



The Unintended Consequences of Housing Finance

February 2016*

Executive Summary

Growing numbers of young and old Americans prefer to live in communities where they can walk to stores, school, services, parks and public transportation. But federal housing rules make it difficult to meet this demand. By capping the amount of commercial development permitted in federally-backed mortgages and programs, the rules make it hard to finance construction or renovation of three-to-four story buildings in many mixed-use, walkable neighborhoods. These rules, mostly devised for an earlier era to reduce perceived risks to federal investments, have a number of unintended but damaging consequences.

Americans want walkable neighborhoods, but development is not meeting this demand

- ▶ Fifty-six percent of millennials and 46 percent of baby boomers prefer to live in more walkable, mixed-use neighborhoods; demand is also evidenced by sharp increases in rents in recent years.
- ▶ While there is a growing shortage of multi-family housing, the nation's current supply of single-family homes is estimated to exceed future demand for at least the next 25 years.

Federal loan programs do not support the mixed-use, multi-family development essential to these communities

- ▶ Eighty-one percent of federal loans and loan guarantees support single-family home ownership.
- ▶ Federal Housing Administration, Fannie Mae and Freddie Mac loans, loan guarantees and mortgages typically cap commercial floor space or income at 15 to 25 percent of multi-family projects, effectively disallowing most buildings with six stories or less. Commercial rent is also discounted by underwriting rules designed to reflect risk, furthering the problem.
- ▶ These regulations promote larger buildings that are out of scale in many communities, and bring less diversity than do smaller, mixed-use buildings.

- ▶ Recent research on loan performance indicates that loans in walkable, mixed-use neighborhoods are less risky than those in single-use, single-family neighborhoods, suggesting that updated rules could also reduce loan program costs.

Financing rules reinforce concentrations of poverty

- ▶ Much of America's poor live in low-rise neighborhoods in older urban areas and inner suburbs, where the finance rules discourage rehabilitation and otherwise work at cross-purposes with federal and local initiatives designed to break the cycle of disinvestment.
- ▶ Increasing suburban poverty and worsening gentrification in some areas also argue for greater flexibility to encourage construction and renovation of mixed-income housing.
- ▶ The 2015 decision by the Supreme Court upholding the government's obligation to affirmatively further fair housing when policies result in disparate impacts underscores the need to remove these impediments.

A range of actions could eliminate or reduce these impediments

- ▶ Raise non-residential caps on loans to mixed-use projects.
- ▶ Allow alternatives, such as shorter loan periods or larger down payments, to address risk, to the extent it still exists.
- ▶ Provide higher limits on non-residential development for projects with low income housing and community services.
- ▶ Implement higher, context sensitive caps that reflect federal and local policy priorities, such as for development areas or housing initiatives.
- ▶ Create a secondary market for mixed-use loans.
- ▶ Investigate ways to encourage program participation by smaller developers.

* This updates research published in January 2016.



Photo: Doug Kerr / Wikimedia Commons

Introduction

Despite overwhelming evidence that a growing number of Americans prefer to live in walkable communities with stores, services, parks and other amenities, federal housing rules are impeding the private market from creating enough housing choices to meet this demand. By definition, walkable communities have a mix of housing and non-residential uses in settings ranging from high-rise urban neighborhoods to traditional downtowns to newer suburban main streets. Among the most common and sought-after places are those characterized by older low-rise buildings, typically three-to-four stories, with ground floor retail and apartments on the upper floor. But development projects with this mix of activities are ineligible for most federal loan guarantees and financing, and are often unable to attract private financing as a result. Notably, lower income people suffer most from this entrenched problem.

The Department of Housing and Urban Development (HUD), the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac all place regulatory limits on the amount of non-residential space allowed within developments, and usually cap the non-residential share of a project at percentages that are too low for low-rise communities. These rules had their genesis during the Great Depression or early post war era, and are based on the obsolete assumption that mixed-use developments are financially riskier than single-purpose residential developments. In addition to eliminating government financing that is essential

to keeping new housing affordable, these non-residential limits are also adopted by private lenders, which can doom projects that would otherwise be viable, often without government support.

The restrictions can have a particular impact on low-income neighborhoods sorely in need of upgraded housing and services. Many of America's poor and moderate-income households live in three-to-four story neighborhoods, with a large share suffering from disinvestment. Caps on non-residential development can impede rehabilitation and new infill development that could improve housing choices, job opportunities and quality of life for residents of these neighborhoods. Making projects conform to the regulations they results in developments that are bigger and bulkier, with set-backs and other design features that may reduce neighborhood vitality and the viability of commercial activity essential to a healthy mixed-use community. Removing these restrictions would enhance the success of comprehensive community development strategies. Public investment to preserve affordability, limit displacement and improve infrastructure and public services would still be essential in most instances, but lowering the threshold for private investment would better leverage these taxpayer investments.

HUD recently relaxed one of the restrictions in two of its programs and has given its regional directors limited flexibility to grant waivers for particular projects, if other conditions are met (e.g. supplemental market studies). However, these changes are too small to significantly increase the number of qualifying projects or alter private lending practices. Far more needs

to be done to align public financing with private demand and the housing needs of the most vulnerable families and individuals. By discouraging mixed use, the non-residential restrictions are also inconsistent with the goals of HUD and other federal agencies regarding healthy diets, automobile and energy use and overall sustainability.

Federal financing shapes the housing market

Federal financing guidelines have had considerable impact on the nation's housing market and the character of its communities. Government actions, from the legal doctrines governing property transactions to investments in infrastructure that make private development possible, are essential to the efficient functioning of the economy.¹ Federal housing finance regulations, including direct subsidies, tax deductions and mortgage guarantees, play an enormous role in determining what type of housing gets built, where it is located and who can afford to live in it. Virtually every home in America is reliant either directly or indirectly on some aspect of federal housing rules and funding. Forty-seven percent of homeowners receive a federal tax deduction on their mortgage.² Thirteen percent of rental homes are directly subsidized.³ All of these fuel a large secondary mortgage market, allowing circulation of an exponentially larger amount of private capital reinvested in housing construction, but almost entirely for single-use residential homes. The definitions and framework of federal regulations affect home prices and rents even for homeowners or renters who don't directly benefit from tax deductions, subsidies or other elements of the federal housing programs.

Federal regulations created low-density, single-use suburbs, and continue to incentivize them

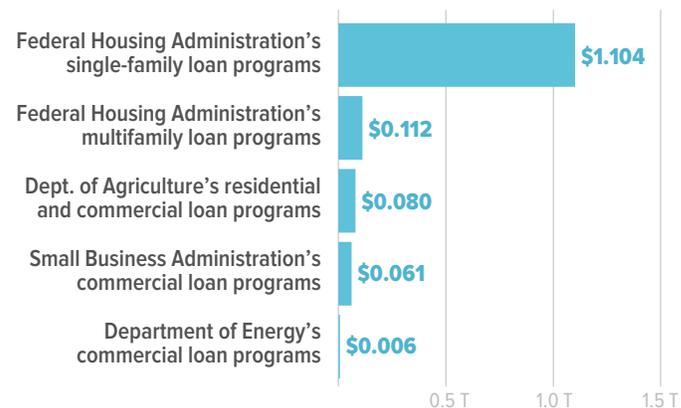
America's current suburban landscape has been developed through a perfect storm of socioeconomic trends and intentional policies. Postwar preferences for single-family homes were reinforced by cheap energy and land that made single-family developments in open space less costly than infill development. The creation and maintenance of interstate highways made auto-centric, low-density suburbs accessible, and HUD and FHA programs and the mortgage interest tax deduction subsidized, and continues to support, the purchase of single-family homes at a massive scale. Middle- and upper-class baby boomers flocked to the suburbs, reaping the benefits of these programs. Many low-income populations, especially of color, were barred from moving to the suburbs due to discriminatory regulations such as exclusionary zoning and redlining. As wealthier residents moved

out of cities, poverty was further concentrated in urban centers. The primary housing programs simply were not designed to maintain older, mixed-use areas.

Federal housing programs through HUD, FHA, and the federally-sanctioned Fannie Mae and Freddie Mac programs continue to favor single-family home ownership. Since 1934, FHA and HUD have insured mortgages for 34 million homes, of which only 7.4 million were in multifamily buildings.⁴ These programs have, perhaps unintentionally, given disproportionate financial support to single family homes in mono-use suburbs, while discouraging development in mixed use, urban areas and suburban downtowns.⁵

The lion's share of federal loans and guarantees also support single-family home ownership. As shown in Chart 1, of the \$1.363 trillion in loans and loan guarantees issued by the federal government between 2007 and 2011, 81 percent went toward single-family loan programs, while only 8 percent of these funds were used for multifamily loan programs.⁶ These figures do not include loans made by Freddie Mae and Freddie Mac, which further support the production and ownership of single-family homes.⁷

Chart 1: Federal Loans and Loan Guarantees (in \$trillions), FY 2007-2011



Source: Smart Growth America *Federal Involvement in Real Estate: A Call for Examination*. 2013.

Federal guidelines and programs also shape the vast secondary market that fuels much of the private financing for housing. This market, in which mortgage originators sell their loans to third parties, provides liquidity to banks and other mortgage originators, allowing them to expand the availability of loans to both home buyers and developers. Federal support for single-family homes gets magnified in the secondary market. Freddie Mae and Freddie Mac are actually the "market makers" for most of the secondary market, issuing massive volumes of bonds sold worldwide. The Federal program guidelines also shape how pri-

¹ Alex Marshall. *The Surprising Design of Market Economies*. (Austin: University of Texas, 2012).

² Calculated using 2014 data from the US Congress' Joint Committee on Taxation (*Estimates of federal tax expenditures for fiscal years 2014-2018*, August 2015) and US Census Estimates of housing inventory, for the third quarter of Fiscal Year 2014 (<http://www.census.gov/housing/hvs/files/currenthvspress.pdf>)

³ Calculated using HUD's 2013 Picture of Subsidized Housing Data (<http://www.huduser.gov/portal/datasets/picture/yearlydata.html#download-tab>)

⁴ US Department of Housing and Urban Development. "The Federal Housing Administration." (http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/fhahistory)

⁵ John Norquist. "Roadblock on Main Street." *The American Conservative*. Nov. 18, 2014.; Emily Talen. *Prospects for Walkable, Affordable Neighborhoods*. 2011.

⁶ Smart Growth America. *Federal Involvement in Real Estate: A Call for Examination*. 2013.

⁷ Ibid.

vate financial markets assess the risks of different types of loans. Defined as unconforming, there is no significant secondary market for mixed use loans or even a defined asset class for them; most banks simply don't make them.

Federal financing does not create the housing people want

Americans' housing preferences are shifting. Millennials are pulling away from auto-oriented, single-family suburbs in search of denser, more diverse neighborhoods, whether in large cities, older suburbs or transit-oriented villages. Their parents, the large baby boom cohort now in their 50s and 60s, increasingly seek to downsize to the same types of walkable neighborhoods as they age. Yet the supply of mixed-use, walkable neighborhoods with character is too limited and not expanding rapidly enough to respond to these changing preferences. Federal financing rules are a major reason for the mismatch, which results in higher financing costs, higher housing prices and limited investment in poorer communities. The complexity of the regulations lead to dominance by larger developers and larger projects that can afford the resources and time required, limiting both the type of product and pool of available developers available to municipalities.

Americans want walkable neighborhoods, but development is not meeting this demand

In a recent survey by Urban Land Institute, 50 percent of people said that walkability is either the top or a high priority in where they would choose to live.⁸ A Brookings Institution study concluded that convenient, amenity-rich communities are economically appealing, and that the walkability of an area increases the per-foot price of commercial and residential spaces.⁹ This study also found that 63 percent of millennials would prefer to live where they do not need a car often. While this demonstrates demand for walkable areas, it also suggests that many people who want to live in these areas may not be able to afford them, as higher rents lead to more gentrification and dislocation.

Housing in walkable, mixed-income urban neighborhoods isn't keeping up with this demand. A recent American Planning Association survey found that across all demographic groups, fewer people want to live in suburbs. The survey found that of the respondents, 40 percent live in an auto-dependent neighborhood today, while only 10 percent would see themselves in the same type of neighborhood in the future. This preference also spanned generations, with 56 percent of millennials and 46 percent of baby boomers preferring to live in more walkable, mixed use neighborhoods, according to the APA survey.¹⁰ While there is a growing shortage of multi-family housing, the nation's

current supply of single family, detached homes is estimated by Arthur C. Nelson to exceed future demand for at least the next 25 years.¹¹

Because the housing finance system has been created to support single-family development, providing affordable housing in walkable neighborhoods is expensive and difficult. Without adequate subsidies and financial support to increase the supply of multifamily units in mixed-use, walkable neighborhoods, prices will continue to increase.¹² The land in these areas is more desirable, and therefore more expensive. Developers agree that private sector approaches alone will not create affordable housing in urban areas, but rather a government approach is needed.¹³ Reforming the regulations would reduce the amount of cash subsidy that is needed by generating more lower-cost units while aligning with market principles, and is in turn politically more practical.

Federal programs that support multifamily housing development are ill-suited for walkable, mixed-use communities

Although the housing subsidies and loan guarantees largely support single-family development, there are several federal programs that support the creation of multifamily housing. HUD Section 221(d)(4)¹⁴ of the National Housing Act provides FHA mortgage insurance for new construction or substantial rehabilitation of rental and cooperative housing. HUD Section 220¹⁵ is similar to 221(d)(4), but allows extra non-residential footage if the project is located in an urban renewal area, or other areas where local authorities have prioritized redevelopment. Fannie Mae and Freddie Mac support multi-family as well as single-family developments, though far less in total and with far more restrictions than for single family.

The catch is that all of these programs are designed to support primarily single-use, residential properties. Mixed use is treated like an exception or after-thought, and the "missing asset class" and lack of a secondary market for mixed use is a critical flaw in US housing policy. For developers to apply for FHA loans, they must generally limit the amount of non-residential in their development according to the percentages in Table 1. For most of these programs, only a small percentage of non-residential is allowed. The rules were established in the mid-20th century, when both theory and practice emphasized the separation of residential, industrial and commercial uses. They were intended to protect taxpayers from what were considered riskier commercial loans, even though much of Main Street America was built on the notion of mixed use. Recent research, described below, indicates that single-use projects may actually be riskier than ones with higher shares of non-residential uses. This contradicts the regulations and the concept that underlies them.

11 Arthur C. Nelson. "The Next 100 Million." American Planning Association. January 2007.

12 Talen. *Prospects for Walkable, Affordable Neighborhoods*. 2011.

13 Ibid.

14 US HUD. "Mortgage Insurance for Rental And Cooperative Housing: Section 221(d)(4)" 2015. (http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/progdesc/rentcoopsg221d3n4)

15 US HUD. "Mortgage Insurance for Rental Housing for Urban Renewal and Concentrated Development Areas: Section 220" 2015. (http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/progdesc/progsec220)

8 Urban Land Institute. *America in 2015*. 2015

9 Christopher Leinberger and Mariela Alfonzo. *Walk this Way: The Economic Promise of Walkable Places in Metropolitan Washington, D.C.* Brookings Institution. 2012.

10 American Planning Association. *Investing in Place for Economic Growth and Competitiveness*. 2014.

Federal Program Caps for Underwriting Purposes

	Cap on Gross Income Derived from Commercial	Commercial Gross Floor Area/Net Rentable Space
HUD 221(d)(4)	15%	25%
HUD 220	30%	25%
Fannie Mae	20%	35%
Freddie Mac	25%	20%

Source: CNU 2015, HUD 2016

Note: In January 2016, HUD raised the Sec. 221(d)(4) and Sec. 220 floor area limits to 25%, and introduced a waiver process which would require added submissions, multi-year leases or other indications that risk is limited. Given no changes to commercial income caps, it is unclear if new projects would result from the floor area change or waivers. HUD appraisal regulations also specify a maximum 80% commercial occupancy factor, vs. 93% for market rate housing and up to 97% for rent-assisted units. Despite the recent changes, these elements suggest the problem will continue.

The effect has been to essentially exclude from federal support and dramatically limit the creation and redevelopment of parcels with ground floor retail or non-profit uses in low or mid-rise buildings, the very type of place where an increasing number of Americans want to live and where higher shares of low income people reside. One third of renters in America live in smaller multifamily buildings with more than five units but less than 50.¹⁶ With such a low cap on the amount of non-residential in a building, projects that comply with the restrictions may not be the appropriate scale for infill or rehabilitation within these existing urban areas. Generalizing, since mixed-use projects in urban areas can only have a maximum of 20 percent non-residential use, this means that typically on a single lot a building must be at least five stories to accommodate ground floor non-residential use. This building height may not only be out of scale in many urban settings, it may be noncompliant with existing local zoning. Construction costs can also be higher than for low-rise buildings.

Developers cannot easily finance mixed-use, walkable development

Developers want to answer the market demand for new units in walkable urban neighborhoods, but face often insurmountable hurdles with both the availability of capital and the time and effort it takes to complete deals that are not seen as “plain vanilla” by both HUD and private lenders. Small developers especially have trouble navigating HUD’s complex rules while maintaining capital throughout projects that have uncertain timelines. But the non-residential limits are issues for developers of all sizes.

The complexity of mixed-use projects, much of which relates to financing difficulties, makes them more costly in several respects. Since each project is unique, both the design and financing of New Urban or mixed-use transit-oriented development are more complicated and expensive than standard product that can be replicated in a variety of settings, financing must often be cobbled together from multiple sources, and the cost of capital is higher due to the perceived higher risk and unfamiliarity of lenders with these types of projects.¹⁷ Especially when creating

urban infill projects, it is difficult for developers to take advantage of scale economies by mass producing a single commodity.¹⁸ Developers believe there is a “lack of understanding within the financial community” when it comes to financing mixed-use projects.¹⁹ Developers have a difficult time explaining why their non-conforming project is a good investment, even when it has been demonstrated time and again that these types of developments are in high demand. As major banks often won’t make the loans, a tenacious developer might find financing with a smaller, community bank. In practice these projects would be good investments, but require time and openness from the lender, and an interest in supporting the local community. Yet as there is no secondary market for mixed use loans, they are held on the bank’s balance sheets, keeping the bank from “reusing” the funds for other loans and collecting more fees. Including these opportunity costs, the loans are notably more expensive for the bank, and thus expensive to the developer. Banks prefer “cookie cutter” conforming loans and sell them easily, but non-conforming loans are relatively rare, expensive, and unsalable. Generally the loans simply are not made, and without financing opportunities many mixed use projects, especially in older areas, aren’t conceived.

Financing rules reinforce concentrations of poverty

While the most common image of poverty is a high-rise public housing project, in fact many of America’s poor live in the very type of neighborhood where investment is impeded by current financing regulations. These are the neighborhoods with three and four story buildings, many with ground floor retail uses that predominate in many cities and in older, inner ring suburbs. The rapid growth in suburban poverty is hitting many of these former streetcar communities or older downtowns outside of the urban core. Limiting investment in these communities reinforces poverty in two ways. It reinforces a cycle of disinvestment that leads to deteriorating housing stock, fewer jobs, higher crime and worse schools. And by limiting supply and adding cost to what is built, it also puts greater pressure on housing prices in walkable communities with changing demographics.

Neighborhoods that are walkable are often not affordable.²⁰ Not developing more affordable housing within denser, urban communities that are in high demand will result in higher rents and further displacement of lower income individuals from increasingly desirable, mixed-use urban communities. Recent analysis shows that gentrification is accelerating, with 20 percent of low income, low property value census tracts gentrifying since 2000, while only 9 percent gentrified between 1990 and 2000.²¹ Part of the answer is to increase supply in mixed-use walkable communities to put demand and supply in better balance. Less restrictive

¹⁶ Smart Growth America. *Federal Involvement in Real Estate: A Call for Examination*. 2013.

¹⁷ Joseph Gyourko and Witold Rybczynski. *Financing New Urbanism Projects: Obstacles and Solutions*. Working Paper #330. University of Pennsylvania, March 2000; Christopher

B. Leinberger. “Developer’s Viewpoint: Urban Markets Strengthen, But Standard Real Estate Products Are Not Suited for Mixed-Use Urban Development Communities.” Cascade No. 60. Federal Reserve Bank of Philadelphia, 2005.

¹⁸ Gyourko & Rybczynski. *Financing New Urbanism Projects*. 2000

¹⁹ Talen. *Prospects for Walkable, Affordable Neighborhoods*. 2011. p 11

²⁰ Ibid.

²¹ Mike Maciag. “Gentrification in America Report.” *Governing*. February 2015.

financing can also make it possible to provide housing at a wider range of price points. There will still be a need for subsidies to preserve and upgrade existing low-income housing and protect tenants, but making it easier to accommodate market demand also provides more opportunity for cross-subsidizing below market rents. And the majority of poor households receive no subsidy at all. Of households living below the poverty line, 70 percent do not live in housing units that benefit from Section 8 or Low Income Housing Tax Credits²².

America's poor urban neighborhoods need investment

While the risk of displacing low-income residents through new investment is real, continued disinvestment is worse for these populations. Bringing new development, and therefore a mix of incomes to these struggling urban and suburban downtowns can, in theory, increase school performance, revitalize public space, and increase investment in shops, restaurants and other amenities and services.²³ Despite recent suggestions that cities are once again desirable and not as distressed as they were, there has been an increase in the number and geographic coverage of high-poverty neighborhoods since 2000. This can largely be attributed in part to the continuing expansion of suburban development, which has been pulling investment out of weak market cities.²⁴ Poverty is also increasing most rapidly in the suburbs, especially in older, inner ring suburbs. A large proportion of these high-poverty neighborhoods are located in low-rise, mixed use areas, yet current housing regulations largely prevent investment in these locations.

These neighborhoods have the physical characteristics to attract new development. But sustainable urban form does not necessarily correlate with higher opportunity; many places with higher density, higher land use entropy, and access to transit have lower job access, lower school performance, and higher crime rates.²⁵ However, attracting market rate development can provide a mix of incomes, jobs, and services in these areas that could potentially improve access to opportunity. Mixed-use developments can expand the tax base within a municipality, increasing the resources available to increase the quality of education and other assets to improve opportunity and quality of life.²⁶

The 2015 Supreme Court ruling and HUD rules on fair housing reinforce the need to reform financing rules.

The June 25, 2015 decision by the Supreme Court in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project* upheld the government's obligation

to affirmatively further fair housing when policies result in disparate impacts, even if there was no explicit discriminatory intent. Final HUD rules issued in July 2015 provide guidance and tools to states and localities for meeting these obligations. These highlight the need to both break the cycle of disinvestment in racially-concentrated areas of poverty and to expand the amount of affordable housing in areas with good schools and other opportunities. Reforming financing rules to make it easier to finance mixed-use development will remove an impediment to investment that can help achieve both of these goals.

The myth of increased financial risk

The risk perceptions and resulting restrictions in our housing programs are relics from mid-twentieth century urban planning theories that believed in a separation of uses to create more desirable, clean, urban environments. Current planning theories that have given better results than separated uses, such as New Urbanism and transit-oriented development, support a more traditional form of neighborhood development with a mix of uses, transportation options, and housing types. However, new developments in these neighborhoods do not fit into the cookie-cutter molds of financing applications, which precludes government support and causes private lenders to assume these more holistic forms of development are at a higher risk of default. Recent research has shown these risk assumptions are more perceived than real.

Loans in walkable, mixed-use neighborhoods are less risky than those in single-use, single-family neighborhoods.

A study by Prof. Gary Pivo for Fannie Mae in 2013 and a follow-up study completed in 2015 provide compelling evidence that mortgages for properties with sustainable features, such as access to transit and other amenities, are actually less likely to default than standard mortgages.²⁷ Most variables tested were associated with reduced risk of default, with the strongest impact from walkability, followed by transit access and energy efficiency. This contrasts with FHA's central concern that these loans are riskier than single-use residential loans. The results make intuitive sense. Besides being in greater demand as a product type, projects with a range of uses can diversify and mitigate risks, and are more likely to withstand downturns in the housing market. In recent decades and especially since 2008, mixed use areas have gained or sustained value far better than single use areas, contradicting the view that mixed use neighborhoods are riskier.²⁸

²² This statistic is calculated by taking the number of households receiving federal rental assistance (5 million according to the Center on Budget and Policy Priorities 2015, Factsheets) divided by the total number of families living below the poverty level (17 million according to 2014 ACS 1 Year Estimates) then subtracting the resulting value from 100%, to arrive at 70% of households below the poverty level not receiving some type of rental assistance.

²³ Robert Collinson, Ingrid Gould Ellen, and Jens Ludwig. *Low Income Housing Policy*. National Bureau of Economic Research Conference. August 2015.

²⁴ Paul Jargowsky. "Issue Brief: The Architecture of Segregation." The Century Foundation. 2015. (http://www.tcf.org/assets/downloads/Jargowsky_ArchitectureofSegregation.pdf) 2015, p 14.

²⁵ Talen. *Prospects for Walkable, Affordable Neighborhoods*. 2011.

²⁶ Joseph Minicozzi. "The Smart Math of Mixed-Use Development." Planetizen, 23 January 2012.

²⁷ Gary Pivo. *The Effect of Transportation, Location, and Affordability Related Sustainability Features on Mortgage Default Prediction and Risk in Multifamily Rental Housing*. University of Arizona. 2013. Xudong An and Gary Pivo. *Default Risk of Securitized Commercial Mortgages: Do Sustainability Property Features Matter?*, March 30, 2015.

²⁸ Kevin Gillen. *The Correlates of House Price Changes with Geography, Density, Design, and Use: Evidence from Philadelphia*. Congress for the New Urbanism. October 2012.

What can be done?

The federal government can improve housing choices and remove barriers to investing in urban areas, and especially in poor neighborhoods and without additional subsidy, simply by reforming the outdated program rules inhibiting mixed-use. Since the non-residential limits are *regulations*, syncing them in line with market needs would not require new law or budget allocation. The recent relaxation of the floor area regulation to 25 percent will likely have very limited impact, and only over an extended period, unless a change in the income limitations is also made. Similarly, the waiver process, based on supplemental submissions, may be difficult and costly to apply in practice. A number of potential reforms would more successfully align risk with the realities of the market and enable more production of mixed use, mixed income and higher density developments in desired areas.

Raise non-residential caps on loans to mixed-use projects

The caps on non-residential loans within federal financing should be raised or potentially lifted altogether. This is the simplest and most powerful reform. It would allow the private financing market to better meet market needs and preferences, and determine the risk and cost associated with different projects. Raising the non-residential limits to at least 35 percent but under 50 percent would allow three-story mixed-use buildings to be financed. HUD should also review its commercial appraisal policies; the 20 percent commercial vacancy assumption is three to seven times that for residential, and means less commercial income can be capitalized as a loan. A lower maximum loan size could make a relatively low-rent tenant (such as a hardware store, small grocery, non-profit, or other community service) even less viable for a building, and encourage more high-end tenants in neighborhoods that may need basic services.

Provide alternatives for mitigating potential risk

HUD, Fannie Mae and Freddy Mac could formulate alternate ways of addressing risk that would be more flexible and market-friendly. Instead of fixed limits, risk can be mitigated using standard tools of finance. Just as private finance creates flexibility with nuanced approaches to risk, federal rules can do the same by permitting some or all of the following for mixed-use projects:

- ▶ Shorter loan periods
- ▶ Larger down payments
- ▶ Higher interest rates
- ▶ Supplemental/secondary mortgage insurance for initial years of a project
- ▶ Insurance against vacancy rates exceeding a stated level
- ▶ “Rent Bonds” for a portion of the non-residential income for initial years
- ▶ Annual “stress test” review that could trigger actions to diminish risk
- ▶ Other ways to accomplish risk-sharing

Provide flexibility for projects with low income housing and community services

Along with modest relaxation of the existing limits, affordable housing and community services in low income communities could be incentivized with further relaxation of the limits on non-residential floor space and income. Thus, higher limits might be allowed if a stated share of low income housing is provided; for example, if 20 percent of a project is devoted to lower income housing, up to 40 percent non-residential space and income might be allowed. Given that rent from low income housing can be less, it may be especially important to allow higher non-residential income.

Similarly, designating space for “community supportive services” – e.g., health services, day care or other non-profit -- could enable a project to have a further increase in the share of non-residential use. The current regulations actually discourage community services, especially the 50 percent vacancy underwriting assumption, as they mandate that non-residential space generate the highest possible income, vs. providing supportive services important to a complete neighborhood. Especially important for a low income area could be the provision of a grocery to address the “food desert” problem.

Any of these revisions or other variants would move toward what cities historically produced and what is currently most desired and recommended by urban advocates: complete communities.

Implement context sensitive caps

Short of eliminating the caps, or to supplement modest relaxation, it would make more sense to have non-residential development caps that reflect the context of the development. If, for example, a project is located close to transit, the development could be allowed a higher percentage of non-residential floor area and revenue; this would support traditional transit-oriented development, reduced auto use, etc. Other considerations could include:

- ▶ Projects receiving municipal support in designated “redevelopment areas” could have added flexibility (this is noted as a consideration for granting a waiver in the recent HUD changes).
- ▶ Projects in undeveloped areas could be precluded (riskier per recent research)
- ▶ Other context variables that could be used to adjust caps include:
 - Projects in existing downtowns (mature neighborhoods)
 - Projects in existing suburban areas
 - Projects in “stable neighborhoods”
 - Projects in areas deemed to be “revitalizing”
 - Projects in areas deemed at risk for loss of low income housing

- Projects where walkability currently exists; per the recent research, walkability is the primary factor in reducing default risk
- Projects where transit exists (transit is the second most important factor in reducing default risk, and beyond central and old inner suburban areas it often exists along newer suburban corridors with considerable vacant property and opportunity for new housing)
- Projects in cities/regions of different sizes
- Qualifying projects might require a certain density

Secondary Market

The market for conventional housing loans is based in part on the secondary market, that banks and other mortgage lenders can sell the loans to Fannie Mae, Freddy Mac, major banks and other financial intermediaries who then package the loans as bonds. This generally does not exist for mixed use loans, largely because they are defined as non-conforming. Creating a mixed use loan asset class and otherwise stimulating the market for sale of such loans and bonds could markedly increase the availability of mixed use loans. Changing the non-residential limits for conforming loans would remedy this. Other ways of doing so should also be explored; for example, even if the non-residential caps are not changed the intermediaries (especially Fannie and Freddy) might be encouraged to define a new category for mixed use loans and begin to purchase them, such that a market for “quasi-conforming loans” is created.

Consistency of goals and practice

HUD should seek to better align its financing regulations with its policy goals, as reflected in many of its mandates such as those in its Sustainable Communities program. The disconnects in the finance process inhibit the delivery of desired projects and thus greatly diminish progress in realizing policy and program goals. A restatement of the relevant program goals and assessment of each financing provision relative to the broader HUD goals could be effective to this end. This effort would also contribute to any reform of Fannie Mae and Freddy Mac.

Demonstration projects

HUD could demonstrate the success of projects with higher percentages of non-residential through pilot projects or comprehensive district plans. These developments and neighborhoods would be the focus of research and evaluation over time. A logical place to start is through HUD initiatives such as Promise Neighborhoods or Sustainable Communities programs that are combining multiple strategies but face daunting challenges to implement ambitious plans. This would combine relaxed financing with comprehensive neighborhood revitalization, build on the planning and research efforts already done and extend its focus to project finance and implementation.

Communications

The development market is highly complex and federal government procedures, evidenced by the detail in the Multifamily Assistance Processing (MAP) Guide, are daunting. With appro-

priate changes in the non-residential limits, HUD should also undertake an ambitious communications effort to advance the changes and focus on the stimulation and delivery of mixed use communities. Each of the building, finance, banking, appraisal, insurance, municipal and other sub-sectors of the development process has its own networks and vehicles for communications. Beyond the required changes in policy, achieving the goals suggested here will require time, effort and expertise to deliver the desired land use, housing and community development results. Substantial change in our development process and the products it delivers is called for but is also achievable with appropriate policy changes and efforts to integrate them into the development community.

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