



Newport Partners LLC.



Transportation II – Strategies for Expanding Affordable Housing Near Transit

Policy Paper #2 Financing Tools and Strategies

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About This Report/Acknowledgements

In 2008, HUD and FTA assembled a report outlining strategies for how they could work together to better coordinate housing and transportation programs to promote affordable housing near transit. The report was in response to the Joint Explanatory Statement issued by the House-Senate Conference Committee with the FY 2008 Consolidated Appropriations Act urging HUD and FTA to continue their efforts to promote the inclusion of affordable housing near transit.

This paper, the second in a series of three policy papers written as part of a HUD-funded research project Strategies for Expanding Affordable Housing Near Transit, focuses on financing strategies for affordable housing near transit. The first paper's focus was on barriers and incentives to affordable housing near transit and the third paper discusses how communities have attempted to strengthen coordination between transit and housing efforts. This project is a direct response to the proposed actions offered as strategies in the FTA / HUD¹ report.

The paper was written by Newport Partners, LLC in partnership with the Center for Transit-Oriented Development (CTOD). The recommendations in this paper also reflect the input and review of an expert committee comprised from academia, policy institutes and other transit and housing experts listed below who reviewed and commented on multiple drafts:

Michael Bodaken, National Housing Trust;

Robert Cervero, Professor of City & Regional Planning; Director, University of California Transportation Center; Interim Director, Institute of Urban & Regional Development;

Alyssa Katz, Pratt Center for Community Development;

Robert Puentes, Brookings Institution;

Sarah Rockwell, Partner, Kaplan, Kirsch & Rockwell LLP;

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Regina Gray, Project Manager, Office of Policy Development and Research
Edwin Stromberg, Senior Program Manager, Office of Policy Development and Research
Salvatore Sciafani, Senior Policy Analyst, Office of Community Planning and Development

¹ FTA / HUD, "Better Coordination of Transportation and Housing Programs to Promote Affordable Housing Near Transit," 2008.

Financing Tools and Strategies

Executive Summary

Financing of any affordable housing project typically involves complex combinations of private equity, multiple layers of debt (including “soft loans” representing hybrids of grants, equity, and subordinated debt), philanthropic support, public money, and preferential tax treatment.

Locations near transit often add additional challenges, particularly premium land costs, logistical complications stemming from the interface with the transportation facilities, complex and lengthy approval processes, and more intensive mixtures of residential and nonresidential uses.

This paper discusses several issues that arise uniquely, or more prominently, around transit. These include transportation-related public policies that affect the appeal to private sources of funds and the increased share of land in the total financial requirements. It reflects on these conditions at a point in time when the overall real estate market is undergoing significant change, and real estate investments generally are not viewed in as favorable a light as they have been over the past decade. The current conditions make federal policy more important than ever.

The paper explores the financing tools and strategies for TOD development within this context. The focus and the recommendations are largely from the federal perspective. The overall conclusion is that although there is currently little at the federal level that specifically supports the development of affordable transit-oriented development, the federal government often acts more as a permissive partner, enabling state and local actions that support affordable housing around transit. We offer a set of policy recommendations that we believe may strengthen the federal government commitment to the principle of expanding affordable housing around transit through workable financing solutions. These recommendations include:

1. Modifying government policies that unnecessarily make it more difficult to attract investors or obtain loans for affordable housing. Land use regulations for TOD and other areas around transit should be formalized and "of right" prior to when financing is needed, rather than left uncertain. Land leases in joint development should include protections for lenders.

2. Data on costs, activity, absorption, and outcomes for affordable housing around transit should be assembled and made available to investors and lenders who otherwise perceive such investments as mysterious and unproven.
3. Subject to prudent underwriting requirements, federal agencies should be prepared to offer mortgage insurance and other credit enhancements to draw private financing to affordable housing in transit areas without creating excessive risk premiums.
4. All states should consider location relative to transit and combined cost of housing and transportation in their Qualified Allocation Plans for LIHTC.
5. HUD should revisit the methodology for designating Difficult Development Areas under the LIHTC program, incorporating data on costs in areas around transit and making designations for areas smaller than counties.
6. The new underwriting criteria for FHA multifamily mortgage insurance, which require substantially higher debt service coverage for unassisted affordable housing, should be reconsidered, with special provisions for housing near transit.
7. CRA ratings should give credit for lending that helps reduce the combined cost of housing and transportation.
8. A sub-goal of the Fannie-Freddie Enterprise Affordable Housing Goals could be to finance affordable housing around transit.
9. FHA and GSE lending rules should permit higher commercial share of space or rent in properties close to transit. Furthermore, while there are no criteria that eliminate TOD projects from qualifying under Sec 220, it could be helpful to specifically declare it an eligible type of project under the program.
10. Given that the basis for low-income housing tax credits excludes land value, all grants and loans, including tax-exempt bond financing, for land acquisition should not preclude eligibility for 9 percent credits.
11. FTA should modify and clarify requirements for “continuing control” under joint development regulations to allay concerns of lenders and investors about the security of affordable housing collateral. This could include specifying that affordable housing subject to long-term use restrictions in connection with project-based subsidies, tax credits, and inclusionary housing requirements represents a long-term commitment to transit-supportive use.
12. FTA could modify the formula used in the federal New Starts transit capital funding program to prioritize transit alignments that provide better connections between existing concentrations of affordable housing and job centers, as well as alignments in

jurisdictions that have adopted zoning and other local policies that support the construction of affordable TOD and/or commit local funds to the development of affordable units near stations on the proposed alignment.

13. A program should be established to incentivize creation of regional loan funds to finance purchases of property to be used for affordable, workforce and mixed-income housing in conjunction with purchases of land for transit facilities.
14. To address the challenges related to acquiring and holding property for development and redevelopment of affordable TOD, public officials should consider the development of a dedicated, housing-related federal finance or funding resource designed to support local and regional affordable TOD property acquisition loan funds.
15. There is also much to be gained by disseminating best practices in existing local and regional property acquisition funds that target affordable housing sites near transit.

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I. Introduction

This paper focuses on options for financing affordable housing near transit. As with the previous installment in this series, which discussed incentives and barriers arising from public policies, this paper addresses:

- Both housing that is subsidized through payments and tax preferences for property owners and private market housing that is affordable to moderate-income households;
- Neighborhoods and land around heavy and light rail transit systems, rather than bus or commuter rail services;
- Construction of new housing and the preservation of existing housing; and
- Neighborhoods near transit that developed before the transit system was created, or that developed without a comprehensive plan, as well as integrated, planned transit-oriented developments (TOD).

While the term "financing" may be interpreted as including measures such as tax abatements, grants, free or discounted land, or other contributions to increase the economic feasibility of affordable housing, this analysis is focused more narrowly on loans and equity investments and government policies that affect the availability of these financial resources.

The key question in this analysis of financing, and in the overall subject of this series, concerns whether affordable housing can be made available despite elevated costs and complex development processes that often characterize locations adjacent to transit. In such locations, without policy interventions or incentives, existing housing or construction of new housing is often limited to upper-income households.

However, not all locations near transit have expensive land prices and high-cost housing. When that is the case, the problems of providing affordable housing, while often formidable, are no different than in neighborhoods that are not near transit. This study focuses on areas where the presence of transit facilities and services affect the cost and availability of land for housing.

A. The Current Environment

While the financial system has stabilized since its near collapse in 2008, financial institutions are still very reluctant to lend. Real estate developers face a serious credit crunch. In addition, the market for tax credits and tax-exempt bonds has been substantially weakened and has been

heavily dependent on extraordinary measures such as exchanges of tax credits for Treasury Department cash, allowed for 2009 credits. Despite today's uncertainties regarding the future of the nation's housing finance system, this analysis attempts to look beyond the short-term disruptions in the economic cycle to focus primarily on long-term policy issues.

There are two key factors influencing financing for affordable housing near transit that deserve particular attention. First, the unique characteristics of TODs and other housing near transit create financing needs that are different from those found in other locations. Second, government housing and credit policies may direct credit to places where low-income households have lived in the past, rather than to places near transit where they might want to live or where their combined cost of housing and transport may be lower. Following a discussion of these two topics and policy options for addressing the challenges they present, this paper reviews the extent to which current federal policy has or has not considered housing near transit, and how state and local policies have been more innovative in encouraging housing around transit facilities. Following that, more detailed descriptions of various financial instruments and policies are provided.

B. What makes locations near transit different?

Several "unusual" features of housing near transit, especially in TOD, have been cited in past studies and in practitioners' experience for creating special financing challenges. Although a reduced need for parking in TOD is increasingly being recognized in land use regulations, some lenders are reluctant to finance projects with less parking capacity [Arrington and Cervero 2008, p. 29; Cervero et al. 2004, pp. 90, 95; Belzer and Autler 2002, p. 21; Reconnecting America 2009a, p. 15]. The use of unsubordinated land leases and other forms of continued participation by transit agencies in joint development projects, partly mandated or implied by Federal Transit Administration (FTA) requirements, discourages some equity investors and compromises the first lien position of mortgage lenders, making it more difficult to obtain loans [Parzen and Sigal 2004; Cervero et al. 2002, pp. 30, 56]. The overall complexity of TOD and associated delays and uncertainty are unattractive to both equity and debt financing sources. The effects of station location and TOD on land values in the immediate area create issues regarding comparability to properties only slightly further away, and that alone is enough to raise questions about valuations. Lenders may be unwilling to commit funds when they lack a clear understanding of a project's overall market value.

Because of these and other factors, lenders generally view TOD housing as high-risk ventures. Local banks often have little experience with such projects. Appraisers don't have "comparables" to use in determining value. The secondary mortgage market demands loans that are "commodities," meaning they have standard loan terms and property characteristics, for packaging into securities.

The perception of risk could be addressed by the FHA mortgage insurance or Fannie Mae-Freddie Mac purchase programs. FHA and the housing Government Sponsored Enterprises (GSEs) can't be indifferent to risk either, but they can develop the expertise to underwrite TOD loans. Historically, FHA and the GSEs have often been at the forefront of innovations in housing finance. With government backing, local banks and secondary-market investors won't get bogged down by worrying about the number of parking spaces in a development.

In some cases, the issues raising risk concerns or otherwise causing difficulties attracting investment or loans for affordable housing in TOD are inherent in the type of development. In other cases, the problems are caused by government policies or procedures. Local permitting and approval requirements can be time consuming and unpredictable, creating added risk that will make financing for acquisition, development, and construction less available and more expensive.

Federal requirements, or the interpretation of federal requirements by transit agencies or local governments, may also complicate financing. The FTA's joint development regulations require transit agencies to have "satisfactory continuing control" over land leased or sold for housing or other transit-area purposes. In the 2007 revision of FTA regulations, that is defined as "the right and power to direct that such project shall be used for activities eligible for funding under Federal transit law." [Federal Register February 7, 2007, p. 5794]. That requirement may compromise, or appear to compromise, the collateral value of the property for mortgage lenders. Where the land is leased, the lease could be canceled in the event of a foreclosure or a failure of a financially struggling borrower to make scheduled lease payments.

Some types of financing for rental housing impose limits on the share of space or of rental income that can come from nonresidential use. With mixed use being among the defining characteristics of transit-oriented development, that can be a significant barrier. The limits on nonresidential elements are particularly problematic with FHA and Fannie-Freddie programs,

perhaps because of a concern that mixed-use properties lie outside their housing-oriented missions. One common response where residential and nonresidential uses are in the same building is to "condoize" the building, making the nonresidential component a separate property legally, with separate financing, even though it is in the same building. Under that arrangement, however, the income from the commercial space is not available to support mortgage payments on the housing, possibly making it more difficult to meet debt service coverage ratio requirements.

The September 2008 FTA / HUD report entitled, "Better Coordination of Transportation and Housing Programs to Promote Affordable Housing Near Transit," identified "the high land cost that results from the market demand for housing, office space, and amenities within walking distance of transit" as the primary challenge in developing mixed-income housing. The value of land is more difficult for investors to evaluate than costs for construction, and many financing and subsidy sources do not provide help for land costs. Land cost cannot be depreciated in calculating taxable income², the basis for low-income housing tax credits excludes land, and programs of tax abatement for affordable housing typically do not apply to land value. Higher land cost is offset, in part, by building at higher density. Doing so requires regulatory accommodation, but even where that is provided, challenges remain.

Building at higher density spreads the cost of the land over more units and may have positive environmental impacts and lead to energy savings, but it requires more complex construction processes and increased construction costs per square foot. To compensate for higher construction costs per square foot, as well as to spread the land cost over more units, a common response is to build smaller units, but that causes even further increases in costs per square foot, because there are some fixed costs associated with each unit and a larger share of the area within each small apartment consists of more costly kitchen and bathroom space, rather than bedroom space.³ Building smaller units also limits the opportunity to provide housing for families with children.

² While it could be argued that the depreciation allowance simply reflects the reality of gradual deterioration of structures, the 27.5-year depreciation schedule for rental housing is considered a tax preference based on estimates that economic depreciation would more accurately be calculated as a 40-year lifetime.

³ For more on the relationship of cost to density, building height, and unit size, see Mortgage Bankers Association (2009), Wheaton and Simonton (2007)

The dominant, and underlying, problem is still the cost of land. Programs that subsidize the cost of structures but not land, such as the Low Income Housing Tax Credit (LIHTC) and most tax abatements, may indirectly offset the land costs, but such indirect approaches are less effective.

C. Credit Steering

Government is deeply involved in the financial system through regulation, direct borrowing and lending, and tax policy. In addition to ensuring economic stability and efficiency, that involvement is often exploited to pursue other policy objectives, from increasing the availability of credit for low- and moderate-income households to promoting investment in new energy sources. This might be described as "credit steering."

Credit-steering as incorporated in federal financial policies has directed credit for low-income housing toward areas with high poverty. Federal rules for low-income housing tax credits have provided incentives for building in high-poverty "qualified census tracts." Lending goals set for Fannie Mae and Freddie Mac have also favored depressed areas. Similarly, the Community Reinvestment Act favors lending in poor areas rather than in areas where the poor might find better opportunities. HUD policies, in contrast, have largely sought to reduce the concentration of low-income households in high-poverty areas.

The inconsistencies between HUD housing programs and various financial policies are rooted in a long-standing debate over whether the government should focus its emphasis on places or on people. That debate is complicated, with legitimate arguments on each side. For the current analysis, however, the conflict is less about places versus people than about places versus places. Should resources be directed toward places that are most distressed, with the highest poverty concentrations, or should the choice of targets reflect the needs of the intended residents, and possibly other goals such as reduced congestion or more-efficient labor markets? It would be useful to distinguish poor neighborhoods where transit, jobs, educational opportunities, and public services are available from areas where the only characteristic is poverty.

Largely as a result of provisions in the 2008 Housing and Economic Recovery Act (HERA), the pressure to direct credit to high-poverty areas has been reduced, creating greater financing opportunities for affordable housing near transit. Where the designation of qualified census tracts meant only high-poverty neighborhoods were eligible for additional tax credits in most

metropolitan areas with transit, state housing finance agencies can now designate any property for additional credits. HERA also changed the LIHTC rules to allow low-interest loans under the HOME program to be used without disqualifying a project from receiving larger tax credits. Another HERA provision changed the goals for Fannie Mae and Freddie Mac multifamily lending from a requirement to provide funding for low-income families in low-income areas to funding affordable rental housing for low-income families in any area.

Such changes mean that federal regulations are less discouraging toward financing housing near transit, but the opportunity to actually create positive incentives for location efficiency as a factor in directing credit flows has not been exploited. Congress hasn't chosen to abandon all provisions dictating financing priorities. There is still a confusing mix of directions given in financial regulations, tax provisions, and expenditures. But affordable housing near transit has not become one of the favored categories.

Most of the analysis presented here concerns the supply of debt and equity funds for properties containing affordable housing. However, the supply of debt and equity funds and the overall feasibility of investment in affordable housing depend on the level of support for neighborhood development around transit, through public investments in infrastructure and community amenities. Such public investments help attract private investments, as well as serving the needs of the entire community.

D. Transit Funding and Affordable TOD

Although the primary focus of this paper is on debt and equity related to financing affordable housing near transit, it is relevant to note that there may be opportunity to create efficiencies between HUD and FTA investments by also aligning federal transit capital investments with affordable housing goals. Funding from FTA's largest transit capital program, New Starts, is distributed through a formula that scores projects based on a number of criteria including cost effectiveness, environmental benefits and mobility benefits. New Starts is highly competitive and vastly oversubscribed – with \$250 billion in planned transit projects between 1995 and 2009 but only \$9.5 billion spent by FTA 2003-2009.⁴ The New Starts formula currently does not include criteria related to how well the proposed system will connect low-income communities to

⁴ Reconnecting America, "Jumpstarting the Transit Space Race: How the New Administration Could Make America Energy-Independent, Create Jobs and Keep the Economy Strong," 2009.

job centers⁵, whether local jurisdictions along the proposed route have adopted zoning or other policies that support the development of affordable housing, or whether local/regional funds have been dedicated to support the construction of affordable units near stations on the proposed alignment. Changing this formula to give priority to systems that address affordability at the outset of system development could lead to long-term cost efficiencies and create an incentive for New Starts applicants to strengthen local affordable housing policy and investment.

⁵ The formula does award points based on the extent to which transit-dependent populations will be served by the proposed system, but transit-dependents are often defined based on car-ownership, not income.

II. Low Income Housing Tax Credit

The LIHTC has become the primary vehicle with which the federal government supports the production and preservation of rental housing reserved for households with limited income and with limited rents. The LIHTC was initially created as part of the 1986 Tax Reform Act and has been used to produce nearly 2 million units.⁶ From 2003 to 2007, an annual average of 122,000 new construction and rehab units were placed in service in tax credit properties. Tax credits have been a key tool for retaining assisted housing as affordable when contracts established under earlier subsidy programs have expired. Moreover, LIHTC has played a role in a large share of affordable rental projects in TOD. [Kniech and Pollack (2010)]

In order to qualify for credits, housing units must be reserved for households with income under, at most, 60 percent of local area median family income, adjusted for family size. The law requires a minimum share of units in a property to be reserved, but since credits are only provided for the reserved units, most projects using LIHTC are entirely, or almost entirely, reserved for limited-income households. Rents (including utilities) are capped at 30 percent of the maximum qualifying income, but are not adjusted based on the income of the actual tenant, so households with incomes below the upper limit may end up paying more than 30 percent of their incomes for rent, unless they also receive a voucher.

There are two varieties of federal LIHTC. If a property is newly constructed or substantially rehabilitated, and if it is not financed with tax-exempt bonds, a credit equal to about 9 percent of the qualified basis (calculated according to the cost of the structure—excluding land—and adjusted for the share of the property reserved for low-income tenants) is provided each year, for 10 years. If the property is financed with tax-exempt bonds or is an existing building with no more than minor rehabilitation, the annual credit is about 4 percent.⁷

Congress provided for the qualified basis of properties to be increased by 30 percent in "high-cost areas." Initially, there were two types of high-cost areas: Qualified Census Tracts (QCTs) and Difficult Development Areas (DDAs). A QCT was defined as one in which 50 percent of the

⁶ The operation of the LIHTC is complicated, and the discussion here is necessarily somewhat complicated, but it is greatly simplified and does not describe provisions that are not especially important for housing around transit.

⁷ The actual credits may vary from 9 percent or 4 percent, depending on interest rates at the time the property is placed in service. From July 2008 to December 2013, the higher credit is subject to a minimum of 9 percent. Otherwise properties placed in service in May 2010 would have received annual credits of only 7.85 percent. There is no floor for the lower credit, and that rate for May 2010 is 3.36 percent. Although credits are only provided for 10 years, the obligation to restrict rents and tenant incomes lasts for about 30 years.

households had incomes below 60 percent of the area median, or where the poverty rate exceeded 25 percent. A DDA was defined as an area with high construction, land, and utility costs relative to median income. The HUD Secretary was given responsibility for identifying those areas, and HUD has published notices identifying QCTs and DDAs. It turns out that QCTs in older urban areas often contain transit stations, although the availability of transit was not a factor in the designations. Suburban TOD areas, as well as suburban areas near transit where integrated TOD activity has not occurred, are rarely in QCTs.

The HUD designations of QCTs use tract-level income data for 1999, as reported in the 2000 Census. Next year, data from the American Community Survey (ACS) at the tract level will become available. If, as expected, the ACS data are then used to identify QCTs, gentrification around transit stations over the past decade will probably mean that a number of areas close to transit will lose QCT designations, and therefore will not be automatically eligible for a 30 percent increase in qualified basis.

In the absence of local data measuring "construction, land, and utility costs," HUD used rents to designate counties as DDAs. The statute doesn't specify that DDAs should be counties or how large the areas should be. It does, however, dictate that "the portions of metropolitan areas that may be designated [as DDAs]...shall not exceed...20 percent of the populations of such metropolitan statistical areas." HUD has interpreted that to mean that the designated counties cannot represent more than 20 percent of the population in all metropolitan areas.⁸

All five boroughs of transit-rich New York City are designated as DDAs. Some other designated counties, such as Los Angeles and San Diego, have rail transit, but most metropolitan areas with rail transit did not have any DDAs. The list of DDA counties does not conform to any concept of difficult development recognized by developers. In California, Fresno and San Bernardino counties are DDAs, but San Francisco and Contra Costa are not. In Massachusetts, Brockton is a DDA, but not Boston or Cambridge. There are no HUD-designated DDAs in the rail transit-endowed states of Colorado, Washington, Oregon, Illinois, Minnesota, Missouri, Maryland, Virginia, Pennsylvania, or Georgia. Thus, the QCT and DDA designations by HUD, based on criteria specified in general terms by Congress, are generally not supportive of

⁸ Reports by the Joint Committee on Taxation, however, summarize the law as limiting DDA population to 20 percent of **each** metropolitan area. See, for example, Joint Committee on Taxation (2007, 2008) www.jct.gov/x-2807.pdf , <http://www.jct.gov/publications.html?func=startdown&id=1276>

locating affordable housing near transit. In 2008, however, Congress provided authority to state agencies to designate "any building" as eligible for the 30 percent boost in qualified basis.

Usually tax preferences, such as the mortgage interest deduction or accelerated depreciation, are entitlements available to anyone meeting the specified criteria. LIHTC, in contrast, is rationed, like housing choice vouchers. Authority to assign 9 percent credits is provided to state agencies in amounts based on population. The key role of the states in allocating credits is a notable distinction of this program, since state governments have generally had smaller roles in housing than either the federal government or local governments. Low-income units in projects financed with tax-exempt bonds automatically receive 4 percent credits, and those are not counted against the tax credit cap, but they are indirectly limited by a cap on the volume of tax-exempt "private activity" bonds that may be issued in each state.

Demand for credits exceeds the limited supply. States are required under federal law to spell out their criteria for choosing among applicants in a Qualified Allocation Plan (QAP). States design their own allocation systems, but the federal law⁹ specifies three types of projects that must be given preference and 10 selection criteria that must be included in the QAP. The three preferences are:

1. projects serving the lowest income tenants;
2. projects obligated to serve qualified tenants for the longest periods; and
3. projects which are located in qualified census tracts, the development of which contributes to a concerted community revitalization plan.

The 10 mandatory selection criteria are:

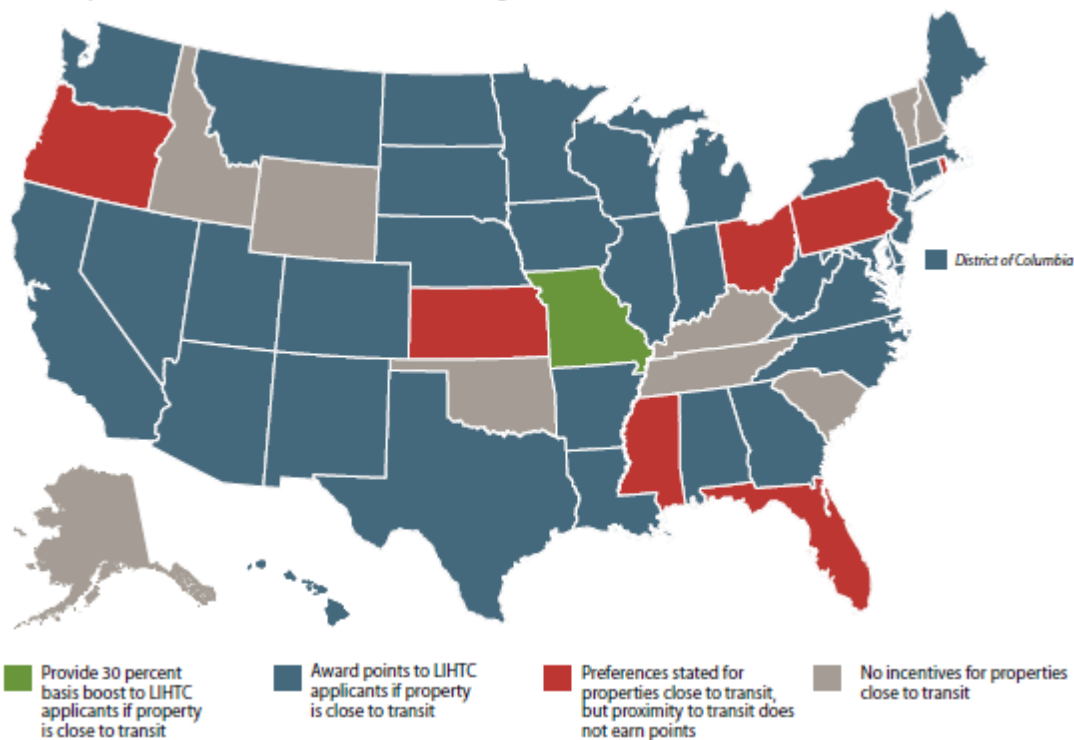
1. project location;
2. housing needs characteristics;
3. project characteristics, including whether the project includes the use of existing housing as part of a community revitalization plan;
4. sponsor characteristics;
5. tenant populations with special housing needs;
6. public housing waiting lists;
7. tenant populations of individuals with children;

⁹ 24USC42(m)

8. projects intended for eventual tenant ownership;
9. the energy efficiency of the project; and
10. the historic nature of the project.

The final two selection criteria were added by HERA. There is nothing specifically referencing transit proximity or tenants' transportation costs. Explicit inclusion of transit in the list of criteria would be helpful, but the absence of that as a required QAP criterion has not prevented state agencies from including transit among their allocation factors. An analysis by the National Housing Trust found that 41 states indicated preferences or awarded points for properties close to transit in their QAPs. Often, however, the weight given to transit proximity has been too small to make a difference.

Proximity to Transit Preference in the LIHTC Program



New TOD housing using LIHTC is usually produced and operated by private for-profit or (sometimes) nonprofit developers, with financial institutions and other corporate investors as limited partners.¹⁰ The limited partners can use the credits to offset their federal tax liability.

¹⁰ Recent ownership arrangements have often been structured as limited liability companies (LLCs) involving a "managing member" and "non-managing members." The more familiar partnership terms "general partner" and "limited partners" are used here, for simplicity, to refer to both partnerships and LLCs.

Although, strictly speaking, they are participants in the ownership of the property, the arrangement is typically described as "selling" the credits. If the state housing agency provides more credits to a project, it has less to provide to other projects. On the other hand, the agency may provide less than the maximum amount implied by the qualified basis, leaving more credits available for other projects. Moreover, the federal statute directs that the amount of credit allocated "shall not exceed the amount the housing credit agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period."

Given the authority of state agencies to designate projects for the same 30 percent basis increase as those in areas on HUD's lists, as well as the agencies' authority and responsibility to give less than the maximum credit for which a project is eligible, the HUD designations of QCTs and DDAs may become less influential. Nearly all states have taken steps to implement their authority to designate projects as eligible for additional credits, in many cases adopting formal policies with regard to the types of projects to be considered. In a few states, including Oregon and Missouri, TOD locations have been specified as appropriate candidates for the 30 percent increase in basis.¹¹ Even so, at least in the short term, the HUD designations still seem to matter.

Ten years of 9 percent credits is intended to represent a present discounted value of 70 percent of the value of the structure. If the qualified basis is raised to 130 percent of the structure value, the present value rises to 91 percent (1.3×0.7), although that is based on discounting at the government's cost of borrowing rather than the internal rates of return required by investors. In addition to the credits, investors receive further tax benefits in the form of deductions for depreciation.

The nature of the LIHTC changes the calculus for investment. There is less incentive to control construction costs, especially after credits have already been assigned. With the cost of the structure effectively discounted, land costs become a much larger share of the required investment. Without transit proximity being considered in credit allocations, LIHTC developers are discouraged from proposing projects near transit. If proximity to transit is considered

¹¹ Missouri has a list of criteria the state will use to designate a property for a basis boost, including being part of a TOD plan. The 2010 QAP specifies that "The TOD plan must be centered around and integrated with a transit stop. The plan must be mixed-use, mixed-income, pedestrian friendly and of appropriate density for a TOD." [Missouri Housing Development Commission 2009]
http://www.mhdc.com/rental_production/2010_FY_items/documents/2010_Qualified_Allocation_Plan.pdf

mechanically (e.g., 5 points for being within ½ mile of a station), without considering transportation quality or other neighborhood characteristics, LIHTC projects could be concentrated around stations with infrequent service to places where few want to go, without the amenities and advantages of more desirable TOD areas. States' complicated formulas for assigning points based on neighborhood characteristics and transit service levels represent attempts to compensate for the fact that marketplace forces, in the context of the subsidy programs rules, don't automatically draw affordable housing to locations that would best serve residents.

Providing especially large subsidies for structures may be an indirect way of addressing the fundamental problem of elevated land cost in the limited area within walking distance of transit, but it's hard to get that right, offering just enough incentive. Measures that directly affect the cost and availability of land, or that provide financing for land acquisition on favorable terms, may be more effective and efficient. State and local use of CDBG, HOME, and other flexible programs, as well as their own resources, for acquisition, development, and construction-period financing, are among the more direct measures.

III. Tax-Exempt Bonds

States and localities may issue tax-exempt bonds (TEB) to finance multifamily rental housing. The interest rate on mortgages funded with those bonds is reduced because the bond holders don't have to pay federal (and possibly state) tax on the interest payments they receive. In properties financed with tax-exempt bonds, units reserved for low-income households are automatically provided with LIHTC at the lower "4 percent" rate. Over the period from 2003 to 2007, an annual average of 37,000 rental units were financed using tax-exempt bonds, of which slightly more than half were new construction. [Abt 2010] Denver provides an example of targeting tax-exempt bond financing to transit areas. Seven municipalities in the Denver MSA pooled their bond authority to finance affordable housing projects within 1,500 feet of planned or existing transit facilities.¹²

As with the 9 percent LIHTC program, multifamily housing financed with tax-exempt bonds must either have a minimum of 40 percent of units reserved for households with incomes below 60 percent of area median or have at least 20 percent set aside for households with less than 50 percent of area median. Since the advantage of the reduced interest rate applies to the entire property, rather than only the low-income units, there is more incentive to use bond financing with mixed-income, rather than strictly low-income, properties. The average share of low-income units in properties financed with tax-exempt bonds, however, has been just as high as the share of low-income units in properties with 9 percent LIHTC. During 2003-2007, 95.0 percent of units placed in service in bond-financed properties were low-income units, slightly exceeding the 94.9 percent share in all properties with LIHTC. The legislation and regulations for LIHTC and TEB established minimum shares for low-income occupancy, but not maximums. In practice, these programs have both been used for housing that is entirely, or almost entirely, low income, rather than mixed income.

The advantages of tax-exempt financing are greater when market interest rates are higher, and the interest rate advantage would also likely to be higher if marginal tax rates for high-income taxpayers were to rise and alternative tax-shelter devices were to be restricted. The tax exemption for housing bonds normally does not apply to the alternative minimum tax (AMT), somewhat limiting their attraction and interest rate savings, although a temporary provision

¹² Center for Transit-Oriented Development (2007) <http://www.reconnectingamerica.org/public/show/denverenterp>

under the American Recovery and Reinvestment Act of 2009 (ARRA) legislation extended the tax exemption to include the AMT until January 1, 2011.

There is an overall volume cap on private activity bonds issued in each state, based on population. States and localities decide how much of that volume to allocate to rental housing, rather than to fund mortgages for first-time homebuyers (see below), student loans, redevelopment, and other eligible uses that fall under the "unified volume cap." State and local agencies may also issue taxable bonds to finance housing, especially to finance acquisition, development, and construction. If financed by tax-exempt bonds, the tax credit project is disqualified from receiving LIHTC at the higher rate, even if the bond is paid off before the property is placed in service and tax credits kick in. Using taxable bonds avoids that restriction, as well as falling outside the private activity bond volume cap.

IV. Federal Housing Administration (FHA) Financing

The FHA has, since 1934, provided insurance against default on mortgages for single-family (1-4 unit) and multifamily (5+ unit) housing. The borrower-paid insurance fee is expected to offset the risk associated with more liberal payment terms, including higher loan-to-value ratios and amortization periods of up to 40 years. FHA does not make loans (except in some special circumstances), but the federal insurance facilitates the sale of loans in the secondary market.

FHA-insured loans are intended to enhance the supply of affordable housing. Most of the single-family insured loans are used by first-time buyers. Multifamily FHA loans often finance assisted housing, LIHTC projects, and other properties serving mainly low- and moderate-income households. There are generally not any restrictions on occupants or rents, but there are limits on per-unit loan amounts which act to influence the market segment the units are able to serve. In addition, the multifamily underwriting standards are less stringent for assisted and tax-credit properties.

FHA's share of both the single-family and multifamily mortgage markets had been shrinking for many years as private mortgage insurance companies, the GSEs, and private lenders expanded their activities. The recent and ongoing financial crisis has restored, at least temporarily, the FHA market share. Nearly all single-family FHA-insured loans are packaged into Government National Mortgage Association (GNMA) securities that (like the underlying mortgages) are fully backed by the federal government. Only FHA and other government-insured loans are eligible for GNMA securitization. Many multifamily FHA-insured loans are also packaged into GNMA securities, but in other cases FHA insurance is provided for mortgages funded by tax-exempt bonds or other arrangements.

There are a number of different FHA mortgage insurance programs. Insurance for multifamily loans to finance new construction and substantial rehabilitation is provided to for-profit developers under the Section 221(d)4 program. A much smaller and more liberal program, Section 221(d)3, serves non-profits. These programs not only insure long-term mortgages, but also cover, or facilitate, construction financing. The Section 223(f) and 223(a)(7) programs are used for acquisition and refinancing of existing properties. These programs thus could help in the preservation of existing affordable assisted and market-rate housing. Under the Section 542(b) and Section 542(c) programs, FHA shares risk with Qualified Participating Entities and Housing Finance Agencies. Those programs may be useful for financing transit-related

housing. For example, the Montgomery County MD Metropointe project used financing under 542(c). The Montgomery County Housing Opportunities Commission, which serves a local housing finance agency as well as a developer and operator of affordable housing, shares the risk with FHA.

The limits on the size of FHA loans, intended to preclude use of FHA insurance for luxury housing, can be a barrier to financing affordable housing in TOD situations where land prices and construction costs are quite high. A recent change in the way land is treated [HUD Notice H 10-07 March 16, 2010] may make the cap on the loan amount less of a deterrent.

There are other features of FHA mortgage insurance that may serve as barriers to financing affordable housing near transit. The restriction on commercial space and income is one. Under the 221(d)4 program, commercial space cannot exceed 10 percent of the gross floor area of a project or 15 percent of its total gross project income. However, for TOD, with its focus on mixed-use, an alternative could be FHA's Sec 220 program. Sec 220 helps finance residential construction or rehabilitation where revitalization efforts have been made by local governments. Projects insured through the program are able to include commercial space that comprises up to 20 percent of the total project square footage or 30 percent of the gross project revenue. Including commercial space that exceeds this limit is permissible through a special approval process. This could be a particularly attractive arrangement for a developer of a TOD project not looking to "condoize" and allowing nonresidential rental receipts to be used to help meet debt service coverage ratio requirements. Although localities have wide discretion to designate revitalization areas, it may be helpful to specifically identify areas near transit as eligible in federal regulations for Sec. 220.

Delays and paperwork requirements are another disincentive to use of FHA programs. As part of a recent legislative change, the Housing Tax Credit Coordination Act of 2008 was put in place to help facilitate the joint use of LIHTC with FHA mortgage insurance programs. The Act calls for administrative and procedural changes related to the processing of projects utilizing FHA mortgage insurance with LIHTC or tax-exempt housing bonds. Such changes are expected to result in reduced wait periods for approval. This is particularly important for a TOD project opting to include an affordable housing component, since TOD often involves development processes that can be complex and time consuming.

V. Government-Sponsored Enterprises

A. Fannie Mae & Freddie Mac

Fannie Mae and Freddie Mac have played major roles in financing housing generally, including affordable housing around transit. They have not only provided a secondary market outlet for mortgages on both owner-occupied and rental housing, but they have accounted for a large share of LIHTC investments.

Today, even in their troubled state, Fannie Mae and Freddie Mac's share of secondary mortgage market purchases has actually increased, as "private label" mortgage-backed securities have largely disappeared and many portfolio lenders have withdrawn from the market. With no taxable income, however, Fannie and Freddie are no longer investing in tax credits. The future of Fannie and Freddie is one of the greatest uncertainties for the housing finance system. It is likely, however, that to the extent that they, or their successor(s), are associated with and backed by the government, their operations will be restricted to a narrower range of activities in support of specific public-policy objectives. There has been no indication, so far, that transit-accessible affordable housing will be among their stated objectives. Whether that is, or is not, an explicit mandate could make a big difference.

Although Fannie and Freddie were created largely to ensure liquidity and facilitate nationwide credit flows, as well as to dampen economic and financial cycles, they have had a public mission and special responsibility for lower-income housing from the outset, reflected in limits on the size of loans they could purchase. Beginning in 1992, however, they were given specific goals to provide credit to underserved populations and locations. Those goals, like the other credit-steering regulations described here, encouraged lending in low-income areas.

The 2008 HERA legislation belatedly changed oversight of Fannie and Freddie with regard to safety and soundness, including establishing a procedure for placing them into conservatorship, which was implemented soon afterward. It also made some changes in their responsibilities to serve disadvantaged populations, reflected in proposed goals announced by the Federal Housing Finance Agency [Federal Register February 26, 2010]. For single-family housing, there remained goals both for purchases of mortgages to finance home buying by low-income households and goals for purchases in low-income areas. The new goals for purchases of multifamily loans were specified only in terms of the population served, regardless of location.

Although that falls short of creating a goal to finance affordable housing near transit, jobs, and services, it eliminates a bias toward financing affordable rental housing in high-poverty areas.

The goals also include references to supporting housing finance agencies (including through providing credit enhancement) and to providing credit for smaller (5 to 50 unit) properties.

Those directions may help in the effort to preserve existing affordable housing near transit.

Given the uncertain future of Fannie and Freddie, it is difficult to assess how any of these goals will be implemented, but the newer goals may get carried forth in whatever arrangements are made for the future. As the activities and goals of Fannie and Freddie, or their successors, are defined in forthcoming legislation and regulations, there will be opportunities to incorporate and prioritize financing of transit-accessible housing.

B. The Other Housing GSE

Fannie Mae and Freddie Mac are not the only government-sponsored enterprises involved in housing finance. The 12 regional Federal Home Loan Banks support housing lenders and also use 10 percent of their profits to fund Affordable Housing Programs that provide low-cost capital for land purchases, construction, and rehabilitation, as well as assistance for first-time homebuyers.

The individual Federal Home Loan Banks each have their own arrangements for selecting projects to be funded under their Affordable Housing Programs, and detailed nationwide information on the types of projects is difficult to assemble. Some funds have gone to transit-area affordable housing. Perhaps that could become a larger share of selected projects if the concept of affordability for housing plus transportation, and perhaps ancillary benefits of transit-oriented development, were considered in the competitive process for selecting projects for funding.

VI. Community Reinvestment Act

The Community Reinvestment Act (CRA) was enacted in 1977, and repeatedly updated, to ensure that banks served the credit needs of all segments of their communities, particularly low- and moderate-income (LMI) areas that had previously been penalized by redlining. The obligations of the subject institutions reflected the interests of the population in the community, but were largely defined in terms of places [Olson, Chakrabarti, and Essene 2009].

Financial Institutions are rated on compliance with CRA, and those institutions that fall short of satisfactory ratings may be denied approval to merge or create new branches. Even institutions with satisfactory ratings or with no desire to expand still strive to obtain higher ratings, so the CRA does seem to provide a significant incentive. Demand for low-income housing tax credits from banks has been attributed to the influence of CRA.

The areas around transit, where developing or preserving affordable housing may be especially problematic, are often not considered to be among the "LMI geographies" that are heavily weighted in CRA evaluations. The standards for CRA rating are complicated and somewhat arbitrary, however, and favorable consideration is also given to "affordable housing (including multifamily rental housing) for LMI individuals." The influence of CRA is unlikely to starve transit-oriented development, but if CRA criteria were updated, as some have suggested, specific favorable consideration in CRA ratings of lending for affordable housing that enhances mobility and reduces transportation cost might overcome the reluctance of some banks to lend to the non-standard affordable housing projects typical around transit.

VII. Homeowner Financing

Although the majority of housing units located close to transit are rented, there are also many owner-occupied homes. Nationwide, about 35 percent of households living within half a mile of fixed-guideway transit stations in 2000 were homeowners, according to data compiled by the Center for Transit-Oriented Development. Excluding the New York City metropolitan area, the share was about 40 percent. Appropriate financing tools may facilitate ownership near transit for moderate-income households.

A. Location-Efficient Mortgages

The financing vehicle most directly targeted at homeownership near transit is the location-efficient mortgage (LEM). The concept of the LEM is that underwriting should take into account the transportation cost savings available to those living near transit, and their corresponding capacity to support higher mortgage payments relative to their incomes. The LEM would not reduce the cost of ownership for borrowers. It would merely allow them to borrow more. Given recent experience, policies to facilitate greater homeowner debt burdens must be considered cautiously, but adjusting standards for payment to income ratios for homes near transit may not matter that much anyway. Credit scores have come to be the dominant factor determining loan eligibility, and coming up with the down payment is also probably more of a constraint. Of course, the lending standards during much of the last decade were unusually lax or nonexistent, so perhaps in a more conservative lending environment any changes in eligibility will matter more.

The LEM is modeled after the energy-efficient mortgage (EEM), which similarly allows higher payment to income ratios in recognition of savings in energy costs. Only about 1,000 FHA mortgages were underwritten as EEMs in 2007. A conventional EEM offered by Fannie Mae generated even less activity, with an average of only 61 mortgages per year from 2005 to 2007 [Gerarden 2008]. This was not because few borrowers were buying homes that met the energy-efficiency requirements. With no interest rate advantage, with few borrowers constrained by payment to income ratios, and with cost and effort required to demonstrate eligibility¹³, the attraction of the EEM was limited. Another factor affecting conventional loans may also have been the fact that Fannie Mae was the only secondary market outlet with a formal EEM product,

¹³ One advantage for LEMs, relative to EEMs, would be the absence of the need to conduct an energy audit. Proximity to transit would be obvious from a map.

and lenders preferred to create loans using more generic underwriting criteria that could be sold through multiple secondary market channels.

B. Inclusionary Housing for Home Buyers

Devices to actually reduce the cost of ownership, rather than to merely facilitate larger loans, could be expected to have a greater impact. Inclusionary housing programs requiring a share of homes to be reserved for sale to home buyers with limited incomes at affordable prices, similar to the practice of having reserved rental units under rental subsidy programs, is one approach. For that to be acceptable for developers, there must be enough profit available from reduced land costs or from unreserved units in the project to provide such a cross-subsidy. One complication with programs offering below-market prices is that low-income buyers could turn around and resell the home at full market value to a higher-income buyer. Various resale restrictions or recapture provisions are typically involved. Inclusionary programs often affect entire jurisdictions, but may be targeted to apply specifically to areas around transit.

VIII. Mortgage Revenue Bonds

Housing finance agencies can provide financing for home buyers by issuing tax-exempt mortgage revenue bonds (MRBs) and using the proceeds to make mortgage loans at below-market rates. Such bonds, like the tax-exempt bonds for multifamily rental housing, are subject to the volume caps for private activity bonds in each state. States can also trade authority to issue MRBs for mortgage credit certificates (MCCs) that may be offered to eligible homebuyers with taxable income to reduce their federal taxes and therefore more easily afford to pay for a market-rate mortgage. These programs are responsible for assisting about 100,000 home buyers per year. In general, the mortgages or certificates are limited to first-time buyers (or at least buyers who haven't been homeowners in the preceding 3 years) with incomes below 115 percent of the local area median¹⁴ purchasing homes priced at less than 90 percent of the area average.¹⁵

As with LIHTC, there are more liberal rules for low-income areas. For this program, targeted areas must either be census tracts in which at least 70 percent of families have incomes below 80 percent of the statewide median or be areas of "chronic economic distress." The latter is defined as an area designated by the state, with the approval of the Treasury Department and HUD, based on the condition of the housing stock, the need for financing indicated by conditions such as high poverty and unemployment, and the potential for owner-occupied housing to improve the area. In such areas, loans can be provided to households who are not first-time buyers, with somewhat higher incomes, and with higher price limits. Although the state has a role in designating areas of chronic distress, its discretion is clearly more limited than with LIHTC, and the approval process has proven to be cumbersome.

Subject to the target area provisions, loans are generally provided on a first-come, first-served basis within jurisdictions, but loans may be set aside for particular developments, provided that the other requirements are met. We did not find instances where there were formal policies to set aside MRB financing for areas around transit, but that could be a useful tool to provide for affordable homeownership. In many places where transit proximity is reflected in high land and construction costs, however, the price limits may be too restrictive.

¹⁴ Households with fewer than 3 people must have incomes below 100 percent of area median.

¹⁵ The average price is calculated separately for new and existing homes, allowing new homes, which are typically higher-priced to be included (26 USC 143e(3)(B)) There are some special rules for metropolitan areas with high ratios of average house price to income.

The MRB/MCC provisions for targeted areas are not as likely to add to concentrated poverty as the designation of qualified census tracts in the LIHTC program. In fact, introducing moderate-income homeowners into such areas may reduce concentrated poverty. The federal rules don't, however, establish any priority for transit-oriented or other compact type development.

As with many inclusionary housing programs, households benefiting from MRB/MCC assistance are subject to recapture penalties if they resell their homes in less than 10 years. The logic of that provision is less obvious for these programs subsidizing the cost of financing than for arrangements where the purchase price has been reduced, since the owner cannot reap a windfall profit by reselling the house.

IX. Considering Transit in Finance: States & Localities in the Lead

In general, HUD policies and other federal policies related to housing finance are not oriented toward affordable housing near transit. A variety of federal programs help to finance affordable housing, but transit proximity and transportation cost are not considered. Some transportation programs support the development of housing near transit, but do not distinguish between affordable housing and luxury housing. One of the very few cases where transportation is even mentioned is in the competitive Section 202 program of housing for the elderly. The 2009 Notice of Funding Availability [Federal Register September 8, 2009, pp 46218-46219; www.nls.gov/offices/adm/grants/nofa09/sec202esec.pdf] indicates that the selection criteria include points for "proximity or accessibility of the site to shopping, medical facilities, transportation, places of worship, recreational facilities, places of employment, and other necessary services to the intended occupants...." The regulations cited for that criterion (24CFR891.125(a),(d), and (e)) do not, however, specifically mention transportation. Even so, the NOFA reference to transportation is thought to have contributed to the award of Section 202 funds for San Francisco's Armstrong Place.

Other references in HUD regulations are even more indirect and limited. Regulations regarding noise levels in HUD-assisted housing allow a 5 decibel adjustment in maximum acceptable levels if, among other requirements, "the project meets other program goals to provide housing in proximity to employment, public facilities, and transportation." [24CFR51.105(a)(3)] The criteria for selecting properties for project-based vouchers specify that a site for existing or rehabilitated housing must "be so located that travel time and cost via public transportation or private automobile from the neighborhood to places of employment providing a range of jobs for lower-income workers is not excessive. While it is important that housing for the elderly not be totally isolated from employment opportunities, this requirement need not be adhered to rigidly for such projects." [24CFR983.57(d)(4)]

In contrast to the lack of encouragement, or even acknowledgement, of transit access in federal housing finance-related policies and programs, numerous states, regions and localities give prominent attention and detailed consideration to transit proximity and/or integrated plans for transit-oriented development. In most cases, state, regional and local financing programs are funded with federal grants or tax expenditures, but there are also cases where state and local resources are provided as well. Where federal resources have been used by states and

localities to finance housing near transit, it was despite, rather than because of, stated federal priorities.

A. LIHTC Allocation

As detailed previously, the most common state and local agency contribution to financing affordable housing near transit is through federal and state LIHTC allocations. State credit allocation agencies may take transit proximity and transit orientation into account in two ways. First, by considering transit in deciding which projects receive credits from the limited pool. Second, under the new authority provided by HERA, by choosing whether to designate a project as eligible for up to 30 percent more credits.

In setting forth the criteria for these decisions, states often make highly nuanced distinctions among locations near transit, demonstrating the attention given to this subject. In a point system used in California for LIHTC allocations, for example, locations within ¼ mile of a station, with service at least every 30 minutes, where the project density is at least 35 units per acre, can get 7 points (of 25 possible in the relevant category and 150 overall). If the station is a bit further away, the service is less frequent, or the density is lower, the number of points is correspondingly reduced. California is one of 15 states with state LIHTC programs to supplement the federal credits, and similar criteria are used to allocate those credits against state income tax.

California also has had a program that is more strictly targeted to projects within ¼ mile of transit, created under the Proposition 1C ballot initiative passed in 2006. That program hasn't merely provided credits after the project was placed in service, but provided loans or grants for development and construction, with projects chosen using even more detailed criteria including whether there is supportive zoning and whether local amenities are adequate. New Jersey has had a task force that includes housing, transportation, environmental protection, and economic development agencies to designate areas with integrated transit-oriented development plans as "transit villages." In allocations of LIHTC and other financing tools, that designation gets substantial weight.

Massachusetts has set aside 40 percent of its LIHTC allocations for preservation of affordable housing that might otherwise opt-out of project-based subsidy programs or that is physically and financially distressed. In allocating those set-aside credits, the state suggests that "sponsors

should note the Department's ongoing commitment to sustainable developments with an emphasis on projects located near major public transit as well as extensive retail and commercial opportunities and services." Proposals for new construction LIHTC projects are also evaluated under a framework where proximity to transit is a factor [MA Department of Housing and Community Development 2010 [\[www.mass.gov/Ehed/docs/dhcd/hd/lihtc/final2010gap.pdf\]](http://www.mass.gov/Ehed/docs/dhcd/hd/lihtc/final2010gap.pdf)].

Massachusetts also offers 30-year interest-free loans for housing projects within neighborhood commercial areas and in proximity to public transit nodes under its Commercial Area Transit Node Housing Program [760 CMR 62.00] and has provided support for housing and station-area improvements under its Transit-Oriented Development Infrastructure and Housing Support Program [701 CMR 6.00].

Other examples of state and local initiatives and creative use of flexible federal funds are included in this paper as illustrations of various programs. Further examples may be found in the September 2009 GAO report, the 2004 TCRP Report #102 by Cervero et al., the April 2007 "Realizing the Potential" Report by Reconnecting America's Center for Transit-Oriented Development, and the April 2010 White Paper prepared by the Texas Department of Housing and Community Affairs.

B. Transit Investment Value Capture Methods

Local methods of capturing value transferred to surrounding properties by transit investments have some ability to assist with the bigger picture of public infrastructure finance that is key to the realization of equitable TOD as a whole. Since the 1950s, tax-increment financing (TIF) has been used across the country to pay for district-level redevelopment and community improvement projects, including improvements to existing transit stations. Over the past 15 years, special assessment districts have successfully financed portions of several local streetcar lines and individual stations within light-rail corridors (the Pearl District streetcar in Portland, OR, South Lake Union streetcar in Seattle, WA, and New York Avenue Station, Washington, D.C.). Most recently, the federal credit assistance program established under the Transportation Innovation Finance Improvement Act (TIFIA) and originally dedicated to financing toll roads and other revenue-producing infrastructure is making loans toward two regional multi-modal centers partially secured by projected revenues from value capture finance tools (Transbay Terminal, San Francisco, CA and Union Station, Denver, CO).

Some of these tools have potential to also assist in financing affordable housing near transit. TIF statutes and regulations in some states require set-asides of tax increment for funding of affordable housing in designated districts (e.g. 20% affordable housing set-aside in California). However, the potential for value capture methods to fund affordable housing can be overestimated as most value capture tools other than TIF, e.g. special assessment districts or development exactions, either raise the cost of development by adding additional fees up-front, or exempt affordable housing projects, thereby decreasing the revenue potential of the tool and discouraging local governments that seek fiscal neutrality in new development from approving affordable projects. Both federally and in many states, these tools also have legal restrictions on the relationship between the fee or assessment and the use of generated revenues. Most critical in the current economy, all of these tools are reliant on upward real estate market trends and a strong tax-exempt bond market, both of which are unstable in the aftermath of the recent housing credit crises and lingering impacts on the housing market and economy, as a whole.

Nonetheless, there have been recent federal efforts to incentivize these local value capture methods that include required set-asides for affordable housing. The proposed Livable Communities Act, S. 1619/HR 4690 includes a pilot \$100 million credit enhancement program for local finance districts and requires that a portion of revenues derived from assisted districts go towards affordable housing.

C. Financing Property Acquisition

One area of affordable TOD finance that is seeing a good deal of recent local innovation is property acquisition and predevelopment finance. As discussed previously, one of the big gaps in federal resources for financing affordable TOD lies in the acquisition and holding of property for development or redevelopment. In general, land acquisition is a challenge for affordable housing projects that must compete with market-rate development for quality development opportunity sites, have few pre-development financing resources and must overcome the exclusion of land costs from the most significant source of affordable equity, LIHTC.

For affordable TOD, this is compounded by the scarcity and generally higher cost of land near transit. In a healthy real estate market, affordable housing developers face strong competition for good development sites near transit, and a lack of ready capital to secure sites. In today's depressed market where private competitors have been seriously weakened by the credit crunch, affordable housing developers find it even more difficult to gain control of property

because of a combination of limited short-term resources and questions about the timing of long-term project financing.

In response to this widespread problem, two types of local or regional funds for affordable housing property acquisition in transit locations have emerged over the past 10 years as a tool for addressing the critical problem of land acquisition for affordable housing near transit.

The most common model is that of a low-interest, short-term (i.e. less than five years) structured loan fund that issues loans at rates sufficiently low to allow affordable housing developers to secure land as opportunities arise and before traditional affordable housing financing mechanisms become available. These types of mission-driven loan funds have succeeded in attracting investment from public sector entities with grant funding streams that can be dispersed without return expectations, thereby allowing them to occupy the critical top risk absorption position and leverage other investment with lower risk tolerance. Other investors include community foundations with project-related investment funds that have below-market rate return expectations, community development finance institutions that make below-market rate loans and commercial banks meeting Community Reinvestment Act requirements. Borrowers make payments back into the fund, which either revolves to allow additional lending, or is held as security until the fund expires and investors are repaid.

Nationally, there are approximately twelve such affordable housing structured loan funds, that are currently operating or under development, including three that are exclusively dedicated to transit locations. These include:

- Denver TOD Fund (operated by Enterprise Community Loan Fund, closed in 2010);
- Puget Sound Affordable TOD Acquisition Loan Fund (currently under development by the Seattle Office of Housing); and,
- Bay Area Affordable TOD Revolving Loan Fund (currently under development by the Low Income Investment Fund (LIFF)).

The public source of top loss grant investment for these funds varies. The Denver and Puget Sound funds have locally derived sources for projects in Denver (economic development and energy franchise fees) and Seattle (Seattle Housing Levy) and are seeking Sustainable Communities grants to provide top loss grant investment for projects outside of the central

cities. The Bay Area Affordable TOD Revolving Loan Fund has received a commitment of \$10M in funding from the Bay Area Metropolitan Transportation Commission's (MTC) Transportation for Livable Communities program (TLC); LIIF aims to use these top loss funds to leverage four to six times this amount in program-related investment from foundation investment, community development finance institutions, and commercial banks. MTC intends to assemble its \$10M fund contribution by exchanging Congestion Mitigation and Air Quality Improvement Program (CMAQ) and Surface Transportation Program (STP) funds for unrestricted funding from local governments that is intended to pay for roadway maintenance or pedestrian improvements. The TLC program has used this same method of exchanging funds in order to make grants for much smaller projects, i.e. less than \$2M, that are TOD-related but do not qualify for transportation funding, such as below-ground infrastructure improvements.¹⁶

The second type of land acquisition fund is regional acquisition or land banking funds drawn entirely from public funds. There are approximately three Metropolitan Planning Organizations that have sustainable development programs that include grants or loans for property acquisition by local jurisdictions or developers or direct acquisition by the MPO itself. Metro Portland, the Twin Cities Metropolitan Council and the North Central Texas Council of Governments all have land acquisition programs that prioritize locations near transit and/or projects that include affordable housing. The source of funds for these programs varies: Metro Portland and North Central COG programs have been funded by swapped-out federal transportation dollars similar to Bay Area MTC's structured fund investment; the Met Council's program is funded by a regional property tax levy.

Both the structured fund and public grant models have met with varying degrees of success, depending on the characteristics and aim of the particular fund, as well as the state of the broader real estate credit market. The application of the structured fund model to transit locations is so new that it is inappropriate to conjecture on the success of the model in concentrating dwindling federal permanent finance resources in transit locations. The New York Affordable Housing [Structured] Fund, which did not have a specific focus on transit and closed in 2007, issued 23 loans in 2007 and 2008, all of which were taken out by permanent affordable finance loans at or prior to term. Since 2008, it has not issued further loans due to the downturn

¹⁶ MTC staff cites the conservatism of the California State DOT and its ultimate authority over metropolitan planning organization (MPO) grant-making as the major reason for fund exchanges, rather than FTA restrictions or increased costs due to cross-cutting requirements. Interview with Doug Johnson, Senior Planner, Bay Area Metropolitan Transportation Commission, April 16th, 2010.

in permanent affordable housing finance resources. While acquisition loan funds meet a critical gap in the existing affordable finance web of resources, they are not a substitute for on-going stable sources of permanent financing.

The public grant model has met with limited success or failed, depending on the fund. Both the Portland Metro Fund and the Met Council Fund have facilitated a limited number of acquisitions, given the cost of land near transit and the small amount of public grant funds available. The North Central Texas COG fund has a \$1 million limit on loans, which has not been sufficient for loan requests. The challenge that these funds have met is providing large enough grants or loan points to the leverage potential of the structured fund model.

D. Opportunities for Efficient Federal Leverage of Local Finance Resources

The emergence of swapped-out transportation funds and other non-housing sources of public funding as major sources of subsidy capital for affordable TOD property acquisition raises questions.¹⁷ The length to which regional and local governments are going to secure subsidy funds demonstrates the need for a permanent, dedicated federal housing finance tool that applies to land and property for affordable housing near transit, or a source of federal grant funding that is dedicated to this purpose and can be used to leverage other debt.

In the Bay Area, land costs near transit are so high that if the fund leverages the MTC investment at a ratio of 4 to 6:1, as currently estimated, approximately 12 to 20 projects might receive loans at a time; in a nine-county area with significant transit, this is unlikely to meet the financing gap need from quality potential projects. For sufficient short-term cheap debt with flexible terms to be available to meet this demand and provide housing for low-income and workforce households near transit, more public subsidy dollars are needed than can currently be produced at the local and regional levels. Federal financing or subsidy of land acquisition for housing could be a highly efficient use of federal housing resources given its leverage potential, both relative to local efforts and relative to current federal support for construction.

Additionally, federal credit and credit enhancement programs for transit and other transit-related infrastructure that are based on local and regional sources of revenue can require that some portion of the bond or loan issuance be devoted to support for affordable housing. It does not

¹⁷ The Portland Metro TOD Fund also exchanges regional transportation funds for local transit farebox revenues, through an intergovernmental agreement with TriMet, in order to have unrestricted sources for the TOD fund.

make sense to restrict such federal credit programs to local property-based finance districts, which are cumbersome for finance of major infrastructure investments with broad benefit and can be legally and fiscally problematic for inclusion of affordable housing, as described. Expansion of existing credit resources (i.e. TIFIA) or new programs (i.e. Livable Communities Act credit enhancement program) should extend to regional-scale and sales tax measures, as localities and regions find most feasible.

X. Conclusions and Recommendations

Federal regulations usually do not discourage financing housing near transit, but the opportunity to actually create positive incentives for location efficiency as a factor in directing the flow of credit has not been exploited. A number of policy measures to address the special financing challenges around transit are possible:

1. Government policies that unnecessarily make it more difficult to attract investors or obtain loans for affordable housing could be modified without undermining the intent of those policies. Land use regulations for TOD and other areas around transit should be formalized and "of right" prior to when financing is needed, rather than left uncertain. Land leases in joint development should include protections for lenders.
2. Data on costs, activity, absorption, and outcomes for affordable housing around transit should be assembled and made available to investors and lenders who otherwise perceive such investments as mysterious and unproven.
3. Subject to prudent underwriting requirements, federal agencies should be prepared to offer mortgage insurance and other credit enhancements to draw private financing to affordable housing in transit areas without creating excessive risk premiums.
4. All states should consider location relative to transit and combined cost of housing and transportation in their Qualified Allocation Plans for LIHTC.
5. HUD should revisit the methodology for designating Difficult Development Areas under the LIHTC program, incorporating data on costs in areas around transit and making designations for areas smaller than counties.
6. Although FHA should avoid excessive risks, the new underwriting criteria for multifamily mortgage insurance, which require substantially higher high debt service coverage for unassisted affordable housing, should be reconsidered, with possible special provisions for housing near transit.
7. CRA ratings could give credit for lending that helps reduce the combined cost of housing and transportation.
8. A sub-goal of the Fannie-Freddie Enterprise Affordable Housing Goals could be to finance affordable housing around transit.
9. FHA and GSE lending rules could permit higher commercial share of space or rent in properties close to transit. Furthermore, while there are no criteria that eliminate TOD projects from qualifying under FHA Sec 220, it could be helpful to specifically declare it an eligible type of project under the program.

10. Given that the basis for low-income housing tax credits excludes land value, all grants and loans, including tax-exempt bond financing, for land acquisition should not preclude eligibility for 9 percent credits.
11. FTA should modify and clarify requirements for “continuing control” under joint development regulations to allay concerns of lenders and investors about the security of affordable housing collateral. This could include specifying that affordable housing subject to long-term use restrictions in connection with project-based subsidies, tax credits, and inclusionary housing requirements represents a long-term commitment to transit-supportive use.
12. FTA could modify the formula used in the federal New Starts transit capital funding program to prioritize transit alignments that provide better connections between existing concentrations of affordable housing and job centers, as well as alignments in jurisdictions that have adopted zoning and other local policies that support the construction of affordable TOD and/or commit local funds to the development of affordable units near stations on the proposed alignment.
13. A program should be established to provide grants or no-interest loans to regional funds that leverage private sources of debt and equity to finance purchase of property to be developed or preserved for affordable, workforce and mixed income housing in conjunction with purchases of land for transit facilities. Land costs around transit are a dominant and underlying problem, as is the lack of financing resources for pre-development of affordable housing.
14. In addition, to address the challenges related to acquiring and holding property for development and redevelopment of affordable TOD, public officials should consider the development of a dedicated, housing-related federal finance or funding resource designed to support local and regional affordable TOD property acquisition loan funds.
15. On a more modest level, there is also much to be gained by disseminating best practices in existing local and regional property acquisition funds that target affordable housing sites near transit.

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