Think of Affordable Housing as an Opportunity, Not an Obligation

By Alan Kline, American Banker, January 3, 2016

The demand for affordable rental properties has long outstripped the supply, but the gap has widened in recent years as incomes have stagnated, homeownership rates have fallen and rents have soared in many markets.

Adults at all income levels are affected — even well-paid millennials with college degrees are spending an increasingly higher percentage of their take-home pay on rent — but those at the lowest end of the income spectrum are struggling the most. For every 100 households with incomes at or below 30% of area median income, there are only 28 affordable units available, down from 33 in 2007 and 37 in 2000, according to the Urban Institute. The situation has gotten so out of whack that there's not a single county in the entire country where the supply of affordable rental properties meets the demand, says Erika Poethig, the institute's director of urban policy initiatives.

"We are not adding more homeowners. We are adding more renters, but we are not adding enough apartments to keep pace," says Poethig. "That's putting more pressure on rents, which are rising most significantly for the lowest-income people."

The situation is likely to get worse over the next few years as contracts on 400,000 units designated as Section 8 expire and could potentially be converted by their owners into market-rate properties, says Poethig.

But with every crisis comes opportunity, and for KeyBank, the opportunity to boost the supply of affordable units — and make money doing it — is just too good to pass up. Armed with years of affordable-housing lending experience within its 12-state footprint, the Cleveland bank last year took the business nationwide in hopes of filling what it sees as a void in the market for funding these types of projects.

Robert Likes, a longtime executive in KeyBank's commercial real estate lending unit, manages the new national platform. He says the bank now has employees all over the country making connections with for-profit and nonprofit developers and identifying opportunities for building affordable multifamily properties or preserving existing ones. Financing for such projects can be complex — it may start with a construction loan, but can also include an equity investment through the federal Low-Income Housing Tax Credit program and a commercial mortgage that might later be sold to Fannie Mae or Freddie Mac — but done right it can generate decent returns at a time when all banks are struggling to grow revenue. KeyBank also benefits from Community Reinvestment Act credit on projects it finances within its branch footprint.

"The demand for affordable housing out there is really unlimited, so we see a real opportunity to take this business national and add substantial revenue," says Likes. "Providing safe, decent, affordable housing for families to help them get ahead is also just the right thing to do."

Recent government efforts to spur interest in affordable housing could make this a good time for other banks to become bigger players in the sector as well. One factor that has made the perpetual shortage worse is banks' reluctance to finance the development or rehab of smaller multifamily properties — roughly five to 50 units — so Fannie Mae and Freddie Mac are trying to make such lending more appealing. Both recently expanded or launched loan programs aimed at growing the secondary market for fixed-rate loans on these projects. The Federal Housing Administration also recently rolled out a risk-sharing program that lets banks and community development financial institutions use their own underwriting guidelines to originate multifamily loans of up to $5 million in high-cost areas (and up to $3 million everywhere else) provided they take 50% of the credit risk. With the FHA backing the other 50%, banks can hold far less capital against the loan than they would with a non-FHA loan.

Benson "Buzz" Roberts, the president and chief executive at the National Association of Affordable Housing Lenders, says these new programs will add liquidity in a market that desperately needs it. "It used to be that Fannie had some interest, Freddie did not and FHA simply did not have a product that was suitable for small loans," he says. "For lenders and borrowers, this competition is really important and really beneficial."

While credit is flowing at the higher end of the apartment market, it's nearly at a halt for older, smaller properties that make up the bulk of the affordable-housing stock. Many smaller banks have lost their appetite for financing the purchase of smaller properties because new Basel III rules would require them to hold too much capital against those loans. There's also not much of a secondary market for these types of loans, says Thomas FitzGibbon, the former president of MB Financial Bank's community development arm and now a board member at the Chicago nonprofit Neighborhood Lending Services.

"There aren't a lot of banks or savings and loans that are in position to do long-term financing without someplace to sell the loan," he says.

Roberts says lenders are particularly enthused about the FHA's program — expected to roll out in early 2016 — because it will allow them to sell the loans to a government entity called the Federal Financing Bank, thus freeing up more capital while relieving them of any interest rate risk. "It's not a secondary market, but it serves the same purpose of providing funding and liquidity," he says.

There are risks to financing such properties, as leases turn over frequently and operating expenses could conceivably rise faster than landlords can raise rents. But most observers say those risks are minimal, given the demand for affordable rentals.

With only about 200,000 new affordable units coming online each year, it would take decades to build the roughly 8.3 million units needed to house just the lowest-income families. Add in moderate-income households spending 40% or 50% of their income on housing and that figure gets significantly larger, says KeyBank's Likes.

Rising rents benefit property owners, but aren't so great for the broader economy. A recent study from economists Chang-Tai Hsieh at the University of Chicago and Enrico Moretti at the

University of California at Berkeley concluded that the dearth of affordable housing in high-cost markets like New York and San Francisco is costing the U.S. economy roughly $1.6 trillion a year. In other words, if housing were more affordable in those markets, money that's now going toward rent would be spent elsewhere, thereby boosting economic output, they contend.

One reason why there's a shortage of affordable units is that many developers would prefer to build market-rate or high-end apartments that generate fatter returns. Another reason developers — and lenders — shy away is because the financing can be a challenge to put together. FitzGibbon recalls a deal he worked on in the mid-2000s while with MB Financial that had six layers of financing from various public and private sources.

"You can make money on [affordable-housing] deals, but it does require a certain level of expertise when it comes to understanding all that goes into them," he says.

Many experts say the solution to increasing the supply of affordable multifamily apartments is renovating or rehabilitating older properties instead of relying on new construction. That's a specialty of Avanath Capital Management, a Los Angeles-based investment firm that over the last two years has invested about $300 million in affordable housing across the country.

Daryl Carter, Avanath's chairman and CEO, is bullish on the sector simply because the demand for affordable rentals is so huge. The occupancy rate at Avanth's 35 multifamily properties is at 98%, Carter says, adding that many of its units have waiting lists. Rents average $1,100 a month.

The key to keeping properties affordable is to not "overimprove" them, Carter says. Refurbish, don't replace, kitchen cabinets. Upgrade the lighting to make the properties more energy-efficient. And resist the urge to rip out those 1970s-era popcorn ceilings, which he says could add $50 or $60 to tenants' monthly rent. "We will have investors tell us to remove the popcorn ceilings, but my response is that every household today can afford a $300 flat-screen television, so they aren't looking at the ceilings," Carter says.

Avanath is actively looking to acquire more properties — and that presents a different sort of opportunity for banks. Banks that invest in Avanath — KeyBank, Wells Fargo and PNC Financial Services Group are all equity investors — not only receive CRA credit but can also share in the returns, thanks to the little-known public welfare exemption of the Volcker Rule.

The Volcker Rule largely prohibits banks from using customers' deposits for their own investments, but it does carve out an exemption for investments that benefit society at large. Affordable housing falls into that category.