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THE POWER OF LEVERAGING SECTION 8

A REPORT BY THE CALIFORNIA HOUSING PARTNERSHIP CORPORATION, WITH SUPPORT FROM THE JOHN D. AND CATHERINE T. MACARTHUR FOUNDATION

California Housing Partnership Corporation

California's Experts on Affordable Housing Finance, Advocacy & Policy

369 PINE STREET, SUITE 300, SAN FRANCISCO, CA 94104

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About the California Housing Partnership Corporation

CHPC was created by the State of California in 1988 to assist nonprofit and government organizations to create and preserve affordable housing while providing leadership on housing policy. CHPC is unique in combining transaction-based technical expertise with deep experience in affordable housing policy work. To date, CHPC has helped preserve and create more than 11,000 affordable apartments for low-income households in California. CHPC also provides affordable housing finance training to nonprofit and government organizations across California.

Table of Contents

I) Introduction: The Power of Leveraging Section 8……………….…………………………3

II) Section 8 Subsidies and Affordable Housing Finance: Key Concepts………………………5
  1) Types of Section 8: Tenant-Based and Project Based…………………………………...5
  2) The Importance of Private Financing……………………………………………………6

III) Leveraging Project-Based Section 8 Vouchers…………………………………………….8
  1) How Leveraging of Project-Based Section 8 Vouchers Works………………………….8
  2) The Potential for Leveraging Project-Based Section 8 Vouchers………………………11

IV) Leveraging Federal Section 8 Contracts………………………………………………..13
  1) How Leveraging Federal Section 8 Contracts is Different…………………......………..13
  2) The Potential for Leveraging Federal Section 8 Contracts……………………………....15

V) Beyond Leveraging: The Power of Section 8 to House the Homeless........…………...……16
  1) How it Works…………………...……………………………………………………..16
  2) Significance of the Different Section 8 Increments……………………………………...17
  3) Findings…………………………………………………………………………………20

VI) The Role of Public and Private Sectors in Leveraging Section 8……..…………………....21
VII) Recommendations……………………………………………………………………..24
VIII) Conclusion…………………………………………………………………………......26
IX) Appendices…………………………………………………………………………..…..27

I. Introduction: The Power of Leveraging Section 8

The U.S. population is expected to exceed 349 million by 2025, an increase of 67 million people over the year 2000. This unprecedented growth in the U.S. will necessitate tremendous investment in new housing units to accommodate some 32 million households by 2025. As one researcher noted, this new housing stock will be the equivalent to about half of the stock on the ground in 2000 and will come with a price tag of roughly $30 trillion.[1] The U.S. Department of Housing and Urban Development (HUD) estimates that nearly six million households (more than 5% of our population) face "critical housing needs." In considering how our country will develop new housing for our growing population, it is essential, therefore, that we think creatively about how we will invest in affordable housing in particular.[2] Resources are scarce: federal budget constraints and priorities for funding military operations have put great pressure on state and local housing budgets, and have necessitated increasingly innovative state, local and private partnerships to preserve and build affordable units. This report will explain how Section 8 increment financing offers one model to leverage public resources and yield a greater number of homes affordable to low income households without additional cost to the federal government.

The Section 8 program can be used as an efficient and powerful mechanism for leveraging more than $3.6 billion from the private sector to preserve and create apartments affordable to very low income households.[3] Policy changes over the last 10 years have expanded the potential for affordable housing developers to leverage Section 8 in unprecedented ways.[4] Unfortunately, developers and financial markets have a poor understanding of the power of Section 8, leaving its potential largely untapped. This report describes the potential for leveraging project-based Section 8 on a national scale to produce significantly more affordable housing without using additional federal resources. In addition, this report illustrates the power of project-based rental subsidies to make

What is Section 8?

Section 8 is a rent-subsidy program developed out of the National Housing Act of 1937 and innovative housing programs of the 1970s, in which tenants generally pay 30% of their income and the U.S. Department of Housing and Urban Development (HUD) pays the difference, up to a market-based contract rent amount set based on HUD guidelines. Landlords are generally willing to participate in the program because they can charge market-rate rents. Unlike other federal direct spending programs that produced affordable housing, Section 8 survived the budget cuts of the early 1980's because it was seen as a relatively efficient, market-driven, demand-side program that supported private landlords and developers. There are approximately 1.4 million households participating in the older federal Section 8 program and another two million households participating in the Section 8 voucher program.[4]

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[1] Nelson, A.C. (2006) "Longer View: Leadership in a New Area. Journal of the American Planning Association, 72(4): 394.

[2] HUD defines "critical housing needs" as the number of families and individuals "whose incomes fall 50 percent below an area's median income, who either pay 50 percent or more of their monthly income for rent, or who live in substandard housing." U.S. Department of Housing and Urban Development. "Affordable Housing Needs 2005" Released May 2007: 1.

[3] Congress and the U.S. Department of Housing and Urban Development (HUD) have defined housing costs as "affordable" when they do not exceed 30 percent of a household's income. Section 8 is a rent-subsidy program in which tenants pay 30 percent of their income and HUD or the Public Housing Authority pays the difference generally up to the fair market rent as determined by HUD. $3.6 billion includes project-based Section 8 vouchers and federal Section 8 contracts, assuming 20-year contracts.

[4] In 2005, HUD issued its Final Rule on Project Based Vouchers, re-affirming the ability of local public housing authorities to allocate up to 20% of their Section 8 vouchers for Project-Based contracts as first permitted in 1998.

mainstream affordable rental housing accessible to extremely low-income and fixed income households, some of whom may be coming out of homelessness.

Recommendations

Our research reveals that harnessing the market-based power of Section 8 could yield up to $3.6 billion in additional financing over the next 20 years for the new development and preservation of homes affordable to low income households in 24 states without any additional outlays of federal funds. The leveraging of project-based vouchers is made possible by combining this project-based rental subsidy with the syndication of Low Income Housing Tax Credits. Combining these resources together has the potential to finance the construction of at least 56,000 additional affordable rental apartments in these 24 states. Using these two powerful resources in combination would enable HUD, local Public Housing Authorities, project owners and local governments to provide housing for more families – and families of lower incomes – than could be reached with the Section 8 program or the Low Income Housing Tax Credit program alone. To harness this potential, we must take three key actions:

(1) Educating developers, local governments and financial institutions about the power of Section 8 leveraging;
(2) Changing federal laws and regulations to provide greater flexibility to housing authorities to use this tool; and
(3) Stabilizing federal financing of the two Section 8 programs to reassure the financial markets that it is reasonable to have confidence in Section 8 rental income.

Pathways for such actions are outlined in the final sections of this report.

Organization of this Report

The report is organized into three main sections. The first section provides background information on key housing programs that enable Section 8 leveraging. The second section considers two leveraging models – project-based Section 8 vouchers and federal Section 8 contracts. For each type, we will define the Section 8 increment, describe how it can be used, through case study examples, and discuss how much increment could be leveraged nationwide. Finally, the third section of the report presents conclusions and recommendations for developers, government agencies and policymakers to effectively maximize Section 8 leveraging potential.

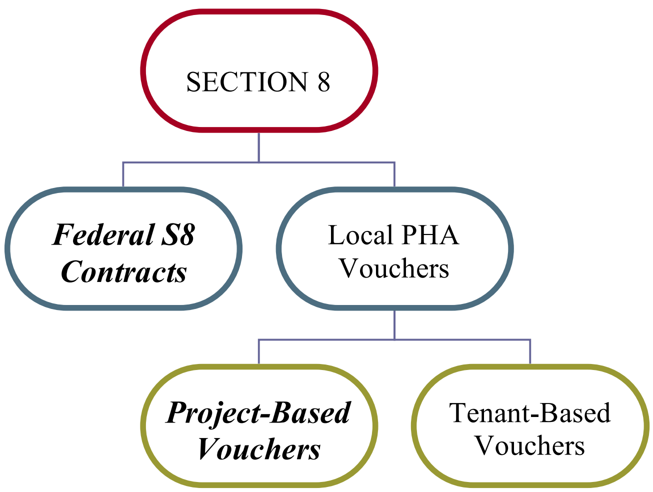
[5] Center for Budget and Policy Priorities. "Introduction to the Housing Voucher Program." Revised July 6, 2007.

II. Section 8 Subsidies and Affordable Housing Finance: Key Concepts

Leveraging of Section 8 involves combining project-based Section 8 rental income with the provisions of the Low Income Housing Tax Credit program. Key provisions of each program are discussed below.

1) Types of Section 8: Local and Federal; Tenant-Based and Project-Based

Section 8 contracts are administered in three scenarios: tenant-based vouchers and project-based vouchers, managed locally by Public Housing Authorities, and Section 8 contracts, administered by HUD.



The first scenario, *tenant-based vouchers*, consists of a voucher provided to a low-income household. In this scenario, *local* Public Housing Authorities (PHAs) allocate vouchers to low-income households to assist them to pay market rents for private apartments. In this Section 8 scenario, the voucher stays with the household.[6] The tenant-based program is the largest of the three models, but is not compatible for Section 8 leveraging since the subsidy follows the household rather than being linked to the development.

In the second case, regional HUD offices administer *federal section 8 contracts* with funding provided from the HUD budget. In the 1970s and 80s, the federal government authorized and funded a variety of long-term Housing Assistance Payment (HAP) contracts. These HAP contracts began to expire in 1997 and can now be renewed generally for one-, five-, or 20-year terms, with renewals subject to federal appropriations. Federal contracts are a secondary focus of this report; they have more limited potential in terms of leveraging because their supply is limited.

Determining Section 8 Rents

The local PHA or HUD field office determines the local rental rate using market comparable studies in combination with a fair market rent (FMR) schedule provided by HUD. FMRs are based on a survey of area market rents and adjusted by formulas designed to set the rent just high enough to ensure that is attractive to a significant number of landlords. The PHA has authority to set its maximum rent level ("Payment Standard") between 90 and 110% of the FMR for its area.[6]

[6] A household that obtains a tenant-based voucher has the right to use it to lease any apartment meeting minimum health, quality and safety standards and where the landlord is willing to accept the terms of the voucher program. The household has the right to move and take the Section 8 voucher to another apartment and to pay no more than 30% of its income if the rent on the apartment it selects exceeds the market-based payment standard.

[7] Rents in the federal Section 8 contracts were initially set to cover the initial cost of the development in the case of the New Construction, Substantial Rehab and Moderate Rehab programs, or they were set to cover capital and operating expenses in the case of the Loan Management Set Aside contracts. Initial rents in the PHA Section 8

A third Section 8 model has emerged in the last 10 years, in the form of *project-based vouchers* issued by PHAs. In 1998, the Quality Housing and Work Responsibility Act authorized PHAs to use up to 20% of their Section 8 vouchers in the form of project-based contracts. In 2005, HUD issued the final rule on Project Based Vouchers, paving the way for PHAs to use their vouchers at specific properties. PHA project-based contracts can have initial terms of no more than ten years with renewals currently limited to one-year at a time, again subject to federal appropriations. Section 8 regulations stipulate that non-senior housing developments may only receive project-based Section 8 contracts on 25% of project apartments. In affordable senior housing developments, by contrast, 100% of the apartments may be covered by a project-based Section 8 contract. Project-based vouchers – in both senior and family developments – are the central focus of this report given their relative newness and under-utilization of this program.

2) The Importance of Private Financing: Tax Credits and Private Debt

The development and rehabilitation of affordable housing relies increasingly on the availability of private financing sources. During the 1980s, 1990s and 2000s, the federal government steadily retreated from its role as a financing source for affordable housing. Much of this responsibility has shifted to local governments, who provide "gap financing" to affordable housing developers. These city funds often originate from federal programs such as Community Development Block Grants and the HOME (Home Investment Partnerships) program. Today, cities are watching these funding sources dwindle, even as land scarcity, regulatory hurdles, and rising construction expenses drive up housing development costs.

To make affordable projects feasible, many developers now seek out private financing sources. Developers often raise equity through the sale of Low Income Housing Tax Credits (LIHTCs) to investors. In just two decades, the LIHTC program has in fact emerged as the single largest funding source for affordable housing development.[8] The LIHTC program therefore drives the financing options for most affordable rental projects undertaken today – new construction and rehabilitation alike. However, private construction and permanent loans are often still necessary to enable projects to pencil out – as is gap financing from local government agencies. Section 8 leveraging helps local governments to maximize the impact of their limited gap financing budgets to serve more households, while helping developers offer rental apartments to households at lower incomes.

Under the LIHTC program, owners agree to develop their projects with a percentage of homes affordable to low or very-low income households. Rents are pre-set to be affordable to households typically earning either 50% or 60% of Area Median Income (AMI). If we suppose a local area has an AMI of $83,000 for a family of four, then a 60% AMI household of three could earn up to $45,240 and qualify for a 60% AMI apartment in a property with tax credits. The rent for this LIHTC apartment would be set at $1,131 per month, with the assumption that the

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program are generally set only based on the market for comparable rental properties. Federal project-based Section 8 rents, however, were generally not designed to keep pace with market rents. Instead, they were allowed to increase based either on Operating Cost Adjustment Factor for the Moderate Rehab program or Annual Adjustment Factor for the New Construction/Substantial Rehab program.

[8] See the American Bar Association Legal Guide to Affordable Housing Development, 2006, for more information on LIHTC program regulations and the growth of the program.

household earning $45,240 would be able to pay 30% of its income on rent and therefore rent should be capped at $1,131 per month.[9]

LIHTC rents alone will not attract as much private financing as will the leveraging of LIHTCs with Section 8. Private lenders underwrite loans to projects based on their income potential, and their ability to pay debt service on a loan. Tax Credit rents are pegged, by design, below market – and this limits the income a project owner can use to pay debt service. Section 8, in contrast, provides project owners with rental income equal to Fair Market Rents. (This higher rental income includes a component paid by the tenant and a component paid by HUD.)

Higher rental income means a project has more income available to pay debt service on a loan, which means the property can support a larger loan from a private lender. This additional debt may be used for renovation of existing affordable housing, or for the production of new rental housing affordable to very low income households. Section 8 leveraging combines the equity generated through LIHTCs with the long-term, comparatively higher income stream from Section 8 Fair Market Rents, to maximize the benefits of both programs. Section 8 leveraging weaves together provisions of the Section 8 program and the LIHTC program to attract more private debt from conventional lenders. Section III of this report will describe how property owners and PHAs can calculate the Section 8 increment – the difference between these two rental income levels – and how the increment can help draw in additional loans.

[9] This example uses 2007 HUD data for Oakland, California. For more information on LIHTCs and rent limits, please refer to www.novoco.com/low_income_housing/lihtc/index.php

III. Leveraging Project-Based Section 8 Vouchers

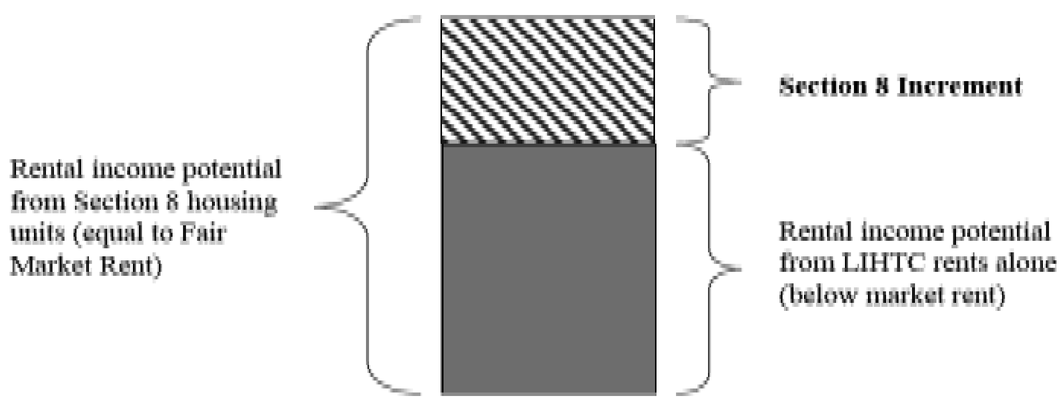
1) How Leveraging Project-Based Section 8 Vouchers Works

Project-based Section 8 rent subsidies can be used in combination with Low Income Housing Tax Credits (LIHTC) to leverage private capital in areas where the market rent exceeds the maximum rents under the LIHTC program. Higher rental income means a project can support a larger loan from a private lender, and this financing in turn reduces the amount of government subsidy required to make the project feasible. This additional debt may be used for renovation of existing affordable housing, or for production of new rental housing affordable to very low income households.

a) Defining the Project-Based Section 8 Voucher Increment

The "Section 8 Increment" is the difference between the market rent paid by the Section 8 rent subsidy program and the affordable rent that could otherwise be charged to a low income household under the Low Income Housing Tax Credit program (See Figure 1 below).

Figure 1
Project-Based Section 8 Increment



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This difference between the market rent paid by the Section 8 program and the LIHTC rental income is called the Section 8 increment. This increment is used by the affordable housing industry to estimate the capacity of the property to pay debt service. More rental income can support higher debt service payments.

b) The Mechanics of Leveraging the Project-Based Section 8 Increment

Project-based Section 8 vouchers may be leveraged in two contexts: either to finance new construction or to acquire and rehabilitate existing buildings. At no added cost to a PHA, a project enters into a 10-year project-based contract, and the owner gains ability to assign Section 8 payments as collateral for the private loan. Owners can thereby drastically increase the amount of private loans for these properties.

Figure 2, below, uses an existing property in El Dorado Hills, California as a guide to the mechanics of calculating the Section 8 increment and determining the amount of private debt the increment can attract. This 168-unit new construction project for large very low-income families includes 42 project-based Section 8 apartments and a total of 40 one-bedroom apartments, 60 two-bedroom apartments, 49 three-bedroom apartments, 18 four-bedroom apartments and a three-bedroom manager's apartment. Funding sources for this project include 4% LIHTCs and bonds issued by the California Housing Finance Agency.

The use off project-based Section 8 vouchers allowed this property to increase its net available annual income by $211,896. Leveraging project-based Section 8 ultimately boosted the private financing for this property by $1.5 million. Figure 2 outlines how this loan was calculated.

Figure 2: How the Section 8 Increment Boosts Maximum Mortgage Calculation

	Tax Credit Rents	Section 8 Increment (Project-Based S8 units)
Income		
Annual Scheduled Gross Income – Residential (See rental comparison chart below)	1,428,924	211,896
Vacancy Loss – Residential	(82,041)	0
= Effective Gross Income	1,346,883	211,896
Expenses		
- Operating Expenses	634,772	0
= Annual Net Available Income (total)	712,111	211,896
Maximum Mortgage Calculation		
Debt Service Coverage	1.10	1.10
Available for Debt Service	647,464	211,896
Maximum Mortgage	**10,000,000**	**1,500,000**

Total amount of government subsidy saved:	**$1,500,000**
Amount of government subsidy saved per Project-Based Section 8 apartment:	$35,714
Total Development Cost of each Project-Based Section 8 Apartment:	$183,990
Percentage of total funding represented by PB Section 8 leveraged private debt:	19.4%

Comparison of Tax Credit Rents vs. FMRs in the Sacramento MSA (2005)

Number of bedrooms	Tax Credit Rent (60%)	Tax Credit Rent (50%)	Tax Credit Rent (35%)	FMR
1	721	601	420	812
2	865	721	504	971
3	999	833	583	1,403
4	1,116	930	651	1,639

Case Study #1, on the following page, provides more detail on how owners are combining project-based Section 8 Increment financing with other financing sources to construct new homes for very low income households. Please see Appendix D to this report for an example of leveraging project-based Section 8 for an acquisition/rehabilitation of an existing property.

Case Study #1: Leveraging Project-Based Section 8 for New Family Housing

Project Description

Orange Grove Gardens is a new construction project located in Pasadena, California and targeted to large families. The building includes 17 two-bedroom apartments, 20 three-bedroom apartments and a two-bedroom manager's apartment. The project was financed with funds from the City of Pasadena, County of Los Angeles, LIHTCs, Federal Home Loan Bank Affordable Housing Program funds, and private debt.

Orange Grove Gardens provides rental housing opportunities for working families with low and very low incomes, at 30% to 50% of Area Median Income. The Pasadena Community Development Commission owns the project site and has executed a 99-year ground lease with the sponsor. Lease payments will be $1/year until the date on which the deferred developer fee and the City's loan have been repaid in full.

Summary of Leveraging

Total project costs for Orange Grove Gardens were $12.1 million, raised from a variety of sources. The project received an allocation of 9% tax credits. Citibank provided taxable construction financing in the amount of $9,124,098; and permanent financing, structured in two tiers: one supported by the net operating income (NOI) from the project's tax-credit restricted rents and a second, shorter-term tier supported by the incremental Section 8 rents. The Pasadena Community Development Commission committed project-based Section 8 vouchers to 25% of the project units (a total of 9) for a ten-year contract term. The Housing Authority of the County of Los Angeles (HACOLA) Industry Fund, the Pasadena Community Development Commission, and the Affordable Housing Program provided secondary financing.

Increment Cash Flow Calculation and Mortgage Leveraging Calculation

	Tax Credit Rents	Section 8 Increment (9 project-based units)
Income		
Annual Scheduled Gross Income – Residential	258,084	78,252
Vacancy Loss – Residential	(12,904)	(3,913)
= Effective Gross Income	245,180	74,339
Expenses		
- Operating Expenses	163,128	0
= Annual Net Available Income (total)	82,052	74,399
Maximum Mortgage Calculation		
Debt Service Coverage	1.15	1.15
Available for Debt Service	71,349	64,643
Maximum Mortgage	**866,500**	**466,800**

Total amount of government subsidy saved:	**$466,800**
Amount of government subsidy saved per project-based Section 8 apartment:	$51,867
Total development cost of each project-based Section 8 apartment:	$310,726
Percentage of total funding represented by project-based Section 8 leveraged private debt:	16.69%

Sources	Construction Amount ($)	Permanent Amount ($)
Citibank - NOI Tier (taxable)		1,036,500
Citibank - Section 8 Tier (taxable)		466,800
Citibank Taxable Construction Bond	9,124,098	
HACOLA-Industry Fund		1,056,699
Pasadena Community Dev. Commission	1,311,200	1,311,200
Affordable Housing Program	380,000	380,000
Subtotal 3rd Party Financing	**10,815,298**	**4,251,199**
Costs Deferred Until Completion	101,700	
Deferred Development Fee	859,600	714,099
Capital Contributions		
General Partner	100	5,100
Limited Partners	355,700	7,162,000
Total Equity Financing	**1,317,100**	**7,881,199**
TOTAL SOURCES	**12,132,398**	**12,132,398**

Uses	Amount ($)
Acquisition/Demolition/Off-Site Improv.	98,900
Construction	6,894,735
Site Improvements/Landscape	259,364
Contractor Fees	804,500
Local Fees	333,440
Architecture	637,474
Survey/Eng./Soils/Landscape Arch./Envir.	100,077
Loan Fees, Interest, Taxes & Insurance	1,242,775
Title/Recording/Escrow	50,835
TCAC Fees, Financial Consultants, Other	335,086
Legal Fees	125,512
Reserves	86,700
Developer Fee	1,093,000
Construction Management	70,000
TOTAL USES	**12,132,398**

2) The Potential for Leveraging Project-Based Section 8 Vouchers

As the examples above indicate, the potential leveraging benefit can be enormous for specific projects. How broad is the program's potential, nationally? This analysis compiles three datasets to determine which localities are eligible to leverage their project-based vouchers (areas where FMRs exceed maximum LIHTC rents), and to determine the amount of leveraging potential. Table 1 shows a state-level summary of the findings, identifying the average per unit increment, the maximum number of project-based vouchers (20% of the total vouchers) and the total present value of the increment available over a 10- and 20-year period (depending on the length of the contract), for each state that contain eligible PHAs.

Table 1
Project-Based Vouchers Leveraging Potential: State-Level Summary

State	Average Increment (Per Unit)	Estimated Number of Project-Based Vouchers	Total Increment (Present Value over 10 Years)	Total Increment (Present Value over 20 Years)
Arizona	$94	1,536	$10,686,971	$16,004,769
California	$192	51,486	$873,385,171	$1,307,978,372
Colorado	$19	12	$18,801	$28,157
Connecticut	$28	3,265	$7,775,961	$11,645,250
District of Columbia	$10	2,358	$1,929,316	$2,889,337
Florida	$106	9,349	$97,656,838	$146,250,517
Hawaii	$262	2,047	$47,049,544	$70,461,221
Louisiana	$209	2,837	$50,944,987	$76,295,023
Massachusetts	$190	12,030	$209,113,522	$313,167,630
Maryland	$10	1,588	$1,299,629	$1,946,320
Maine	$44	807	$3,556,131	$5,325,649
Mississippi	$26	151	$331,190	$495,989
New Hampshire	$18	278	$421,657	$631,473
New Jersey	$139	2,737	$34,974,440	$52,377,590
New Mexico	$62	110	$1,029,210	$1,541,341
Nevada	$71	2,209	$13,727,309	$20,557,967
New York	$85	27,957	$519,260,810	$777,643,051
Oregon	$41	99	$346,719	$519,245
Rhode Island	$27	1,877	$4,363,867	$6,535,311
South Carolina	$16	195	$268,163	$401,600
Texas	$42	2,705	$7,050,493	$10,558,792
Virginia	$10	1,315	$1,075,606	$1,610,824
Vermont	$31	381	$1,001,357	$1,499,628
Washington	$29	246	$526,198	$788,032
Total		**127,575**	**$1,887,793,893**	**$2,827,153,088**

Notes: Increment is equal to the difference between the fair market rent for a two-bedroom unit and the rent at 60% AMI. Estimated number of project-based vouchers is equal to 20% of the authorized vouchers (maximum project-based allowable). Present Value assumes interest rate of 7%. All data were analyzed at the county and/or PHA-level and aggregated to the state.
Sources: U.S. Department of Housing and Urban Development, Center for Budget and Policy Priorities

We estimate that by taking advantage of the Section 8 increment through project-based vouchers, communities could leverage $1.9 to $2.8 billion in additional private debt, over 10 years to 20 years, respectively.[10] At this level of funding, these localities could create and preserve up to 56,000 apartments across the country, affordable to low income households—at no additional cost to the federal government.[11] We identified 418 PHAs, within 23 states, plus the District of Columbia, where the local fair market rent exceeded tax credit rents. These PHAs oversee 127,000 apartments that could use Section 8 increment financing to help pay for rehabilitation or new construction projects. For a full discussion of methods and data sources, see Appendix A.

[10] As some localities are already taking advantage of this leveraging potential, some small portion of this potential may already be being used.
[11] Construction and preservation estimate based on average cost of $50,000 per unit.

IV. Leveraging Federal Section 8 Contracts

1) How Leveraging Federal Section 8 Contracts is Different

Federal Section 8 leveraging is a powerful tool for the preservation and rehabilitation of existing Section 8 buildings – many of which suffer from deferred maintenance or may be at risk of converting to market rate as existing contracts expire. The federal Section 8 increment draws its leveraging power from both mark-up-to-market rent increases and LIHTC allocations.

a) Defining Federal Section 8 Voucher Increment: How it Works over Time

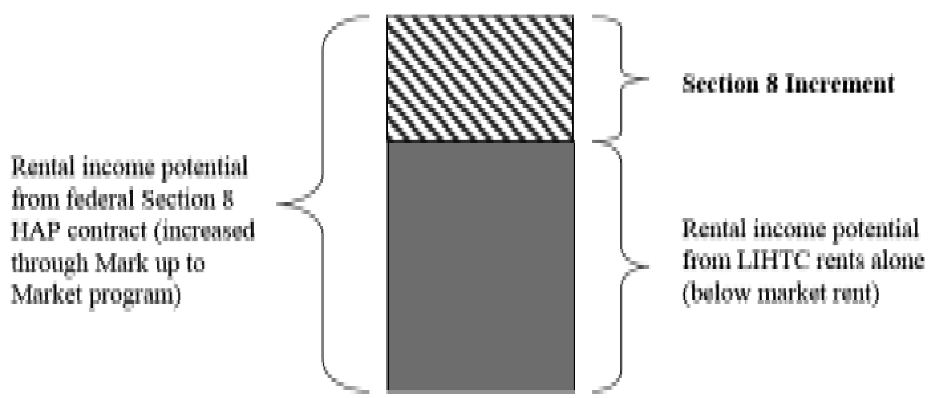
Once an owner enters into the first federal HAP contract, the rents received generally increase annually based on formulas determined by HUD and capped by a percentage of the HUD-determined Fair Market Rent. Over time, rents increased in this way often fall substantially below market rents. Owners with rents below market can generally obtain rent increases to catch rents up with the local market, in exchange for signing longer-term contracts.

Combining contract extensions with the Mark-up-to-Market Program and LIHTCs can draw additional debt to a project. The potential for federal Section 8 increment leveraging is narrower than for project-based Section 8. Because the federal government is no longer issuing new contracts, there are a finite (and shrinking) number of Section 8 contracts in force today. However, property owners are finding ways to recapitalize federal Section 8 through mark-up-to-market rent increases, long-term contract renewals and allocations of tax credits.

b) The Mechanics of Leveraging the Federal Section 8 Increment

The federal Section 8 increment represents the difference between the tax credit rent paid by the tenant and the total rental income received by the property owner under the federal Section 8 contract. Figure 3, below, provides an illustration of the federal Section 8 Increment.

Figure 3: Federal Section 8 Increment



Case study #2, on the following page, demonstrates how project owners can effectively leverage federal Section 8 contracts for acquisition, preservation and rehabilitation financing.

Case Study #2: Preserving At Risk Housing by Leveraging Federal Section 8

Project Description
The East Los Angeles Community Corporation's (ELACC) successfully leveraged an existing Section 8 contract to acquire and rehabilitate Kern Villa, a family Section 8 property in Los Angeles. ELACC is an experienced community-based nonprofit developer that produces and preserves quality affordable housing and nurtures economic development opportunities for low income residents. Kern Villa, a 49-unit apartment complex built in 1982, was at-risk of conversion to market rate. The development was originally financed using a HUD Section 221(d)(4) mortgage and 100% project-based Section 8 contract. ELACC acquired Kern Villa in March 2005 with the goal of continuing to serve large low-income families in the East LA community. The property required extensive rehabilitation; completed in January 2006, improvements included architectural treatments, new exterior and interior paint, new appliances and cabinets, and a children's playground. Kern Villa also incorporated green building methods.

Summary of Leveraging
The total development cost for Kern Villa was $8,650,064. ELACC purchased Kern Villa for $3,328,400. Adding in other acquisition-related expenses, the total acquisition cost came to $3,600,900, which was financed by a $2,800,900 acquisition loan at 7.75% interest from US Bank and an $800,000 loan at 6% interest from Enterprise Community Investment. Construction financing included a $6,783,608 loan at 7.75% interest from US Bank and $853,400 in equity from Enterprise and a $49,100 grant from Enterprise's Green Communities program. In addition, Enterprise Community Investment paid $4,097,000 to purchase the 9% tax credits.

ELACC leveraged the federal Section 8 contract to increase private debt for the project by 300%, ultimately making it possible to preserve this affordable housing without additional local, state or federal subsidies.

Increment Cash Flow Calculation
As 100% of the project units were covered by the federal Section 8 contract, the increment represented a sizable income source for Kern Villa that ensured rental income would be more than $100,000 higher annually than it would be with LIHTC rents alone. This additional income enabled Kern Villa to increase income available to service a private loan, and ultimately to support a sizable permanent "B" loan.

Mortgage Leveraging Calculation
The Section 8 increment is being used to service a permanent "B" loan, in the amount of $3,048,900, at 7.19% interest, in addition to the standard loan of $973,000, at 7.52% interest, underwritten based on the Net Operating Income (NOI) from the tax credit rents. The term of the "B" loan depends on the type and term of Section 8, in this case a new 20-year project-based Section 8 contract.

Sources	Acquisition Amount ($)	Permanent Amount ($)
US Bank Acquisition	2,800,900	
ESIC Acquisition Loan	800,000	
US Bank Permanent - Note A		973,000
US Bank Permanent - Note B (Section 8)		3,048,900
Subtotal 3rd Party Financing	**3,600,900**	**4,021,900**
Income from Operations (during rehab)		411,405
Deferred Developer Fee		70,659
General Partner Contributions		49,100
Limited Partner Contributions		4,097,000
Total Equity Financing	**0**	**4,628,164**
TOTAL SOURCES	**3,600,900**	**8,650,064**

Uses	Acquisition Amount ($)	Permanent Amount ($)
Acquisition	3,328,400	
Acquisition/Construction Loans Take Out		3,609,900
Rehabilitation		3,275,309
Loan Fees, Interest and Expenses	196,450	432,533
Title, Recording & Escrow	38,733	30,000
Contingency	31,317	55,000
Local Fees		10,000
Architectural & Engineering Fees		116,700
Taxes & Insurance (during construction)	15,000	133,000
Legal Fees		82,500
TCAC Fees, Financial Consultant & Other		133,700
Reserves		771,422
TOTAL USES	**3,609,900**	**8,650,064**

2) The Potential for Leveraging Federal Section 8 Contracts

Using the same set of geographic localities from the project-based voucher scenarios, we estimated the leveraging potential from Federal Section 8 contracts. Focusing just on the nearly 40,000 2-bedroom units, we estimate that property owners could leverage $844 million in private debt over a 20-year contract period, as shown in Table 2. This translates to nearly 17,000 units (using two-bedrooms as a proxy) that could be preserved or constructed across these localities. See Appendix A for a description of data sources and methods.

Table 2
Federal Section 8 Illustrative Leveraging Potential:
State-Level Summary of 2-Bedroom Units

State	**Average Increment (Per Unit)**	**# of Units (2-Bdrms) Under Federal S8 Contract**	**Total Increment (Present Value over 20 Years)**
Arizona	$171	42	$962,983
California	$139	15,671	$421,004,189
Colorado	$19	10	$23,862
Connecticut	$27	867	$3,130,470
District of Columbia	$10	3,218	$3,943,124
Florida	$211	1,952	$54,349,617
Hawaii	$267	515	$18,090,248
Louisiana	$209	267	$7,180,392
Massachusetts	$113	5,336	$145,801,503
Maryland	$10	1,393	$1,706,890
Maine	$32	181	$1,262,287
Mississippi	$26	144	$473,624
New Hampshire	$18	52	$117,374
New Jersey	$186	1,300	$37,215,065
Nevada	$63	817	$7,463,766
New York	$232	4,242	$126,937,360
Oregon	$41	58	$302,980
Rhode Island	$27	2,335	$8,131,702
South Carolina	$16	132	$272,411
Texas	$31	1,211	$5,624,024
Virginia	$31	171	$672,708
Washington	$25	64	$198,633
Total		**39,978**	**$844,865,213**

Notes: Increment is equal to the difference between the fair market rent for a two-bedroom unit and the rent at 60% AMI. Present Value assumes interest rate of 7%. All data were analyzed at the county and MSA level and aggregated to the state.
Source: U.S. Department of Housing and Urban Development, National Housing Trust.

V. Beyond Leveraging: The Power of Section 8 to House the Homeless

1) How it Works

Building on the project-based and federal Section 8 increments described above, owners can take advantage of opportunities to leverage additional debt to serve households at lower income levels (extremely low-income, at or below 30% of AMI), including individuals coming out of homelessness. Many of these residents have fixed incomes from SSI disability payments or other government programs. This leveraging model offers financial and social benefits to project owners and PHAs, as well as to extremely low income seniors, individuals and families.

In this Beyond Leveraging model, project owners combine project-based Section 8 contracts with LIHTCs, which enables the property to rent to residents at lower income levels than would otherwise be financially feasible. For each apartment serving an extremely low-income resident, the Section 8 increment is larger than it would be for a household at 50% or 60% of AMI.[12] Figure 4, below, charts this difference, using rent comparisons and Section 8 increment calculations for Sacramento Senior Homes, a supportive senior housing project in Berkeley, California that used a project-based contract for 39 units in a 40-unit property.[13]

Figure 4: How the Section 8 Increment Helps House the Homeless

Increment Cash Flow and Mortgage Leveraging Calculation

	Tax Credit Rents	Section 8 Increment (FMR – Tax Credit Rents)
Income		
Annual Scheduled Gross Income – Residential (See rental comparison chart below)	321,043	197,855
Vacancy Loss – Residential	(15,228)	(9,893)
= Effective Gross Income	305,815	187,962
Expenses		
- Operating Expenses	192,921	0
= Annual Net Available Income (total)	112,892	187,962
Maximum Mortgage Calculation		
Debt Service Coverage	1.15	1.15
Available for Debt Service	98,167	163,445
Maximum Mortgage	**1,441,000**	**1,272,026**

Comparison of Section 8 Increments for Renters at Different Income Levels, Alameda MSA (2006)

Number of bedrooms	Fair Market Rent	Tax Credit Rent (50% AMI)	**S8 Increment (50% AMI unit)**	Tax Credit Rent (17% AMI) = 30% of SSI	**S8 Increment (17% AMI unit)**
Studio	865	733	**132**	249	**616**
1	1,045	785	**260**	267	**778**
2	1,238	942	**296**	320	**918**

[12] For example, if Fair Market Rent for a studio apartment in a given MSA is $865, and tax credit rent for 17% of AMI is $249, the Section 8 increment per month for this unit would be $616. This increment is significantly higher than the increment for tax credit unit set at 50% of AMI. The Section 8 increment thus provides more resources for the property to rent to lower income households.

[13] Please see Appendix D of this report for a full review of the financing model and the use of the Section 8 increment to house formerly homeless seniors at Sacramento Senior homes.

As illustrated in Figure 4, the receipt of Fair Market Rent through the project-based Section 8 contract creates a larger Section 8 increment for the 17% AMI apartments than it would for 50% or 60% AMI apartments. A portion of this increment can be used to service an additional loan, reducing public subsidy to the project. In the property described above, the increment supported a private loan for an additional $1,272,026.

From the PHA perspective, providing project-based vouchers to a supportive housing property enables the PHA to provide extremely low income residents with quality housing that includes on-site services without incurring cost beyond the tenant-based voucher that would be utilized in any case. When a formerly homeless individual survives on SSI benefits and receives a tenant-based Section 8 voucher, the PHA pays the difference between the tenant's income and the FMR to a private landlord. If instead the PHA project-bases these vouchers, the PHA payment goes directly to the property, helping to invest in a long-term housing resource for these residents and households that may come after them.

2) Significance of the Different Section 8 Increments

In this supportive housing model, the additional rental income earned by the property owner is made up of two components in addition to the standard Section 8 increment – the Debt Service Increment and the Operating Expense Increment.

In Figure 5, below, we provide an example that represents the weighted average (by number of units) of increment potential across jurisdictions in our entire sample. Our initial Section 8 increment, which we label Increment A, averages $175 per unit. This increment still represents the difference between the full Section 8 rental income and the LIHTC rental income for the property at 60% of AMI. What we can call Increment B represents the difference between essential operating costs and the maximum tax credit rent. This Increment B averages $335 per unit. Increment C becomes available in units occupied by tenants supported by fixed income payments. The increment represents the difference between the fixed income payment and operating costs.

Figure 5: Using Section 8 Increment Financing to House the Homeless

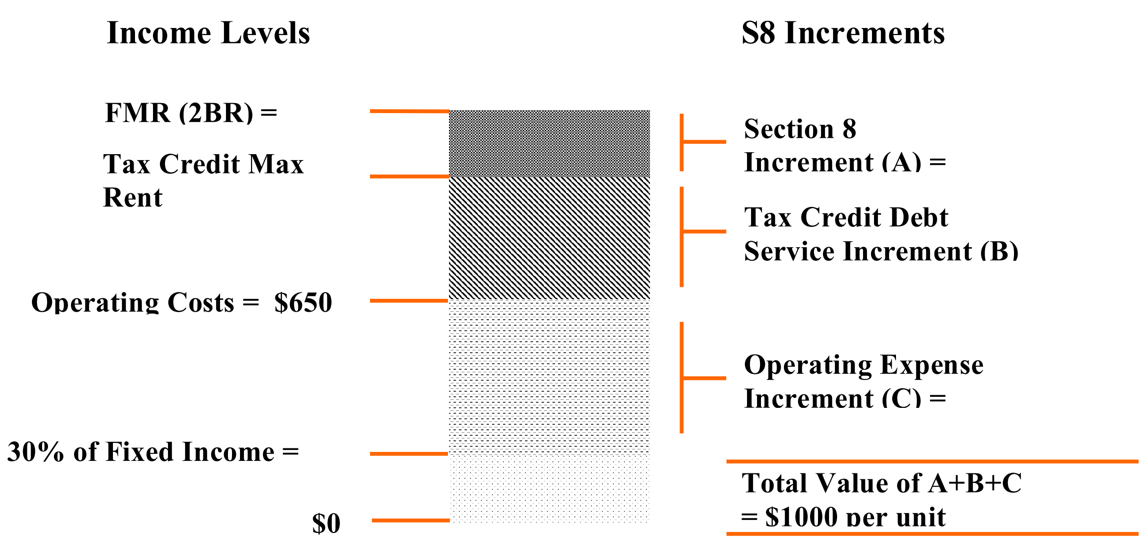


Figure 5 illustrates two concepts: sources of income and uses of the Section 8 increment. The left hand side of the graph explores the amount and the source of rental income for apartments serving extremely low income residents. This figure assumes an average tenant contribution of $160. The Fair Market Rent for the unit, meanwhile, is $1,160. The PHA rental payment for this unit would be $1,000. The right hand side of the graph explores how this income creates a Section 8 increment that could be maximized by the property owner. Assuming that $490 of the $1,160 rental income would help pay operating costs for the property (increment C), an additional $510 would be available as Section 8 increment to pay debt service on an additional private loan (increment A+B). This increment is larger than it would be with a higher income resident at 50% AMI (solely increment A).

Our third case study, below, illustrates the power of project-based vouchers not only to leverage additional private debt but also to enable properties to serve extremely low income households including those receiving fixed income payments. Lorenzo Creek Apartments leveraged Section 8 together with a state-administered Shelter Plus Care contract to maximize public resources and to draw in discreet private financing for the property discussed below based on the Section 8 increment.

Case Study #3: Supportive Housing Leverages Section 8

Project Description

The Lorenzo Creek Apartments[14] located in Castro Valley, in California's Bay Area, houses formerly homeless, low-income and disabled adults. Completed in 2006, the development consists of 28 new construction units: nine shelter and care units, including two specifically for persons living with HIV/AIDS, and 18 project-based Section 8 units. On- and off-site service providers offer essential assistance and universal design features ensure accessibility to the residents. The building was co-developed by two non-profit organizations, Allied Housing, Inc and Resources for Community Development.

Summary of Leveraging

This $11.5 million project took advantage of a host of public and private loans and grants, including project-based Section 8 leveraging. Two tax exempt bonds from the California Housing Finance Authority's (CalHFA) Special Needs Lending Program (SPN) contribute to the permanent financing: a $640,000 loan, at 1% over 25 years, underwritten by the project's net operating income (NOI); and a $1,430,000 loan, at 1% over 10 years underwritten by a ten-year project-based Section 8 contract and a five-year shelter and care contract with CalHFA. Merritt Community Capital was the tax credit investor. California's Department of Housing and Community Development's (HCD) Multi-Family Housing Program loan contributed $1,928,819. Lastly, CDBG funds from several cities, San Leandro, Fremont and Hayward, and San Leandro HOME funds, were recontributed as General Partner capital in the amount of $1,096,196.

Construction financing begins with a $5,600,000 tax exempt loan from CalHFA and Bank of America. Alameda County contributed $2,748,999 through several funding programs, including Housing Opportunities for Persons with AIDS (HOPWA), the Supportive Housing Program (SHP), HOME and County Trust Funds. The City of Fremont and Pleasanton HOME funds rounded out construction funding.

Increment Cash Flow Calculation and Mortgage Leveraging Calculation

Lorenzo Creek Apartments utilized the increment created by the project-based Section 8 contract, which applied to 18 of the apartments and produced income above and beyond the tax credit rents to pay debt service on an additional $1,430,000 loan.

Sources	Construction Amount ($)	Permanent Amount ($)
CalHFA TE SPN Bond - NOI	0	640,000
CalHFA TE SPN Bond - S+C & Section 8 Increment	0	1,430,000
TE Loan - CHFA LTL w/ BoA	5,600,000	0
HCD MHP	0	1,928,819
Alameda County Funding	2,748,999	2,748,999
Affordable Housing Program	210,000	210,000
Fremont HOME	250,000	250,000
Income from Operations	74,810	74,810
Pleasanton HOME	80,000	80,000
Subtotal 3rd Party Financing	**8,963,809**	**7,362,628**
Deferred Development Fee	0	0
Costs Deferred Until Permanent Loan Closing	933,839	0
Capital Contributions	0	0
General Partner	1,096,196	1,096,196
Limited Partners	554,980	3,090,000
Total Equity Financing	**2,585,015**	**4,186,196**
TOTAL SOURCES	**11,548,824**	**11,548,824**

Uses	Amount ($)
Acquisition/Demolition	879,595
Construction	5,547,524
Contractor Fees	957,430
Local Fees	414,561
Architecture & Landscape	1,377,763
Survey, Engineering & Environmental	180,524
Loan Fees, Interest	495,578
Title Recording Escrow	35,000
Taxes & Insurance	121,905
TCAC Fees, Financial Consultants, Other	351,459
Legal Fees	72,303
Reserves	683,847
Developer Fee	420,000
Contingency	11,334
TOTAL USES	**11,548,824**

[14] For more information see: "Lorenzo Creek Apartments." Resources for Community Development. < http://rcdev.org/what_projects_lorenzo.html>

3) Findings

Taking the same set of geographic localities identified in the section above, we have created an illustrative analysis of additional leveraging potential and additional financing for extremely low income households. Table 3 presents a state-level summary of the leverage potential of all three increments. Although we have presented a total value for the three increments, this is an overestimation of the actual financing potential. In the case of Increment C, for example, not all tenants receive fixed income payments.

Table 3
Total Leveraging Potential

		Total Increment (Present Value over 10 Years)			
State	**Estimated Number of Project-Based Vouchers**	**Increment A (FMR - LIHTC rent)**	**Increment B (LIHTC rent - Operating Cost)**	**Increment C (Operating Cost - Fixed Income)**	**Total (A+B+C)**
Arizona	1,536	$10,686,971	$17,845,089	$52,658,194	$81,190,254
California	51,486	$873,385,171	$1,685,555,414	$1,987,429,761	$4,546,370,347
Colorado	12	$18,801	$492,393	$123,356	$634,550
Connecticut	3,265	$7,775,961	$148,804,404	$160,377,863	$316,958,229
District of Columbia	2,358	$1,929,316	$114,235,843	$114,322,358	$230,487,517
Florida	9,349	$97,656,838	$136,094,538	$385,278,709	$619,030,086
Hawaii	2,047	$47,049,544	$81,639,690	$66,845,433	$195,534,667
Louisiana	2,837	$50,944,987	$49,330,239	$104,020,134	$204,295,361
Massachusetts	12,030	$209,113,522	$479,806,975	$522,578,604	$1,211,499,101
Maryland	1,588	$1,299,629	$141,386,005	$14,770,226	$157,455,860
Maine	807	$3,556,131	$24,235,787	$31,512,777	$59,304,695
Mississippi	151	$331,190	$3,643,093	$1,515,225	$5,489,508
New Hampshire	278	$421,657	$8,038,178	$11,949,658	$20,409,494
New Jersey	2,737	$34,974,440	$76,503,786	$122,402,659	$233,880,885
New Mexico	110	$1,029,210	$2,862,220	$1,201,159	$5,092,589
Nevada	2,209	$13,727,309	$39,512,889	$90,943,412	$144,183,609
New York	27,957	$519,260,810	$506,814,320	$1,515,841,997	$2,541,917,127
Oregon	99	$346,719	$3,505,713	$1,001,113	$4,853,545
Rhode Island	1,877	$4,363,867	$55,046,922	$81,025,193	$140,435,982
South Carolina	195	$268,163	$2,127,872	$7,410,725	$9,806,760
Texas	2,705	$7,050,493	$8,444,101	$102,247,919	$117,742,513
Virginia	1,315	$1,075,606	$117,014,632	$12,463,164	$130,553,403
Vermont	381	$1,001,357	$10,049,182	$16,854,226	$27,904,764
Washington	246	$526,198	$7,115,173	$5,170,734	$12,812,105
Total	**127,575**	**$1,887,793,893**	**$3,720,104,458**	**$5,409,944,600**	**$11,017,842,951**

VI. The Role of the Public and Private Sectors in Supporting Section 8 Leveraging

1) Leveraging the Section 8 Increment: The View of Private Lenders and Investors

When HUD began its federal project-based Section 8 programs, lenders allowed developers to borrow against the full amount of Section 8 contract income for two primary reasons. First, the initial form of the project-based Section 8 contract was essentially an unconditional commitment by the federal government to continue paying its subsidy for the term of the contract (typically 20 years) as long as the owner continued to ensure that the apartments met requirements and served eligible households. This commitment effectively guaranteed a certain level of revenue to the lenders. Second, the loans made against the Section 8 HAP payments were insured by the Federal Housing Administration (FHA), meaning that in the event of a default during the typical 40-year loan term, the lender could be assured of recouping 99% of its principal.

Neither project-based Section 8 vouchers issued by PHAs nor extensions of federal contracts enjoy these advantages, however. Renewals of both are annual and contingent on adequate federal appropriations for the Section 8 programs, no matter whether the nominal term is the 10-year maximum for the PHA program or the 20-year maximum for federal extensions.

Despite the insecurities posed by Section 8 appropriations, many lenders have embraced project-basing as a viable means of leveraging private debt. By 2007, most of the major banks active in affordable housing lending in California, including Citibank, Bank of America, US Bank, Union Bank and Wells Fargo, have increased their lending to affordable housing dramatically as a result of leveraged project-based Section 8 Vouchers in this way. We estimate that during the five-year period from 1999 to 2004, developers in California leveraged more than $200 million in additional private debt from lenders such as these.

2) The View of Public Housing Authorities and Developers

Initially, PHAs chose to project base Section 8 vouchers because they ensured a supply of new or substantially renovated apartments to serve people from the Section 8 waitlist. This was critical since residents living in tight rental markets, such as those that exist throughout California and other high cost states, had difficulty finding private landlords willing to accept their vouchers. Housing developers working in these areas had previously seen no advantage to accept voucher holders given the added regulatory burden.

With Section 8 leveraging potential, developers are now motivated to request project-based units because they will be paid market rent for the units while providing housing to very low- and extremely low income residents. Appendix C of this report provides a case study of one local PHA's successful utilization of project-based vouchers and Section 8 leveraging.

3) Role of Government Sponsored Enterprises in Supporting Section 8 Leveraging

a) FHA Risk Share Program

The Housing and Community Development Act of 1992 created two risk-sharing demonstration programs that have been helpful in leveraging the Section 8 increment in some cases. Improvements in these risk-sharing programs could help boost the use of Section 8 increment financing.

These risk-sharing demonstration programs divide the financial liability for any defaults between the federal government and its risk-sharing partners—state housing finance agencies or other qualified financial institutions. The two programs offer incentives to financial institutions to facilitate the financing of affordable multifamily housing. One program provides credit enhancement to state and local housing finance agencies, while the other provides reinsurance to qualified financial institutions. Both programs rely on risk sharing to ensure sound financial management and delegation to increase the efficiency and lower the costs of providing the credit enhancements. The demonstration programs differ from FHA's traditional mortgage insurance programs in that FHA (1) assumes only a portion (generally 50 percent), rather than all, of the risk of loss, and (2) delegates, rather than performs, loan-processing and asset management functions.

Key improvements to FHA risk sharing programs would help facilitate more widespread use of Section 8 leveraging:

1) Authorizing state HFAs to underwrite up to 80% of risk to FHA;
2) Authorizing Risk Share with an A/B split term loan structure that allows for the Section 8 Increment to be financed;
3) Increasing flexibility on pricing to be more compatible with pricing offered by state HFAs; and
4) Making FHA Risk Share available to all lenders (public and private) with "A" rating or better for deals with at least 20% of the units covered by long-term S8 contracts.

b) Impact of FHA Underwriting Standards on Leveraging the Section 8 Increment

FHA has recently taken an important role in facilitating the leveraging of Section 8 Increments. FHA is the largest player in the multifamily lending arena, insuring several billion dollars in loans nationally each year. Given FHA's presence within the HUD umbrella and since FHA originally underwrote many of its mortgage products against Section 8 income, it is logical for FHA to play a major role in leveraging Section 8. In April 2004, FHA updated its MAP Guidelines to specifically allow leveraging of the Section 8 increment. Since that time, the California field offices have underwritten and closed dozens of loans leveraging the Section 8 Increment leveraging tens of millions in additional debt and allowing HUD to compete for this business.

c) Fannie Mae role in financing Section 8 Increment

Fannie Mae has also recently changed its regulations in order to allow is lenders to leverage Section 8 Increments; but it could take further action to fully capture the leveraging potential. Fannie Mae both originates multifamily loans in partnership with its Delegated Underwriting Service (DUS) lenders and is the largest purchaser of multifamily loans on the secondary market.

In May 2004, Fannie Mae announced that it was loosening the limitation on its DUS lenders and allowing them to leverage the Section 8 increment. Unfortunately, the change was accompanied by a limitation that the income from the underlying Tax Credit rents must still pay scheduled debt service at no less than a 1:1.0 Debt Service Coverage Ratio, effectively limiting the leverage of the Section 8 to the difference between Fannie Mae's standard 1:1.20 DSC and the new 1:1.0 ratio. This means that only a small portion of the increment can be leveraged in most cases.

As the largest purchaser of LIHTCs, Fannie Mae drives investor policies with respect to investing in deals that are leveraging project-based Section 8. In this respect, Fannie Mae's policies are potentially as influential as FHA's in driving market behavior with respect to leveraging the Section 8 increment. Although the pending reform measures in Congress may reduce or eliminate this influence, Fannie Mae has tremendous market advantages due to its status as a Government Sponsored Enterprise (GSE) giving it access to lower cost federal funds as well as the implied support of the federal government.

VII. Recommendations

As detailed above, the leveraging potential of Section 8 exceeds $3 billion over 20 years. Section 8 leveraging could prove to be a critical resource in accommodating the existing and projected populations in the U.S. How do we capture this potential and make it a reality? We can make an impact by taking three key actions:

1) **Educating developers, local governments, and financial institutions** about the power of Section 8 leveraging;
2) **Changing federal law** to provide greater flexibility to housing authorities to use this tool; and
3) **Continuing federal financing of the Section 8 program** to ensure the financial industries' confidence.

Restoring the confidence of the affordable housing industry in the Section 8 program is perhaps the single most important action we can take to bolster the use of Section 8 leveraging. Recent federal appropriations shortfalls have cast doubt that the budget for Section 8 contracts will be funded at levels adequate to fully fund renewals of federal Section 8 contracts as they expire. On the project-based side, recent HUD regulatory limitations had until recently locked out potential leveraging opportunities.

Congress and the President must continue to fund and support the federal Section 8 program in its entirety, in order to maintain private sector confidence in its continuation. For fiscal year 2007, HUD failed to request adequate funds to cover the estimated costs of Section 8 contract renewals, which caused widespread delays in contract payments to owners whose contract renewal dates fell in the last quarter of the fiscal year. Owners were forced to use cash reserves to pay operating expenses, and often to cut services. Such funding crises threaten the long-term preservation of these homes as affordable housing, as owners may ultimately choose to leave the Section 8 program. The funding snafu also limits investor confidence in rental income from federal Section 8 contracts. By extension, investors may lose confidence in Section 8 increment financing.

Congress and HUD must also work to restore investor confidence in the project-based voucher program. Over each of the past four federal budget cycles, the current Administration has proposed structural changes to project-based vouchers that would alter their availability for leveraging. Though Congress has rejected these reforms, the proposals have undermined investor confidence in the future stability of the Section 8 program. HUD has meanwhile adopted administrative changes that have effectively reduced the resources available to project base vouchers. HUD issued a particularly limiting decision to sever the historic commitment to providing Section 8 funding to each Housing Authority adequate to maintain the number of Section 8 vouchers currently in use. This regulatory shift severely limited the availability of project-based vouchers. HUD also imposed a cap on voucher rents – without public notice or discussion – that all but eliminates the ability to leverage project-based vouchers. This decision was recently reversed, but left repercussions in the form of weakened industry confidence.

We recommend a series of specific policy changes that will increase the perceived and real stability of federal Section 8 contracts and project-based vouchers. In summary, it is critical that HUD, Congress, and GSEs engage in activities to: A) Increase investor confidence in federal

Section 8 contracts: B) Increase participation of private sector financing institutions in Section 8 leveraging activities; and C) Remove regulatory barriers that limit the efficient use of Section 8. A summary of proposed actions is presented below:

A. Increase Investor Confidence in Section 8 Program

1. Clearly state that it is the intent of Congress and HUD that all project-based Section 8 contracts be renewed upon expiration.
2. Renewals of federal project-based Section 8 contracts should be considered a mandatory rather than a discretionary budget item.
3. Restore the relationship between the Section 8 voucher budget and the actual cost of providing the number of vouchers authorized for each Housing Authority while maintaining incentives for minimizing costs locally.
4. In the event that federal Section 8 contracts must be replaced, ensure that renewals are not subject to appropriations, consistent with the terms of the original contracts.

B. Increase Participation of Private Sector Financing in Leveraging Section 8

1. Reverse the HUD Office of General Counsel opinion that project-based Section 8 contracts administered by state HFAs terminate automatically with prepayment.
2. Re-establish the historic rent floor for project-based Section 8 contracts so that lenders and investors can count on initial rents as minimums.
3. Allow PHAs to commit to two 10-year renewals in addition to the currently allowed initial 10-year term with a renewal of up to five years.
4. Increase financial incentives for housing authorities to project-base vouchers by:
    a. Returning to giving PHAs credit for committing project based voucher units when calculating their annual appropriation.
    b. Allow PHAs to set Payment Standard at 120% of Fair Market Rent (FMR) for project-based contracts supporting new construction or substantial rehabilitation.
    c. Restore the previous FMR formula for 3-bedroom units.
5. Increase the investment of GSEs and HFAs in Leveraging Section 8 by:
    a. Directing Fannie Mae and Freddie Mac to purchase Section 8 increment loans as part of their Congressionally mandated affordable housing mandate.
    b. Clarifying that state HFAs participating in the Risk Share program may underwrite Section 8 increment loans for the full term of the loan regardless of the term of the contract.
    c. Change the 25% cap on project-basing of vouchers in non-senior buildings from per building back to per project.

C. Remove Regulatory Barriers to Efficient Use of Section 8

1. Improve the Subsidy Layering review process by:
    a. Delegating subsidy layering reviews to the state Housing Finance Agency (or to the Tax Credit Allocating Agency, if different).
    b. Allowing the subsidy layering review to occur prior to execution of the Agreement to enter into the Housing Assistance Payment (AHAP) contract.
2. Streamline the environmental clearance process by allowing local HFAs to accept environmental clearances produced under National Environmental Policy Act requirements.

VIII. Conclusion

As housing prices shoot farther out of reach for most low income Americans, and as the economic gap between wealthy and impoverished communities continues to grow, more and more households are in need of subsidized housing. Although government and financial institutions are essential partners in meeting this demand, the affordable housing community must also become more innovative in the way we raise funds.

This report explored the enormous power of one existing, yet largely untapped resource: Section 8 increment financing. We provided examples of communities and housing developers that are already using the power of Section 8 to leverage additional debt to serve housing needs of extremely low-income residents. We identified communities in nearly half the states in the United States that are eligible to take advantage of Section 8 leveraging, given their ratio of fair market rents to tax credit rents. We found that leveraging project-based Section 8 vouchers could provide up to $3.6 billion in additional financing depending on the length of the contract, and federal Section 8 contract renewals an additional $844 million, assuming 20-year contract renewals.

The affordable housing industry has the power to harness this tremendous financial resource. Affordable housing developers, investors and financial institutions must work actively to educate our industry on the potential benefits of Section 8 leveraging. We must also engage key decision makers in discussions about needed reforms to Section 8 that will facilitate this innovative financing model.

The need for affordable housing in our communities is only growing greater. Now is our time to meet this need by making the potential of Section 8 leveraging into a reality.

VIII. Appendices

Appendix A: Methodology for Estimating the Potential for Leveraging the Section 8 Increment

The project-based Section 8 analysis is comprised of the following inputs and data sources:

1. Fair Market Rents, HUD, fiscal year 2006-2007 (by county and metropolitan statistical area)
2. Income Limits, HUD, fiscal year 2006-2007 (by county and metropolitan statistical area)
3. Section 8 PHA Vouchers, Center for Budget Policies and Priorities, as of January 2007 (by public housing authority)

First, we determined the localities where fair market rents exceeded LIHTC rent (equal to 30% of the LIHTC income limits). We chose to use the fair market rents for two-bedroom units and income limits for households at 50% of Area Median Income (AMI) for a three-person household. The difference between these values is "Increment A," a per unit increment value. Next, we determined the number of available project-based vouchers. We took the best-case scenario, in which 20% of all authorized local PHA vouchers are project-based (the maximum allowable). We chose to distribute vouchers administered by statewide PHAs among local PHAs, according to the share of vouchers the local PHA administered in the state. Multiplying the per unit value by the number of project-based vouchers produces the total amount of increment that can be leveraged within that locality.

For example in Boston, Massachusetts, a three-person household at 50% AMI earns $37,850 annually, of which $1,136 (30%) is spent on rent. However, the fair market rent in Boston for a two-bedroom unit is $1,366. This difference of $231 is Increment A. The Boston Housing Authority administers nearly 12,000 vouchers. If 20% of these vouchers, or 2,400, were project-based, they would have the potential to capture over $47 million over the ten-year life of the contract ($231 x 2400, discounted at 7% over 10 years).

Additional Information for Federal Section 8 Analysis

Our analysis of federal contracts follows a similar methodology to the project-based voucher scenario. For this analysis, we relied on a database of Section 8 federal contracts from the National Housing Trust, updated as of February 2007. We eliminated contracts that cannot be extended, from our sample. These contracts fell into the following programs: Section 202, Section 515, Section 236 RAP and Rent Supplement and unknown. Contracts under all other programs were included. Our total sample was 664 federal contracts.

Additional Information for Beyond Leveraging Analysis

This analysis builds on the previous analysis, incorporating two new datasets: fixed income and operating costs.

1. Fixed Income (Social Security Income and Old-Age Survivors and Disability Insurance), Social Security Administration, as of December 2006 (by county)
2. Operating Costs, Center for Budget and Policy Priorities, Harvard GSD Cost Study, inflated to 2006 (by county)

In the few cases where operating costs values were missing, we imputed costs based on statewide averages. Operating costs are based on fiscal year 2000-2001 estimates developed by the Harvard Graduate School of Design's Public Housing Operating Cost Study. The values represent typical costs for a new non-profit-owned family development with walkup/garden type buildings, 25% assisted units, fewer than 150 total units, and an average of 2 - 2.2 bedrooms per unit, located in a central city census tract with a poverty rate between 20% and 30%. These costs have been adjusted to include $218 for taxes, utility costs, an asset management fee, and a replacement reserve, plus a 15% cash flow allowance. We then adjusted for inflation to bring them up to December 2006.

Appendix B: HUD Policy On Setting Project-Based Voucher Rents In LIHTC Properties

On October 13, 2005, HUD created a major problem when it inserted a surprise provision into the final rule on the Project Based Voucher program. This provision eliminated the previously established ability of housing authorities to pay market rents to developers of tax credit financed housing developments, thus preventing developers from leveraging the additional income unless they first obtained a waiver from HUD, a time consuming and uncertain process at best.[15] The new rule weakened those incentives. It also produced the allowed tenant-based voucher rents to exceed those of PBVs in the same building – all without saving HUD any money. The new rule also conflicts with both the Section 8 statute and the LIHTC statute, 26 U.S.C. § 42(g)(2)(B)(i), which does not appear to permit HUD to impose such additional restrictions on the maximum rent.

Ironically, the change has not saved HUD or the Federal Government one penny since the impact is on the choices of the local PHA on how to spend its funds, not on the overall amount of funding available to it, which is set by a formula totally independent of what the maximum allowable rent is for apartments subsidized through the Low Income Housing Tax Credit Program. Instead, if the Final Rule had been allowed to stand, it would have significantly reduced the number of private developers interested in participating in the Project-Based Voucher program and thereby reduce the opportunities for participants in the Voucher program to live in high quality housing.

Following the October 13, 2005 publication of the Final Rule, housing advocates urged HUD relentlessly to reverse this damaging provision, which was inserted without the legally required opportunity for public comment. On May 1, 2007, facing the near certain prospect that the new Congress would act if it did not do so first, HUD finally issued a proposed rule change that would completely rescind the limitation on rents in tax credit buildings. In the rule, HUD acknowledges that the limitation on rents has inhibited the financing of new affordable housing and reduces rather than increases the supply of tax credits. HUD believes that the subsidy layering review process will be sufficient to ensure an excess of federal subsidies isn't used. On November 24, 2008, HUD finally published a notice in the Federal Register making this proposed rule final. To see a copy of the rule in the Federal Register, click here.

[15]This provision in the new rule, issued without the opportunity for public comment, repudiates HUD's long-standing policy on the same issue. It rejects the rent formulation in HUD's Initial Guidance at 66 Fed. Reg. 3609 (January 16, 2001), which was confirmed by HUD in PIH Notice 2002-22 (HA), Section 3(D)(November 1, 2002) and reconfirmed by PIH Notice 2005-20 (June 22, 2005). More significantly, HUD retained this formulation when it issued its proposed regulation for public comment in March 2004.

Appendix C: Origins of Project-Based Voucher Leveraging: San Francisco, California

In 1998, the San Francisco Redevelopment Agency worked with the California Housing Partnership and the San Francisco Housing Authority to develop a renewable 10-year project-based voucher contract issued by the SFHA that would be supported by a limited payment guaranty from the Redevelopment Agency. Due to the historically tight and expensive rental market in San Francisco, tenants with Section 8 vouchers found it very difficult to find vacant apartments with landlords willing to rent to them at the voucher Payment Standard. The SFHA's goal in agreeing to project-base up to 20% of their vouchers was to develop its own source of high quality, privately owned and managed apartments that would be dedicated to serving Section 8 voucher holders from its waiting list.

The Redevelopment Agency's goal was to increase the leveraging of its limited funding, which it makes available in the form of 55-year residual receipts loans. To do this, it needed to find a way to persuade mainstream financial institutions that the risk of underwriting additional debt based solely on the Section 8 increment was reasonable even without the guarantee from the federal government of continued funding. The Redevelopment Agency believed that the real financial risk to the banks of relying on the continuation of the Section 8 payments was far less than the perceived risk. To that point in time, Congress had routinely funded renewals of both the federal Section 8 contracts and the PHA Section 8 voucher budgets. In the event that Congress did ultimately cut the local PHA Section 8 voucher budgets, given the potential political fall out over the displacement any such cuts could cause, the size of the cut was more likely to be a trim on the order of 5-25% rather than a fundamental cut of more than 50%. In addition, a major factor in the Agency's risk assessment was the fact that both the Redevelopment Agency and the SFHA were under the ultimate political control of the same Mayor and Board of Supervisors and that in the event of financial crisis, the SFHA could be counted on to cut its budget in a way that would minimize the impact on the Redevelopment Agency's affordable housing loans.

The Redevelopment Agency succeeded in leveraging the Section 8 increment beyond its most optimistic expectations by using the following tools:

1. **Section 8 Transition Reserve**. The Redevelopment Agency and the California Housing Partnership worked together with lenders and Tax Credit investors to model the impact of the potential loss of Section 8 subsidy once a project had begun operating. The model showed that it was possible to fund a reserve equivalent to three to six months of Section 8 subsidy and cover the investor and lenders risk in the event that the Section 8 program was cut back.

2. **Standby Payment Guaranty**. With assistance from a local firm specializing in Low Income Housing Tax Credit syndications, Gubb and Barshay, the Redevelopment Agency developed this specialized limited form of credit enhancement. The Guaranty specifically supported leveraging the Section 8 increment until the financial industry recognized that the perception of appropriations risk was far greater than the real risk. The **Guaranty** required the Redevelopment Agency to pay for any shortfall in funds required to pay debt service on the Section 8 increment loan, either by making monthly payments or by paying off the entire loan, at its discretion, if the following conditions were met:
    a. The shortfall was caused by the failure of Congress to appropriate sufficient funds to the SFHA to make payments under the contract;

b. All project-level reserves, including the three-month operating reserve and the Section 8 Transition Reserve, had been exhausted; and
c. Neither the borrower nor SFHA was in default under the terms of the loan or the HAP contract.

3. **Section 8 Increment Loan Bifurcation**. With help from the California Housing Partnership, the Redevelopment Agency structured the debt as two separate loans. The first loan was sized and underwritten by the bank based on the typical income assumptions for an apartment development financed with Low Income Housing Tax Credits. Income was assumed to be available to the development for the life of the loan (generally 30 years) based on the rent levels agreed to in the Tax Credit regulatory agreement, which were typically set between 30% and 50% of AMI.The second loan, the Section 8 increment loan, was sized based solely on the additional income created by the higher Section 8 contract rents that would actually be paid on all or a portion of the units, depending on the type of the contract.[16] The term of the Section 8 increment loan was initially matched either to the ten-year term of the initial Section 8 contract or, if the Agency chose to make the term of its Standby Payment Guaranty longer (see below), the bank would agree to match the longer 15- or 20-year term. Because the loan fully amortized within the period covered by the contract and/or the Guaranty, the banks felt more comfortable with making the additional loan in this way.

After issuing a half-dozen or so Standby Payment Guaranties, the Agency found that several lenders were willing to underwrite the Section 8 increment loan without any guaranty so long as the term of the loan matched the term of the contract. This strategy translated into an ability to increase private debt by a factor of 150-200%, sometimes even more in higher rent areas. The result was that developers needed substantially less subsidy to finance their affordable developments with project based Section 8 vouchers and, consequently, local governments were able to stretch scarce subsidy dollars much farther. Some jurisdictions were able to double the number of affordable units they could subsidize in this way.

[16] The Section 8 program regulations limit the number of units that can have project-based Section 8 vouchers attached to them in non-Senior developments to 25% of the total units in each building, whereas in Senior developments, 100% of the units may have project-based Section 8 vouchers assigned to them.

Appendix D: Detailed Case Studies

A. Local PHA Project-Based Voucher Case Study

Case Study: Nimiki Apartments: San Francisco, CA

Project-Based Vouchers can be used to finance the acquisition of existing buildings—in this case one with expiring federal subsidies that was at-risk of conversion to market rate. In 2003, a community based nonprofit housing developer acquired and preserved a 34-unit property serving seniors in San Francisco using project-based Section 8 vouchers. The new owner obtained a ten-year contract for project-based Section 8 vouchers from the San Francisco Housing Authority (SFHA). The annual net income from tax credit rents was $94,447 and the annual net income from the the project-based voucher contract was $308,461. We can calculate the project-based Section 8 increment by subtracting the amount of the Tax Credit rents, uncovering an annual increment of $214,104. The debt underwritten using just the tax credit rents was $1,193,401 while the additional debt underwritten using the Section 8 increment was $2,104,861. In this case, the Section 8 Increment increased private debt by more than 200%, substantially reducing the need for local subsidies.

Base Year Income/Operating Expense Statement

	Loan A - Underwriting Rents	*Loan B - Section 8 Rents*	*Total*
INCOME			
Scheduled Gross Income - Residential	296,952		296,952
Section 8 Increment		324,696	324,696
Misc. Income	2,938		2,938
Vacancy Loss - Residential (5%)	(14,995)	(16,235)	(31,229)
EFFECTIVE GROSS INCOME	284,896	308,461	593,357
EXPENSES			
Total Expenses (includes reserves)	184,142	0	184,142
NET AVAILABLE INCOME-TOTAL	100,753	308,461	409,214
Less: HCD Mandatory Interest Payment	6,306	-	6,306
Net Available Income - Underwriting Loan	**94,447**		**94,447**
Net Available Income - Section 8 Increment		**308,461**	**308,461**

Mortgage Calculation/Bond Ratios

SERIES A Tax-Exempt Bond - Underwriting Rents	
Net Operating Income (not including Section 8 Incr.)	94,447
Debt Service Coverage	1.10
Available for Debt Service	85,861
Maximum Mortgage (Rents)	**1,193,401**
SERIES B Tax-Exempt Bond - Section 8 Increment	
Section 8 Increment (net of vacancy allowance)	308,461
Debt Service Coverage	1.10
Available for Debt Service	280,419
Maximum Mortgage (Section 8 Increment)	**2,104,861**

B. Case Study on Using Project-Based Vouchers to Serve Extremely Low-Income Residents

Case Study: Sacramento Senior Homes, Berkeley, California

Project Description

Sacramento Senior Homes is a 40-unit affordable senior development, located in Berkeley, California, in part financed by leveraging Section 8 increment. This new residential building consists of studios, one- and two-bedroom units, available to low- and very-low income seniors, with incomes between 17% and 60% of AMI. Fourteen of the 40 apartments in this property are set-aside for seniors with special needs, specifically seniors with physical and developmental disabilities, seniors at-risk of homelessness, and seniors with HIV/AIDS or other chronic health conditions. Nearly all of the current residents had previously been spending more than one-third of their income on rent; several were homeless. Now, none of them will pay more than 30% of their income on rent.

Completed in October 2006, the development includes 3350 square feet of commercial space, a community and computer room, and interior and front porch gardens. Toolworks, a supportive services provider offers on-site services for the 14 residents with physical and mental disabilities. The building was designed with "green" building features, including photovoltaic panels (expected to provide 60-70% of the energy needs in the common areas) and a high-efficiency water system. The project, designed by McCamant and Durrett Architects, received an award from the Berkeley Design Advocates, recognizing its high-quality design and sensitivity to the community.

Summary of Leveraging

Affordable Housing Associates utilized a project-based Section 8 contract issued by the Berkeley Housing Authority on 39 of the 40 units at this property, which allowed the project to serve extremely low income residents. Ultimately, the leveraging of Section 8 with LIHTCs enabled the owner to draw a mortgage that was more than $1.2 million greater than the project would have been able to support without the project-based Section 8 contract.

Total government subsidy saved:	**$1,272,026**
Amount of government subsidy saved per project-based Section 8 apartment:	**$32.616**
Total development cost of each project-based Section 8 apartment:	**$295,630**
Percentage of total funding represented by Section 8 leveraged private debt:	**11.03%**

AHA financed this project with bonds, tax credits and public subsidy. The development's Net Operating Income (NOI) supports the first bond, in the amount of $1,144,000. A second bond, in the amount of $1,242,393, is supported by the Section 8 increment. The development is also supported by 4% low-income housing tax credits, and a $2,045,831 loan from California's Department of Housing and Community Development's (HCD) Multi-Family Housing Program. A US Bank Bond of $7,196,806 at a 5.46% interest rate covered the majority of construction costs. The City of Berkeley, HUD's Housing Opportunities for Persons with AIDS (HOPWA) and the Federal Home Loan Bank completed construction sources, bringing the total financing to $11,302,539.

(Continued on following page)

Mortgage Leveraging Calculation

The section 8 increment for Sacramento Senior Homes enabled AHA to pay $163,445 more per year in debt service. At a debt service coverage ratio of 1.15, AHA was able to take an additional loan for more than $1.2 million with this additional income.

Sources	Construction Amount ($)	Permanent Amount ($)
USB NOI Bond	0	1,441,000
USB Section 8 Increment Bond	0	1,242,393
USB Construction Bond	7,196,806	0
City of Berkeley	2,127,072	2,127,072
HOPWA	150,566	150,566
HCD MHP	0	2,045,831
FHLB MHP	216,000	216,000
Subtotal 3rd Party Financing	**9,690,444**	**7,222,862**
Deferred Developer Fee	100,391	100,391
Costs Deferred Until Permanent Loan Closing	442,587	0
Income from Operations	85,946	85,946
PV Rebate	0	102,393
Limited Partners Equity	983,171	3,790,947
Total Equity Financing	**1,612,095**	**4,079,677**
TOTAL SOURCES	**11,302,539**	**11,302,539**

Uses	Amount ($)
Acquisition/Demolition	776,669
Construction	6,524,529
Contractor Fees	448,418
Local Fees	368,738
Architecture & Landscape	961,691
Survey, Engineering & Environmental	73,202
Loan Fees, Interest	522,831
Title Recording Escrow	40,120
Taxes & Insurance	112,283
TCAC Fees, Financial Consultants, Other	130,981
Legal Fees	279,094
Reserves	253,862
Developer Fee	525,000
Issuance/Financing Fees	285,121
TOTAL USES	**11,302,539**