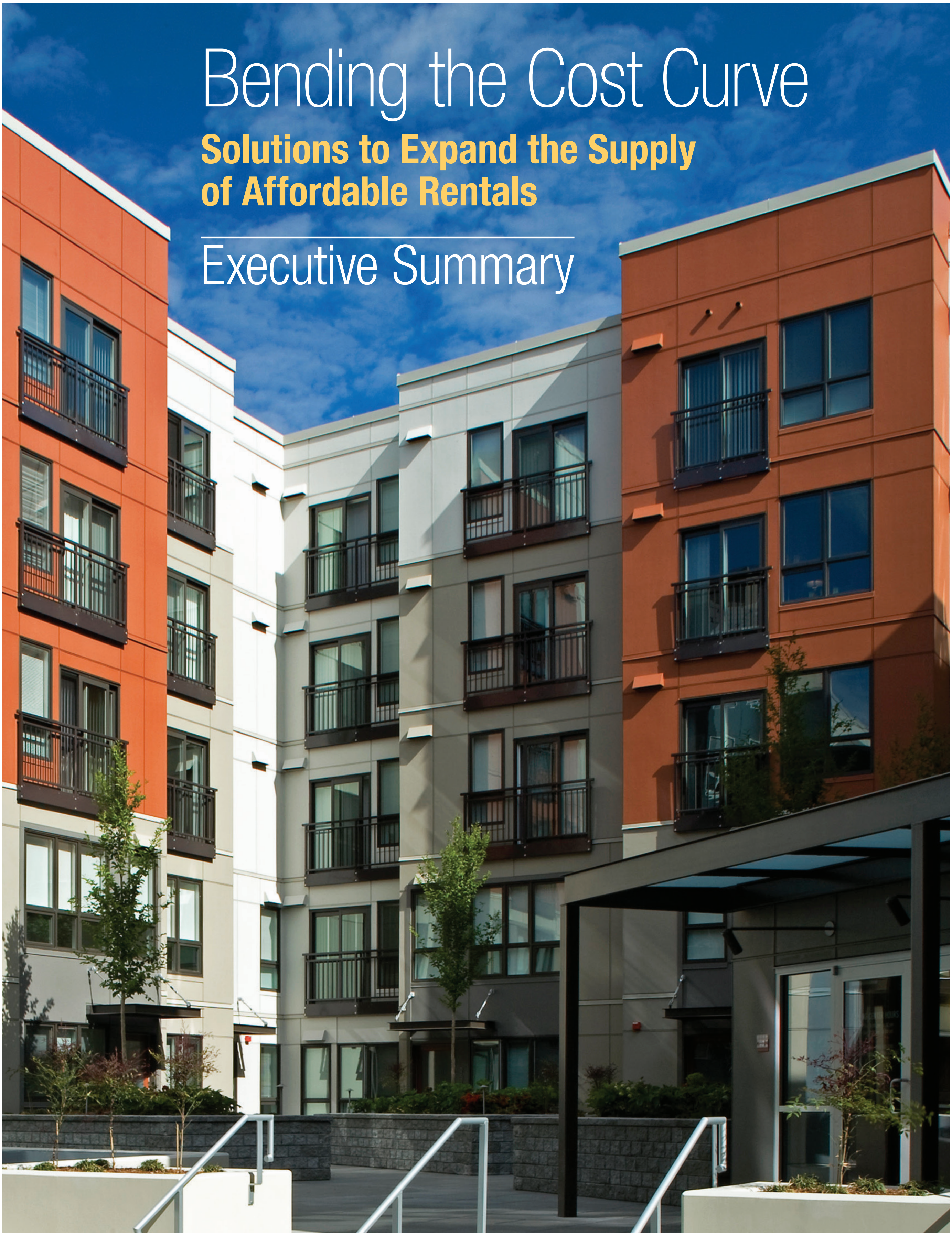
Bending the Cost Curve

Solutions to Expand the Supply of Affordable Rentals

Executive Summary



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Why Bending the Cost Curve Matters

The need for affordable rental housing is on the rise. According to *The State of the Nation's Housing 2013*, there were 12.1 million extremely low-income renters as of 2011, an increase of 2.5 million since 2007. [i] Furthermore, there is a growing body of evidence that the demand for rental housing is growing and that the trend will continue as those under 35 years of age form households of their own.[ii]

Despite the increasing need, the supply of rental housing is generally not keeping up. According to the National Multi Housing Council, some 300,000 new apartments are needed to meet demand annually, but just 130,000 units were built in 2011.[iii] The gap in supply is even more dramatic when one examines affordable rental housing specifically. In 2011, there were just 6.8 million housing units affordable to extremely low-income renters—some 135,000 fewer units than in 2007, a shortfall of 5.3 million units.[iv]

The delivery of affordable housing is affected by a number of procedures, regulations, and policies instituted at all levels of the system and at all points in the development process—each with associated costs. Development costs may be dictated by site constraints, design elements, local land use and zoning restrictions, building codes, delays in the development process, efforts to reduce long-term operating costs, and the affordable housing finance system.

Most affordable housing developments rely on multiple funding streams, both equity and debt, each of which carries its own set of requirements and compliance costs. While there may be some alignment of affordable housing land use regulations, financing tools, or programs, developers far too often must seek a complex series of approvals or obtain waivers to bring a development to fruition. This process alone can introduce costs through delays to the development timeline as well as additional uncertainty and risk, which, in addition to regulatory barriers, can also increase costs.

Moreover, developers of affordable housing are often tasked with providing a variety of amenities and services to create opportunities for and improve the lives of residents. Although developers strive to meet a variety of community goals and foster the development of high-quality affordable housing, these criteria tied to amenities and services increase hard, soft, and ongoing compliance costs.

In an era of growing demand and declining government financial support for affordable rental housing, it is more important than ever to deliver affordable housing as effectively as possible. Bending the cost curve will enable developers to deliver additional affordable rental homes and help jurisdictions provide more housing choices, meet the growing need for affordable rentals, and ensure that individuals and families across a range of incomes have a place to call home within a community. Bending the cost curve will also allow for the most efficient use of increasingly scarce public funding sources.

How the Research Process Worked

The question of how to lower the cost of developing long-term affordable rental housing has important financial and policy implications. While a rich literature on regulatory barriers to affordability exists, much of it focuses on specific elements of constraint related to land use and zoning, process delays, and building codes. However, relatively little work has been done to examine how all of these issues, along with financing, interact with and affect affordable housing development.

In response to this critical knowledge gap, Enterprise Community Partners and the Urban Land Institute's Terwilliger Center for Housing launched a joint research effort not only to examine the various factors affecting the cost of developing affordable rental housing, but also to explore possible solutions. It is also important to note that while the Low Income Housing Tax Credit (housing credit) is a critical production tool for affordable rental housing, this research effort examines a broader set of cost challenges and solutions for affordable rental housing development and preservation not exclusive to housing credit support.

Our work was conducted in multiple phases beginning in September 2012. The first phase of work involved our research team convening a series of roundtable discussions in five cities—Chicago, Denver, Los Angeles, New York City, and San Francisco—to explore the question of cost with sensitivity to how the issue varies by market. As part of the second phase of work, additional interviews were held with an array of practitioners, developers, financiers, and policy makers in five additional markets: Boston, Houston, Minneapolis, Pittsburgh, and Seattle.

As a result of these conversations and other analyses, Enterprise and the Terwilliger Center identified several elements as common drivers of costs in the development of affordable rental housing. These cost drivers were discussed at a high level in an initial report released in November 2013 titled *Bending the Cost Curve on Affordable Rental Development: Understanding the Drivers of Cost*.

Throughout this effort, the research team engaged with nearly 200 key stakeholders representing both weak and strong markets, different population sizes and geographies, and a range of economic and policy environments. The input of these stakeholders was invaluable, particularly as the project team moved to the next phase of the work, which involved identifying best practices and new ideas for solutions to bending the cost curve. The result of this phase of work is a new report titled *Bending the Cost Curve: Solutions to Expand the Supply of Affordable Rentals.*

The findings in this report are largely based on the interviews and conversations held as part of our research. It is important to note that we chose not to identify particular individuals as the sources of specific comments in the report in order to facilitate candid conversations about difficult topics.

This report greatly expands on our earlier publication by providing more detail on the cost drivers, including how those drivers vary by market. In addition, this report offers a detailed set of recommended actions to bend the cost curve with the goal of moving toward a more efficient and lower-cost affordable rental housing delivery system.

What Drives Costs and Why?

Our work identified the following five common sets of cost drivers that impede the development of affordable rental housing:

- **Project Scale.** While a significant portion of upfront cost is directly related to the size and scale of the development, some costs—such as land costs, design costs, legal expenses, and funding application fees—are fixed or only partially correlated to the number of units in a development. These fixed costs make smaller developments (particularly those developed at less than the density allowed by existing zoning and land use codes) less economical on a per-unit basis. Therefore, in some circumstances, per-unit project costs could be reduced by removing the barriers to larger projects. However, there often are significant barriers to increasing the number of units built on a given site. Also, it is worth noting that additional density does not necessarily lead to lower costs. For example, larger developments may require a shift from wood-frame to more expensive steel construction. Alternatively, a development might be built in phases, thus increasing soft costs.

- **Project Design and Construction.** The importance of high-quality design and construction has been proven over the years through failures (such as the high-rise public housing properties that have required expensive redevelopment) and successes (including mixed-income developments and Low Income Housing Tax Credit developments). Furthermore, many developers intend to own and operate an affordable housing development in perpetuity, whereas comparable market-rate developers might operate under a shorter time horizon. Therefore, higher upfront costs may be economical if the measures improve the long-term viability of a development. Some developers have begun to design and build with greater attention to life-cycle costs.

- **Finance and Underwriting.** Real estate development is fundamentally shaped by the sources of capital available. Most affordable housing developments rely on multiple funding streams, both equity and debt, each of which carries its own set of requirements and compliance costs. For market-rate residential and commercial developments, both investors and developers generally share the common and (comparatively) simple goal of profit maximization. The financing process is more complicated for affordable housing developments, however. By targeting lower-income households, the developer is reducing or eliminating opportunities for the same level of profit as in a market-rate development in order to provide a benefit to the community. The reduced ability to earn a profit tends to make affordable housing developments more complicated to finance and can limit the amount of capital available.

- **Program and Investor Requirements.** Investors and public funding programs also can influence costs based on the specific terms under which funding is made available, including regulations, program requirements, and timing. Funder requirements can increase hard costs by imposing specific design and construction standards, though these requirements are also commonly included in municipal building codes and zoning requirements. Funders also influence costs by the timing and methods in which funds are distributed. A notable example is the process through which housing credits are allocated.

- **State and Local Regulations.** The state and local regulatory framework can have a notable effect on the supply of housing and the cost of development. Many state and local regulations and fees have reasonable justifications, including environmental protection and ensuring adequate infrastructure. Growth management policies that allow for denser development within a municipality or region can lead to increased housing supply, and possibly increased affordability. However, other regulations are inefficient at best and discriminatory at worst. Land costs and entitlement and permitting fees can create a substantial cost floor—before a developer even breaks ground—regardless of the developer's efficiency or the project type.

What Are the Recommended Actions and Who Acts?

Clearly, bending the cost curve is a complex challenge that varies across markets and, therefore, requires a range of solutions. Based on the research and interviews conducted as part of this analysis, Enterprise and the Terwilliger Center developed a set of specific, actionable recommendations for bending the cost curve that into fall into six broad categories, which are described in more depth below.

These recommended actions apply to "actors" at the federal, state, and local levels of the housing industry landscape. More specifically, the recommendations were developed with five types of actors in mind:

- **Developer**—includes private and nonprofit developers of affordable multifamily rental housing.
- **Federal Leader**—includes federal officials and agency staff.
- **Funder**—Includes public, nonprofit, private, and philanthropic lenders and investors.
- **State and Local Leader**—includes public officials, city planners, community developers, regulatory agencies, and other actors who operate on the state and local levels.
- **Advocate and Researcher**—includes those working in the advocacy and research arenas to lower the development costs of affordable rental homes.

As you will see, bending the cost curve will require creativity and leadership across the real estate and community development industry. Whether you are a developer, public official, housing finance agency, or other actor, this series of recommendations is intended to arm you with actionable ideas and to stimulate dialogue on this important issue. The following sections explore each category of recommendations and the key actors involved:

Category 1. Promote Cost-Effectiveness through Consolidation, Coordination, and Simplification.
The affordable housing delivery system consists of a diverse range of stakeholder groups, each with its own goals, priorities, and timelines. Rarely are these interests coordinated in a systematic way. However, doing so would result in a simplified, more streamlined system with shorter development timelines and lower costs. The recommendations in this category focus on eliminating duplication, reducing complexity, and enhancing efficiency throughout the affordable housing delivery system.

Who are the actors for this recommendation category? Federal Leader, Funder, State and Local Leader.

Category 2. Remove Barriers to Reducing Construction Costs and Delays.
Jurisdictions can help lower costs by eliminating barriers to timely and efficient affordable housing development. This research identified several common regulatory processes that could be altered at the jurisdictional level, including implementing smart parking requirements; making rehabilitation easier; and supporting innovative building techniques. These changes will reduce costs and delays, and may also encourage innovation in design and construction.

Who are the actors for this recommendation category? Developer, Federal Leader, Funder, State and Local Leader.

Category 3. Facilitate a More Efficient Deal Assembly and Development Timeline.
Jurisdictions and public funders should address regulatory barriers and create incentives to streamline the development process and reduce time-related costs. Recommendations include promoting consistency in the qualified action plan (QAP) process; allowing for more by-right housing development; and providing clarity around the public engagement process.

Who are the actors for this recommendation category? Funder, State and Local Leader.

Category 4. Improve and Align Incentives.
There are roles for policy makers and financiers at the federal, state, and local levels to improve the incentives and to better align the numerous funding streams, timelines, and approvals needed to develop affordable rental housing. While savings can be achieved by creating financial and regulatory incentives for cost control, it is also important to ensure that quality is maintained and that hard-to-reach populations can still be served.

Who are the actors for this recommendation category? Federal Leader, Funder, State and Local Leader, Advocate and Researcher.

Category 5. Improve the Flexibility of Existing Sources of Financing and Create New Financial Products to Better Meet Needs.
A number of potential innovations exist that could significantly reduce affordable housing development costs, but they require the availability of sufficient capital for implementation. Recommendations include exploring more efficient use of project reserves, creating entity-level financial products, and providing greater flexibility in 4 percent housing credit investments. Given investor risk aversion, immediate and widespread adoption of new techniques is unlikely. However, there are many opportunities to conduct pilots to demonstrate the financial viability of these concepts, which in turn will ease further adoption.

Who are the actors for this recommendation category? Developer, Federal Leader, Funder, State and Local Leader.

Category 6. Support the Development and Dissemination of Information and Best Practices.
The diversity of markets, jurisdictions, government agencies, and developers across the country creates significant opportunities for experimenting with different cost-control measures. Therefore, it is important to share the results of these experiments so that others can learn from both best practices and mistakes. Recommended actions in this category include building a community of practice on this issue and creating a forum for sharing data and best practices.

Who are the actors for this recommendation category? Developer, Federal Leader, Funder, State and Local Leader, Advocate and Researcher.

What Are the Key Lessons?

The demand for more rental housing is real and growing, but supply is not keeping up. The United States is in the midst of a demographic sea change that will also signal major changes in where and how people live.[v] As the nation emerges from the Great Recession and begins to consider what a new housing landscape can and should look like, understanding the needs and desires of residents becomes that much more critical. Beyond this understanding, the ability of developers to deliver affordable rental units—new or preserved—to the market in greater quantities takes on more urgency. *Bending the Cost Curve* provides a wide-ranging analysis of the affordable housing delivery system, but there are three key lessons that can be drawn from this work:

> *Lesson 1: The drivers of cost run deep.*
> Our research clearly demonstrates that the drivers of cost come at all points in the development process and are deeply intertwined. Of course, the degree to which the cost drivers identified through our research apply to specific developments varies by market and there may be other factors that can influence an individual development's costs.
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> *Lesson 2: Collaboration is key to taking action.*
> This research has also identified a number of recommended actions, existing best practices from a range of communities, and possible next steps to help bend the cost curve. Clearly, mitigating or eliminating key cost drivers will require multiple stakeholders to engage and collaborate on a sustained basis to build a more efficient affordable housing delivery system.
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> *Lesson 3: Leadership is essential.*
> Implementing our suggested recommendations will take creativity, commitment, and time. Moreover, to truly bend the cost on affordable rental development, leadership also will be required. Why leadership? Bending the cost curve by implementing the suggested recommendations will not be easy; it is essential that this work have true champions within every stakeholder group—developers, public officials, financiers, etc.—to maintain momentum.

Much progress has been made since the Housing Act of 1937, which established low-income housing subsidies and the creation of public housing, and set a goal of providing "decent, safe, and sanitary housing" for all in America. However, it is clear that there is still much more to do in order to achieve this goal. Our hope is that this report will not only continue the dialogue facilitated through our research effort, but also help spark the type of action, thought leadership, and innovation needed to reshape the housing landscape with more affordable rental housing.

Where to Learn More

To learn more about the Bending the Cost Curve research effort and to access the full report, visit the "Research and Publications" section of uli.org/Terwilliger.

[i] Joint Center for Housing Studies. *The State of Nation's Housing 2013*. (June 2013): http://www.jchs.harvard.edu/research/state_nations_housing.
[ii] Bipartisan Policy Center. *Demographic Challenges and Opportunities for U.S. Housing Markets*. (March 2012): http://bipartisanpolicy.org/sites/default/files/BPC%20Housing%20Demography.pdf.
[iii] National Multi Housing Council. April 2013. *Apartments Work: The Policymaker's Guide to Rental Housing*.
[iv] Joint Center for Housing Studies. *The State of Nation's Housing 2013*. (June 2013): http://www.jchs.harvard.edu/research/state_nations_housing.
[v] ULI Terwilliger Center for Housing and ULI Infrastructure Initiative. 2013. *America in 2013: A ULI Survey of Views on Housing, Transportation and Community*: http://www.uli.org/research/centers-initiatives/terwilliger-center-for-housing/research/community-survey/.