Narrowing the Gap

David Smith Proposes New Affordable Housing Solutions

Affordable housing finance leader David Smith, chairman & founder of Recap Real Estate Advisors and founder of the global non-profit Affordable Housing Institute, spoke with *CPE* editorial director Suzann D. Silverman about current and potential initiatives to improve the nation's affordable housing health. Known for his creativity and insight, Smith has long advised both the U.S. and foreign governments on housing solutions.

Q. Do you anticipate a further shortage of low-income housing as federal, state and local government budget deficits grow increasingly harsh?

A. Yes. We have two phenomena going on. The first one is affordable housing always costs money. There is always a gap between the cost to produce market-quality housing and the economic value of that market-quality housing if it is occupied by a poor person. ... Once you've accepted that you have a cost-value gap, then by extension the number of units that you can create and support essentially is the difference between the cost and the value divided by the amount of subsidy. … If you start pulling subsidy resource out of the system, which is going to happen—it's quite clear it's going to happen—you either have to produce fewer units or you have to produce units that are significantly cheaper than the units you're currently producing that you're calling quality affordable housing.

Executive Summary

To improve the nation's approach to affordable housing, David Smith proposes managing property more efficiently, revising financing and giving housing authorities freer rein.

Q. Do you think HUD's proposed privatization of certain portions of public housing should eventually be expanded to encompass all public housing?

A. Housing authorities have to be given the opportunity to act like non-profit, mission-oriented owners, operators and managers through some form of federal decontrol or block granting or deregulation. Whether RAD (Rental Assistance Demonstration) is the specific right one or not is secondary. The reason is very simple: Public housing inventory represents approximately $100 billion of aggregate replacement cost that you couldn't replace now anyway because of its location.

What I've argued in other contexts is that affordable housing—and by extension, public housing—is an essential element of national urban infrastructure. We are failing to reinvest in it, and we have a delivery system that pretty much guarantees it to be obsolete.

So short answer: If it's done properly; if it's done on a voluntary, optional basis; and if privatization is understood to mean that you maintain long-term affordability but you enable the public housing authorities to act like every other kind of non-profit owner, then yes, I'm totally for it.

Q. What kind of new or untapped solutions do you propose to address the nation's affordable housing shortage?

A. The first thing to understand is that the polarity of affordable housing policy in the United States has reversed. If you go back to, say, 1984-85, affordable housing policy in the U.S. was driven by HUD. … Starting in '85-86, for a variety of reasons, that polarity has reversed. … As the federal government has retreated from affordable housing, state and local (governments) have reluctantly gotten into it, and therefore the resources that have to be created have to be those that are essentially "manufactured" in the state and local environment and then "distributed" in the state and local environment. The two of them that are most obvious—that states and locals don't like to think about because it was more fun to have Uncle Sam pay for it—are inclusionary zoning and real estate tax abatements. …

Aside from getting rid of regulatory barriers … we have to find a new way to manage property to be much cheaper. We are still managing property in general as if the Internet did not exist, and as if GPS did not exist, and hub-and-spoke distribution had not been invented. ... In property management, every property has to have its own on-site manager, its own clubhouse, its own rental office. Those are conventions we adopted because we treated each property as a fully autonomous business unit, when in fact they're often under common control. So if we free ourselves from site-basing all the services, using mobile workers electronically directed from a central hub, we could become much more efficient on the operating-cost side of property management.

Q. Have you encountered any efforts overseas through your work with the Affordable Housing Institute that you think could be applied in the United States?

A. Look at U.K. housing associations. They have massive concentrations of units, massive efficiency in property management and scale and so on. We have a lot to learn from the way the U.K. manages and operates portfolios of properties. Portfolio rationalization is related to that. In the U.K., the entities are very much geographically concentrated. The regulatory body strongly encourages consolidation via merger, with the goal of creating operating efficiency and ownership and managerial efficiency.

It's very odd. Count any particular community area that you know of: How many different owners and operators there are of the properties? That's a consequence of the fact that the brass ring in U.S. affordable housing is the development budget. So you get people who have not really portfolios but, if you will, large collections of properties, and they're geographically dispersed. It would really make a whole lot of sense to concentrate them, and we don't do enough of that.

Q. What existing initiatives do you think have been most effective in recent years?

A. For all that I complain about it, LIHTC is a very efficient delivery system. It could be made better, but it is better than any appropriated form of capital. … LIHTC is pure risk transfer. Think about it: The federal government only pays in LIHTC if the unit is built, occupied and compliant. Every appropriated program, the government takes the risk of construction, the risk of occupancy, the risk of initial compliance. That's the first thing. Then you've got the fact that you have recapture, which is collectable. If somebody misbehaves in a LIHTC project, you hit their tax return, and since they're invested in by corporations that pay billions of dollars in taxes, they're collectable. That's appealing; you can't do that with any appropriated form. So I love LIHTC structurally. I'd love to improve it, to refine it, to make the statute one-tenth the size it is—which you could actually do and not lose anything essential—and put the rest of it in reg. I'd love to see that out of LIHTC, but all things considered, LIHTC's been very effective.


Photo by Stanley Rowin

Q. What U.S. efforts have you recommended overseas through the Affordable Housing Institute?

A. I've recommended CRA (the Community Reinvestment Act)—or variations of CRA. CRA is 35 years old, and it's in need of an upgrade. It has worked well. It's done a knowledge transfer. It's created industries. It's created the CDC (community development corporation) industry. … And I really like inclusionary zoning. That works well, too. … India has something called "priority-sector lending," PSL, which is modeled on the CRA. South Africa has something called the Financial Sector Charter, which is CRA-like in nature. Ironically, the U.K. doesn't have anything, and that's a problem.

Q. What do you see to be the issues in recapitalizing private-sector affordable housing assets today, and what are some of the most creative solutions you've provided to overcome them?

A. One, sponsor weakness. We have too many sponsors that are too little. It's exasperating. We have merger-phobia, particularly on the mission side. ... The second thing (is), the capital stack that is used in U.S. affordable housing is way too complicated and cumbersome. I've seen deals with 13 sources of financing. If you boil it down, deals have three types of financing: There's hard debt, which is a regular mortgage you get from a bank. There's soft equity; tax-motivated, usually from LIHTC. In between, there's soft debt, which you get from somebody who is a benefactor or who has a double bottom line or other orientation. … Why people have to go grubbing about for multiple sources of soft debt is at some level a mystery to me. It's horribly inefficient. It adds tons of soft costs that aren't needed. It adds tons of hidden soft costs because everybody is competing for the same scarce resources, so every success has to pay for three or four or five unsuccessful applicants. … The result of it is that when you get a deal financed, you've got all these forms of soft debt that have junior liens on them, and the junior liens get in the way when you're contemplating recapitalization or refinancing or restructuring.

Prepayment lockouts and yield maintenance on GSE multi-family debt are very frustrating. I can understand why they were done before, and why the conservator feels like he is not in a position to waive those things. But if you can't refinance and take advantage of low interest rates because you've got usurious yield maintenance, that's a problem.

Candidly, I don't have a lot in the way of solutions. You almost need a summit that can only eliminate regulations and requirements, not create any, because we have an ecosystem that's highly overgrown. We had a very favorable financial and real estate environment and therefore we figured that we could afford to do those. We need to take them out.

Q. Do you see more or fewer challenges as the market improves and investment sales heat up?

A. Fewer. Right now, ironically, multi-family is the preferred asset class, if only because it looks better than all the other asset classes, and interest rates are really low, and therefore cap rates are low. America is on its way to being a renter nation. We will never see homeownership rates again as high as we saw in 2005-2006, when they got to nearly 70 percent. And we shouldn't need to see those high homeownership rates, because homeownership, much though it has virtues, reduces economic mobility. You can see that now very clearly with all these people who are house-locked. Economic mobility is the key to national economic strength. We need to find ways to enable people to move where the jobs are. …

One other thing I should mention: In conventional real estate, as distinct from affordable, the United States beats every other nation combined just in efficiency. There is nothing like big residential REITs elsewhere in the world. There's nothing like the large-scale property management companies. In all of that stuff, we are way, way, way far ahead of everybody else.

Given that, it's ironic that in affordable housing, the Brits are ahead of us. What you might deduce from that is in fact the British don't have a large conventional multi-family rental sector. For 70 years, they had their own form of rent control, which systematically destroyed that sector. At the end of that process, they had only two things: They had affordable housing and they had homeownership—no conventional rental. It's kind of ironic. …

The biggest challenge is we've got to repurpose the three million units now somewhere in the foreclosure pipeline out of homeownership and into rental, rent-to-own or shared appreciation. … The second big challenge is more regional in nature. It hurts to say this, but it's true: Places like Detroit and Cleveland have to get smaller. There are many others, but Detroit and Cleveland are the ones that are well publicized. They actually have to shrink the footprint of the city, because while the built environment is great if the occupant watches out for it, empty residential property—empty property of any kind—is just a magnet for all the things you don't want: rats, drugs, crime. So the efforts that are being undertaken in Cleveland and Detroit to demolish property, return things to parks or urban greenfields or otherwise, sad though they are, are absolutely essential.

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Q. What kind of opportunities and challenges do you see for investors out of Fannie Mae's REO-to-Rental pilot program?

A. I give Fannie credit for putting these things out there. … They've really tried, I think, to create a program that is not going to lend itself to the creaming and the quick flip and the bad headline of dispossessing somebody who is a good tenant. So I think it's a very worthy experiment. Fannie should keep trying it, because we want to see whether new players can be attracted in and whether they have different property management models and residual models. I will be surprised if it scales, absent somebody solving the property management problem. But as I say, I give them plenty of credit for conceiving it and doing it.

The challenge for investors is very simple: Figure out how you can operate successfully individual, geographically dispersed single-family homes and figure out how you can enlist the occupant as part of your property management value chain. Figure out how to motivate the occupant to protect, improve, maintain the property, whether it's because he's got an equity position or he's got a right to buy at a fixed price or otherwise. That's the challenge. It's not an acquisition challenge; it's how do we set this up so that we can hold this property for five years, where at the end it's in better shape than when we bought it and where our most likely end game is that the current occupant buys it from us and that makes us happy. That's what you're after. If you can figure out how to do that at whatever scale, then you have a potential business model.

Q. What other initiatives are you currently focused on, and what have been the results so far?

A. Supportive housing, service enriching elderly. We have a vast inventory of existing elderly properties. We also have what are called in the trade "NORCs," which stands for "Naturally Occurring Retirement Community." It wasn't supposed to be an elderly community, but it has become one. Those represent an asset. The people in them are older than they were when they moved in. The average age of the residents is 75 or more. If they move out of this housing, they're going to move into something that's going to cost us taxpayers a lot more and is going to make them less happy. Lots of these properties have services brought in on a charitable basis. They need to be physically retrofitted; they need to be operationally retrofitted. …

These elderly properties are the first responder in our healthcare value chain, and yet they're not recognized as such. We have to find ways to bring health-related and wellness-related services into existing elderly affordable housing, because the alternative is to send these folks to assisted living and nursing homes, which they hate, their kids hate, their grandkids hate and the taxpayers hate. So I'm working on a variety of initiatives to create financing structures that make it possible for that capital to flow and to blend the healthcare streams and the subsidy streams and resource streams and housing streams. CPE