk' property

A property whose [sustainable affordability](#) is in near-term jeopardy. This can arise from several different directions:

1. *Market conversion*. Property has substantially higher value as market housing and there is powerful economic pressure to convert.
2. *Financial disruption*. Underlying financing or critical subsidy will terminate, balloon, or change abruptly.
3. *Physical deterioration*. Property age, perhaps exacerbated by an external event (e.g. harsh weather or a physically stressful tenancy), mandates a major renovation or upgrade that cannot be handled with

internal cash flow resources.

4. *Owner waning capacity.* Owners age, buy, sell, change philosophy, experience financial reverses or successes, or simply fail to keep up with changing times.

Discontinuity Any material event disrupting [sustainable affordability](#) and placing a property [at risk](#).

Conversion liquidity A property's conversion potential may be conveniently thought of as being in one of three fundamental states of nature:

1. *Liquid.* The property is economically able to convert today, either because its rents could rise, costs could fall, or an alternate use (e.g. occupant ownership) would be materially more valuable. Liquid properties stay affordable only if restricted by covenant or if the owner is decision-impaired.
2. *Slush.* The property probably has potential above its current use, but not so much as to make it liquid.
3. *Frozen solid.* The property is so uneconomic that only the presence of an affordability-oriented finite resource (e.g. Section 8 contract, below-market mortgage) enables it to be viable.

Over time, individual properties tend to warm up: slush turns liquid, frozen turns to slush.

Policymakers allocating resources are thus challenged to design interventions that capture properties in their incipient slush phase, *after* they have ceased been frozen and *before* they become fully liquid.

Recapitalization The financial restructuring of a property to change its capital configuration. Usually carries with it changes either in operating requirements (rents, expenses) ownership (new partners in, old ones out) or affordability (extended, modified, increased, or relieved). Not only is capitalization restructured, property [sustainable affordability](#) is invariably enhanced.

Many recapitalizations are stimulated by a single proximate externality (e.g. [conversion risk](#), imminent financial default, physical collapse), but in well-designed ones, all relevant attributes are addressed. Indeed, precisely because this is so, recapitalization is useful not simply to patch whatever hole the transaction has suffered, but rather as a *sub rosa* reorientation of program requirements.

Mark-to-market and renewed affordability are both recapitalization programs.

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Exhibit 2

**Taxonomy of American affordable housing, 1937-2002:
Four generations, nine original cohorts**

<u>Generation¹</u>	<u>Heyday</u>	<u>Cohort</u>	<u>Description and challenges</u>
1. Public housing	1937-54	a. Family	Direct local ownership. Slum clearance device not specifically aimed at poverty alleviation. Confusion between goals: affordability, sustainability, urban revitalization.
	1962-66	b. Elderly	Targeted population with specific goal of long-term affordability.
2. Appropriated (public-private)	1968-74	c. Rent buydowns	Provide financial incentives to enable cheap rents yet motivate developers (for-profit or non-profit). Chiefly mortgage insurance or subsidy programs: §202 ² , 221d3, 236, and 515.
	1977-85	d. Section 8 AAF	Build market-quality properties even where markets do not support them. Provide resident income subsidy (§8) attached to the property to enable viability. §221d4, HFA ³ programs, and §8 mod rehab.
3. Tax credit (LIHTC)	1986-90	e. Basic	Offer tax incentives to raise soft equity that enables rent buydown without appropriated funds. Conventional and §515 ⁴ .
	1988-now	f. Deep targeted	Using LIHTC as a base, add supplementary soft debt to deliver even deeper affordability to target populations (disabled, extremely low income, HOPWA).
4. Moving to market	1996-now	g. Mark Up to Market (MUM)	Allow older properties to raise their rents back to market (so they can once again be sustainable) and inject resident income subsidy (to assure ongoing affordability). ELIHPA/ LIHPRHA preservation, Mark Up to Market, and §202 refinancing.
	1996-now	h. HOPE VI	Transfer properties from public housing (Generation 1, Cohort a) to tax credit (Cohorts e-f-g). Usually combined with additional resources.

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¹ In fact, some American affordable housing dates from Pilgrims' era: by 1660, Boston had built an almshouse. Such activities were generally private charities or local civic initiatives rather than national programs, so for this purpose we ignore them.

² Since §202's are direct non-profit ownership, and §515's were originated by the Farmers Home Administration (FmHA, now the Rural Housing Service), some might see them as separate cohorts. Perhaps they are better considerate separate species within the same cohort.

³ While there are important differences between HUD and HFA flavors, we regard them as separate species within the same cohort.

⁴ §515 used an appropriated resource (the 1% FmHA mortgage) on top of the soft equity to create an even deeper rent buydown so theoretically one could classify LIHTC/§515 as a hybrid that straddles cohorts.