REQUIEM FOR A SUBSIDY:
STATE HOUSING ASSISTANCE FOR RENTAL PRODUCTION (SHARP) IN MASSACHUSETTS 1983 - 1986

by

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by

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ABSTRACT

This paper examines the genesis of the Massachusetts "shallow interest subsidy" program known as SHARP (State Housing Assistance for Rental Production). SHARP is a program created to stimulate the production of affordable rental housing in Massachusetts.

The author's conclusion is that the SHARP program was a successful, collaborative effort on the part of state housing officials and private sector developers to create a new and innovative housing production subsidy program.

Based upon information gathered from interviewing key participants, and from extensive review of original documentary sources, this paper discusses the political, legal, and financial issues which arose throughout the process of creating the SHARP program, and concludes that the program -- which may be eliminated in its current form as a result of tax reform legislation -- was successful in treating those issues and in achieving its intended results: the production of new rental housing for low and middle-income families in Massachusetts.

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G.I.B.
Cambridge, September 15, 1986

INTRODUCTION

> Massachusetts congressmen are making a last-ditch effort to save a federal tax break for the wealthy which if eliminated could force developers to turn 6,000 units of low-income housing in the state into high-priced condominiums.... But Sen. Robert Packwood (R-Ore.), the co-chairman of the House-Senate tax reform committee, said yesterday that he opposed retaining the tax break because "the rich would run in droves to these low-income housing tax shelters and pay no taxes." ... The Dukakis Administration seized on the tax shelter as a way to promote low-income projects without federal money. The Massachusetts Housing Finance Agency, using $14 million in state funds and $364 million in tax-exempt bonds, has loaned the money to developers who in turn find wealthy people who want to invest in money-losing projects for the tax benefits.
>
> The Boston Globe, Thursday, July 31, 1986

. . . .

In December of 1983, the Great and General Court of the Commonwealth of Massachusetts passed, and His Excellency Governor Michael S. Dukakis signed into law a piece of legislation establishing a progam that came to be known as SHARP (an acronym for State Housing Assistance for Rental Production).

According to the Massachusetts Executive Office of Community Development (EOCD), SHARP "is a State program ... established to address the critical and growing need for affordable rental housing in the Commonwealth, while recognizing the limitations of the State's ability to subsidize private housing development.... The primary purpose of SHARP, therefore, is to expand the supply of rental housing in the Commonwealth."

The SHARP mechanism adopted to accomplish this purpose is what has been termed a "shallow" interest subsidy. The purpose of the SHARP subsidy is to bridge the gap between a) the cost of permanent financing of multi-family rental housing projects by means of Massachusetts Housing Finance Agency (MHFA) tax-free bonds and b) the rental income generated by such projects.

SHARP projects are specifically designed as "mixed-income" projects, where 75% of the units may be rented to any tenants who can afford to rent them at "the maximum rent at which units can be rented on the open market." The remaining 25% of the units are to be set aside for rental by families deemed to be "low income." These low-income tenants are to pay rents "no higher than the published Section 8 Existing Fair Market Rents...."

Affordable rent levels for these low-income units cannot be achieved simply by means of the SHARP shallow interest subsidy. Affordable low-income rents are achieved by means of a combination of additional subsidies: (1) an "internal subsidy" produced by "rent-skewing," (2) the "external", federal subsidy available to federal Section 8 or state Chapter 707 rental assistance certificate holders, and (3) in the event that certificate holders cannot be found to rent the low-income units, the state's Chapter 707 rental assistance funds could be used to provide yet another external subsidy "in order to prevent the loss of rental income."

The SHARP subsidy, by law, must be "the minimum amount necessary to make the ... project feasible and ... ensure that twenty-five percent of the units in such projects will be occupied by persons and families ... of low income."

The prescribed method for keeping the SHARP subsidy at the required "minimum" level is to keep raising the rents. SHARP developments are intended to consist primarily of market-rate rental unit; rents for these units are free to rise to the maximum level attainable in the free-market. Rent levels for the tenants in low-income units though, may rise only at "a maximum annual trending rate of five percent."

As project rents rise, the gap between net income and the cost of debt service will narrow, and eventually disappear. Consequently, the need for the annual SHARP subsidy will also diminish until, at some point prior to the fifteenth year, projects will become completely self-sustaining.

The SHARP subsidy is in the form of "a loan by the Commonwealth." The aggregate amount of the subsidy loan, together with interest thereon (at a rate of 5% per year), "shall be repaid to the MHFA" by the developer at the end of fifteen years "according to terms and conditions established by MHFA".

This may not mean however, that a cash repayment of the loan will be required. The SHARP statute provides that "such repayment proceeds shall be used for the benefit of low

and moderate income tenants pursuant to this program; and provided, further, ... MHFA shall not waive any loan in whole or in part." This language is interpreted by MHFA, in any event, as allowing repayments "to be recycled back to a project when such a plan will clearly benefit low and moderate income tenants."

MHFA underwriting standards and the program's substantial equity requirement (under SHARP guidelines, "the owner's contribution in SHARP developments will approximate twenty percent of the total project cost ....") meant that there would be a substantial gap between what these projects would cost to build and the amount of the project cost that could be obtained as a mortgage from MHFA.

Developers of SHARP projects were expected to fund this gap by means of equity syndications. Investors in these equity syndications would become limited partners in the partnerships which would be organized to develop, own, and manage the projects.

The primary benefit to the investor limited partners (who typically make their investments in a series of annual payments) would be the substantial tax losses which would accrue to these investors each year, in large part directly attributable to the SHARP subsidy loan, which had been purposefully and carefully structured to generate such losses. Significant cash flow could not be expected because

of the statutorily imposed, below-market cap on return on equity ("net income for return on equity should not exceed 6%"). However, because SHARP rents would be increasing over time, unlike traditional subsidized housing projects, SHARP projects would be expected to develop significant residual value. Investors could thus look forward to capturing some substantial share of that value as a further benefit -- assuming that repayment of the SHARP loan did not consume the lion's share of the residual.

The SHARP combination of (1) a shallow interest subsidy to make units affordable to middle-income tenants, with (2) the internal subsidy generated by rent-skewing and the deeper federal and state rental assistance subsidies that make units affordable to low-income tenants, and (3) the loan mechanism formulated to maximize investor tax benefits (as well as the promise -- however ephemeral -- of residual value) toward the accomplishment of this end, has been viewed as a major advance in state government housing finance technique.

As of the date of this paper however, conferees representing the Ways and Means Committee of the House of Representatives and the Senate Finance Committee are meeting to shape the final form of a major revision of the Internal Revenue Code.

Among the "tax reform" provisions currently under Congressional scrutiny are a raft of proposed changes to the tax Code that deliberately and systematically eliminate those current provisions of the Code that have, up to now, allowed individuals to deduct from their taxable income "paper losses" generated by and sustained on account of investments in real estate partnerships.

SHARP was a program unabashedly designed to take maximum advantage of these "tax-shelter" provisions of the tax Code. Adoption by Congress of such changes as have been proposed to be made to the tax Code will effectively scuttle the program. Certainly no new SHARP deals will be able to be funded. It is also highly unlikely in light of today's unsettled tax environment that SHARP developments already approved, but not yet syndicated, will be able to attract investors. At the same time, it is increasingly uncertain that investors in already syndicated SHARP deals will choose to continue to make their annual partnership payments.

Principal actors in the development of the SHARP program feel "quite embittered" in response to SHARP's imminent demise at the hand of tax "reformers." Since 1961, one of the major SHARP developers points out, the federal government has lived up to its promise to fund the production of low-income rental housing "through the back door" -- by means of tax-shelter incentives.

Now, twenty-five years later, the tax code as the engine of production is being shut down, with no replacement in sight. The promise has been broken; the tools of rental housing production have been snatched away.

SHARP's brief, shining moment appears to have come and gone. The monument to SHARP however, will not only consist of bricks and mortar that might never have been put into place absent its stimulus. The SHARP legacy consists as well of the history of its public/private partnership, the combination of public and private interest, united for the common good, which created this uncommon, innovative program.

This paper will explore that history, and the issues -- political, legal, and financial -- which were dealt with and accomodated throughout the process of forging SHARP.

STATE AND NATIONAL CLIMATE FOR ASSISTED HOUSING

The assisted-housing environment in late 1982 and early 1983 was not healthy at either the state or the national level.

Commentators on the national level noted at the time that the period could be characterized as "a time when the federal presence is receding from this sector [rental housing production]".

Reviewing the prospects for new Federal Housing legislation in the Spring of 1983, Kenneth G. Lore and Sheldon L. Schreiberg, Washington attorneys active in the assisted housing field, wrote in the May 31, 1983 issue of Legal Times about the Dodd-Schumer bill (H.R. 1) -- the housing bill then pending in Congress

Dodd-Schumer was an attempt to "keep some rental housing production on line " by means of Federal assistance in the form of "... capital grants, loans, interest reduction payments ... or other comparable assistance." The authors noted however, that the bill

> ... is a long way from implementation. The differences between the House and Senate proposals are considerable. There are cracks in the coalition, and it is unclear how much all the program's advocates can compromise. The nature of the compromise, now and in conference, certainly will affect the enthusiasm the administration will offer to any new spending program. In its May 4 mark-up, the House HUD appropriations subcommittee excluded funds for any new rental production program. It is too soon to judge whether politics and policy will grind up yet another promising idea, or mesh to produce a modest but useful housing program.

By the Spring of 1983, whatever promise H.R. 1 may have held out had faded. According to the June, 1983 newsletter of Boston's Citizen's Housing and Planning Association (CHAPA), the leading housing advocacy group in Massachusetts:

> The odds for a new housing authorization bill appeared favorable at the beginning of the year -- now it appears the administration would as soon not have any housing legislation again this year. HUD Secretary Pierce says the President will certainly veto any bill that authorizes as much spending as HR-1.... The administration wants no part of housing production.

As then Massachusetts Governor Edward J. King stated in April, 1982, "Current economic conditions, particularly chronically high interest rates ..." had made the work of the state's instrumentalities "dedicated to making decent, safe and sanitary housing available to low and moderate income families ... extraordinarily difficult."

In the May, 1982 issue of its newsletter, Housing on the Hill, the leading housing advocacy group in Massachusetts, Citizens Housing and Planning Association (CHAPA), called the attention of its members to the fact that the Massachusetts Legislature had initiated "major cuts in ... family and elderly housing operating subsidies.... The level of funding for these accounts are a cause of concern to supporters of public housing."

CHAPA reported though, that the state had committed some $250,000 in rental assistance funds for use with a Federal Rural Rental Housing program, noting that the Federal

program was to provide a "1% interest rate loan to a non-profit developer" of such housing, but that "Federal cutbacks in Section 8 new construction have left the program without any deep subsidies to go with the projects. The state rental assistance funds make these FmHA projects feasible and assure they will serve low income tenants." No new funds had been budgeted however, for FY 1983 for the state's own 1% interest rate subsidy, the Section 13A program.

CHAPA also reported that the state's public housing budgets for all items other than utilities were "under strain, caught between a 4% cap and mandated state wage rate increases of 15-20% for housing authority blue collar workers."

CHAPA took note of the sort of politics at work that created this strain: "The Housing and Urban Development Committee rejected legislation that would have raised tenant rents in state subsidized housing to 30% [ed. note: from 25% of income]. EOCD filed the bill, then withdrew its support for the measure. The committee also rejected a measure filed by the Boston Housing Authority which would have capped the wages of maintenance personnel in state projects."

Thus state assisted projects were being caught in a severe squeeze, with their income limited on account of one sort of political pressure, while at the same time, their costs were being forced upward by political pressure from a wholly other direction. Maintenance would, and did suffer.

The November, 1982 issue of Housing on the Hill bore the headline "The First Priority Family Housing." The issue outlined a number of family housing assistance proposals then pending before the Legislature, including a number of programs (notably Chapters 705, 707, and Chapter 667) which provided subsidies for families, the elderly, and Vietnam War era veterans. In the case of families and the elderly, the subsidy represented the difference between project operating expenses and rental income. In the case of veterans, the subsidy represented the difference between market rent and what the veteran/tenant could afford to pay. In all cases, tenants would be required to pay not more than 25% of their income toward their rent.

Because of the lack of available rental housing subsidies, another approach to the problem was also proposed, employing that most notorious form of homeownership, the condominium. Nevertheless, as a means of creating some new low and moderate-income, multi-family housing, Senator Joseph Timilty introduced a bill into the Massachusetts Senate to promote "the construction of private condominium housing and assure that at least twenty-five percent of the newly constructed units will be occupied by low income families and elderly." Sale of higher priced, market-rate units would "subsidize" the cost of those units reserved for purchase by or on behalf of low-income families.

In February, 1983, Senator Timilty released an information sheet listing a number of attributes of the "many-faceted 1982 housing package, Senate 699". Among these attributes were:

"... the potential to create hundreds of housing units with limited state financing;

"... the potential to generate hundreds of jobs in the construction industry;

"provides further opportunity for the state to leverage private housing investment -- a priority clearly recognized by this administration;

"utilizes developments 'left in the MHFA pipeline' -- developments left stranded by the loss of Section 8 funding. (in several instances, investments in development design, site selection, permit acquisition have already been advanced.)"

Senator Timilty characterized as "highlighting the 1983 program ... through the joint participation of EOCD and MHFA, a new program to directly stimulate in the first year the development of at least 1,800 units of private housing, about one-third of which would be available for moderate income families ...."

Senator Timilty went on to indicate that of the "$100 million authorization set by this legislation ... a minimum of $28,500,000 would be initially set aside to the

EOCD/MHFA new construction program.... This level of funding would create 600 units of public housing which, in turn, would directly leverage 1,800 units of private housing."

In the same month as Senator Timilty published his analysis, an MHFA Task Force charged with recommending new State housing programs, stated that "The primary rationale" for its recommendations was that "... neither state nor federal subsidies will be available in the future in the amount needed to continue MHFA's traditional rental housing production program. In the absence of thse subsidies, the Agency must consider a new program ...."

The Staff Task Force report recorded "the growing perception on the part of many housing providers in the Commonwealth that there does not exist an appropriate vehicle to provide rental housing for all segments of the rental market. Not only is there a shortage of adequate low-income housing, there is clearly a shortage of moderate and middle-income housing.... there is little rental housing currently under construction."

Looking back, certain elements of the assisted housing environment in early 1983 can be seen as having prepared the ground for the emergence of a program such as SHARP: increasing public and political awareness of a shortage of affordable rental housing; shrinking -- if not vanishing altogether -- Federal subsidies, and the lack of

any new Federal initiative to replace programs being phased out or abandoned; the willingness of those within the state government who were concerned about housing to consider innovative financing strategies; realization that private sector development was more likely to produce new housing than the government; and the willingness to target government housing production assistance, in whatever form, not only toward low-income families, but toward middle-income families as well.

Perhaps equally important, MHFA was regarded as a highly competent agency, with a respected, technicnally skilled staff. At the time however, there were no development programs underway; an excellent development staff was being wasted -- and might have been lost --for lack of activity. Development of a new program helped to catalyze the agency.

THE GOVERNOR'S TASK FORCE ON PRIVATE HOUSING PRODUCTION

In the midst of this climate, in November of 1982, Michael S. Dukakis was elected Governor of Massachusetts for the second time, and was sworn into office in January, 1983.

Within one month, the Governor's newly appointed Secretary of the Executive Office of Communities and Development, Amy Anthony, established "on behalf of Governor Dukakis", a "Task Force on Private Housing Production."

The Task Force, which Secretary Anthony had been asked to chair by the Governor, was described by Secretary Anthony, on February 9, 1983, as "a small working group whose goal will be to develop over the next 60 days a cost-effective program to stimulate private housing production.

"The Task Force will be comprised of private sector practitioners as well as Senator Timilty and Representative Cusack [ed. note: co-chairmen of the Massachusetts Legislature's Joint Committee on Urban Affairs). In addition to myself, Secretary [of Administration and Finance] Frank Keefe and Director of Development Al Raine will serve as ex-officio members."

The private sector members of the Governor's Task Force were: Pat Clancy, Executive Director of Greater Boston Development, the leading not-for-profit developer in Massachusetts; Wes Finch, President of the Finch Group, and Bob Kuehn, President of Housing Economics, two major developers of assisted housing; and Howard Cohen, a Boston attorney active in the field of assisted housing.

The Task Force's first meetings were held on February 11, and February 25, 1983. Various of its members submitted their own analyses of the rental housing affordability problem, focusing in all cases on the need to achieve maximum housing production stimulus with the minimum expenditure of limited state funds.

HOUSING ECONOMICS AND SHALLOW SUBSIDY MODELS

Bob Kuehn prepared what he termed a "Housing Primer" for consideration by the Task Force. In his Primer, Kuehn made and illustrated the following points concerning housing economics:

1. Housing is a double good thing -- the producing of it provides an economic good and the consuming of it provides a social good.

2. Housing is very expensive -- an average rental unit today costs about $900 per month even with tax-exempt financing as follows:

Housing Cost Component Rent/Month	
Debt service ($60,000 @ 12%)	$600
Operating expenses ($2,400 pupa)	200
Real Estate Taxes (2% of cost)	100
Total	$900

3. Housing is so expensive that most people cannot afford it -- based on even 30% of income spent for rent, the below table indicates who can afford what:

Income	Rent/Month
$10,000	$250
$20,000	$500
$30,000	$750
$40,000	$1000

4. Housing subsidies necessary to make an apartment affordable -- again based on 30% of income spent for rent by various income groups and a $900 economic rent -- are as follows:

Income	Subsidy/Year
$10,000	$7,800
$20,000	$4,800
$30,000	$1,800
$40,000	$ 0

5. Housing supported by the state in the absence of federal assistance must leverage limited resources -- production, need, cost, and equity must be balanced to achieve the most for the least including relying on shallow subsidies for middle income housing and relying on a market mix.

6. Housing programs aimed at the middle income range of $20,000 to $30,000 (80% to 120% of median income) will allow maximum production with minimum subsidy costs to the state -- and it is likely that such a shallow subsidy can also be phased out over time or even repaid.

Wes Finch proposed a similar, self-liquidating, ten year subsidy program. In Finch's plan, the subsidy would represent the difference between an assumed annual debt service cost of approximately $7,200 per unit (on an assumed mortgage amount of $65,550 per unit, at 11%) and the net income available per unit with which to cover debt service.

Finch assumed that tenants would pay rent in an amount equal to 27.5% of their assumed annual income of $27,100, and included the following table to illustrate his proposal:

Year	Prevailing Rate	Paying Rate	Subsidy Cost Per Unit	Partnership Contribution	Rent Increase
1	11.00%	5.00%	$ 3,933	$ -	-
2	11.00	5.75	3,441	820	10.50%
3	11.00	6.50	2,950	820	9.75
4	11.00	7.25	2,458	820	9.16
5	11.00	8.00	1,967	820	8.66
6	11.00	8.75	1,475		8.24
7	11.00	9.50	983		7.88
8	11.00	10.25	492		7.58
9	11.00	11.00	0		7.32
10	11.00	11.00	0		7.09
			$17,699	$6,970 (future value)	

Finch's table made more explicit how the subsidy would be phased out and repaid: by regular rent increases.

Pat Clancy produced another model of a proposed subsidy program. Unlike Kuehn's and Finch's proposals however, Clancy's model was based upon a constant, fixed annual subsidy of $1800. Like Finch and Kuehn, Clancy proposed a subsidy program relying upon increasing rents to reduce, and eventually eliminate the need for the subsidy, which, in Clancy's view, would need to last fifteen, rather than ten years. Like Finch's table, Clancy's models also clearly demonstrate their dependence on equity syndication to fund these projects. Particularly as shown in Examples 1 and 3, syndication proceeds make up the difference between subsidy needs and subsidy payments in the early years. In the later years, the subsidy payments in excess of subsidy requirements flow directly to the investors.

Using Wes Finch's base numbers, Clancy produced the following table:

EXAMPLE 1: FINCH VILLAGE

Year	Finch Village Subsidy Cost	Subsidy Program Contrbtn	Waiver of Devlpr's Fee	Prtnrshp Contrbtn	Return of Prtnshp Contrbtn
1	4,265	1,800	2,319	146	
2	3,773	1,800		1,973	
3	3,282	1,800		1,482	
4	2,790	1,800		990	
5	2,299	1,800		499	
6	1,807	1,800		7	
7	1,315	1,800			485
8	824	1,800			976
9	332	1,800			1,478
10		1,800			1,800
	17,699	18,000	2,319	5,097	4,739

Being most concerned with low-income projects however, Clancy also included two additional analyses of Boston Housing Partnership apartment rehabilitation projects aimed primarily at low-income tenants.

The first was a model of a less extensive rehabilitation effort:

EXAMPLE 2: BOSTON HOUSING PARTNERSHIP

1. Development Budget

Construction Costs	25,000
Development Costs	5,000
Proj. Inv. Fund (Development Fee)	3,000
Total Development Costs	33,000
Mortgage: First	20,000
Mortgage: Second: Grants	6,000
Equity Financing	6,500
Interim Income	500
	33,000

2. Operating Budget

Uses of Funds for Operations: Year 1

	Per Unit	Per Unit Per Month
Operating expense	3,000	250
Debt Service	2,040	170
Reserves	240	20
Total	5,280	440

Source of funds for operations: Year 1

Rental Income	3,180	265
Subsidy	1,800	150
Proj. Inv. Fund Income	300	25
	5,280	440

3. Subsidy

Constant $1,800 per unit per year required. Inflation factor on subsidy may be important to long term viability of low rent units.

Year	BHP Subsidy Cost (Fixed)	BHP Subsidy Cost with CPI inflation (est. 7%)
1	1,800	1,800
2	1,800	1,926
3	1,800	2,061
4	1,800	2,205
5	1,800	2,359
6	1,800	2,525
7	1,800	2,702
8	1,800	2,891
9	1,800	3,093
10	1,800	3,310
11	1,800	3,541
12	1,800	3,789
13	1,800	4,055
14	1,800	4,338
15	1,800	4,642

This example graphically illustrates the need for additional operating subsidies to mitigate the potential impact of inflation.

The next example illustrated by Clancy was of a more substantial Boston Housing Partnership rehabilitation project:

EXAMPLE 3: MORE SUBSTANTIAL REHABILITATION

1. Development Budget

Construction Costs	40,000
Development Costs	10,000
Developer's Fee (15%)	7,500
Total Development Costs	57,500
Mortgage Percentage	90%
Mortgage Amount	51,750

2. Operating Budget

Uses of Funds for Operations: Year 1

	Per Unit	Per Unit Per month
Operating expense	3,100	258
Debt Service	5,693	474
Reserves	300	25
Total	9,093	757

Sources of Funds for Operations: Year 1

Rental Income	6,093	507
Subsidy	3,000	250
Total	9,093	757

3. Subsidy

Begins at $3,000 per unit per year and decreases based upon rent increase of $13 per unit per year (2.5% of initial rent) to cover additional debt service only.

Year	Substantial Rehab. Subsidy cost	Subsidy Program Contrbutn	Waiver of Developer Fee	Partnrshp Contrbutn	Return of Partnrshp Contrbutn
1	3,000	1,800	1,750		
2	2,844	1,800		494	
3	2,688	1,800		888	
4	2,532	1,800		732	
5	2,376	1,800		576	
6	2,220	1,800		420	
7	2,064	1,800		264	
8	1,908	1,800		108	
9	1,752	1,800			48
10	1,596	1,800			204
11	1,440	1,800			306
12	1,284	1,800			516
13	1,128	1,800			672
14	972	1,800			828
15	816	1,800			984
Total	28,620	27,000	1,750	3,482	3,558

SUBSIDIZING MIDDLE-INCOME TENANTS: THE ECONOMICS

Kuehn, Finch, and Clancy may have used different numbers to illustrate their points, but they were all dealing with the same phenomenon (in Kuehn's words): "Two thirds of rental housing costs is currently the capital cost of producing the housing which is in turn reflected in rents through financing costs."

The necessary implication of the issue that they raised may be simply stated: either the cost of producing rental housing, or the cost of financing it must be reduced.

The cost of production is not viewed as fertile territory for achieving significant cost reductions. In Kuehn's view, "... it is unlikely that the basic nut of capital costs can be cracked -- although every effort should be made through regulatory reforms and other measures to at least slow the pace of inflation in these costs."

Pat Clancy concurs that lowering the cost of producing new, affordable housing remains an elusive, if not impossible goal: "There have been a million people who have said there should be a way to build low-income housing cheaper, but low income housing doesn't mean lower housing construction costs.... it is too simplistic a notion to think it can be built cheaper."

If the cost of producing rental housing units cannot be brought within a range where low-income tenants' rents can cover its costs, some subsidy to cover those costs must be provided. "Housing for poor people requires dollars [and that cost] can't be supported solely by rents", says James Luckett, Associate Director of the Boston Housing Partnership. "[This gap] requires subsidy dollars from somewhere.... Without public subsidies, you can't make [the

housing] affordable. I don't know of anything to bridge the gap between what low income-tenants can pay and [the cost of construction.]"

The subsidy burden however, becomes increasingly more difficult to bear as the level of available rents is reduced. Bob Kuehn said, "... the lower the incomes being served, the higher the subsidy cost per unit assisted."

As an example, according to Eleanor White, now Deputy Director of MHFA, and formerly Assistant Director of the HUD Boston area office, the cost of Federal Section 8 new construction subsidies in Boston, targeted exclusively at low-income tenants, amounted to some $10,000 per unit per year. The Governor's Task Force singled out the the Section 13A deep interest subsidy program -- which required a subsidy of some $5000 per unit per year for thirty years -- as an example of a "clearly unacceptable" level of government housing production assistance.

Illustrating the leveraging impact of these facts, Wes Finch pointed out in his analysis of even a shallow interest subsisdy program, that a family paying 27.5% of its $17,600 annual income could afford to pay only $4,837 in rent. After expenses, an annual subsidy of more than $6,500 would be required. By contrast, a family whose yearly income was $35,600, twice that of the first family, paying the same 27.5% of its income in rent, would require a subsidy of only $1,740 per year.

In other words, a family with double the income would require only about one-fourth the subsidy of the lower-income family.

These inexorable calculations led Bob Kuehn to the conclusion that any new subsidy program must "... focus on middle income rents ... households earning between 80% and 120% of median income which in the Boston SMSA would be about $20,000 to $30,000 for a family of four."

Kuehn estimated that "The annual subsidy cost to serve these households is in the range of $2,000 to $5,000 annually (as compared to over $8,000 to serve low income persons with incomes less than $10,000)." Kuehn suggested that the new program should be structured "Assuming an average annual subsidy of $3,500 ...."

Kuehn was not unaware of the political implications of what he proposed. He noted that the "middle income" group "has been largely ignored by housing policies and programs of the past." However, Kuehn went on, "A new state program must acknowledge the above realities and without apology, provide a mechanism to produce primarily middle income rental housing."

SUBSIDIZING MIDDLE-INCOME TENANTS: POLICY AND LEGAL ISSUES

The state housing agencies were thinking along the same lines. In November of 1982, John Blake, then MHFA Executive Director, appointed a staff-level Task Force

"to investigate and discuss the options for new programs available to the Agency given the expiration of the federal Section 8 program."

The Staff Task Force on Future Agency Programs submitted its draft report on February 17, 1983, just prior to the second meeting of the Governor's Private Housing Task Force.

Among the programs that the MHFA Staff Task Force recommended that the Agency pursue was a program summarized as:

> A market rate multi-family rental housing program in stronger market areas, providing assistance to lower-income tenants through rent-skewing as part of this program. The Agency, in conjunction with EOCD, should develop a new shallow interest subsidy program to reduce interest rates to six percent, rather than one percent [ed. note: a reference to the Section 13A program]. (This program will serve tenants whose incomes range between 80% and 130% of median income in the Boston SMSA.)

The political issues addressed by Bob Kuehn were not lost on the MHFA staff: "By relying solely on rent-skewing, agencies are using tax exempt bonds primarily for market-rent individuals with benefits also targeted to a smaller number of individuals with incomes at the upper end of the Section 8 criteria." Advocates on behalf of low-income tenants could be expected to argue that dollars directed at subsidizing middle-income tenants were dollars taken away from the truly needy; advocates on the opposite end of the political spectrum could be counted on to argue the same point.

If housing assistance policy was going to move in this new direction, significant legal issues would have to be confronted.

The Staff Task Force pointed out that MHFA's enabling act would have to be amended in order for the Agency to be able to target a program at a group within the population who were not then considered low income under the law:

> In the Agency's enabling statute, change the definition of "low-income families or individuals" from those who qualify as public housing tenants to the original definition, "those ... whose annual income is less than the amount necessary to enable them to obtain ... decent, sanitary housing without the expenditure of over 25% of such income for basic shelter plus the additional cost of ... heat and hot water."
>
> "Low-income persons or families" are presently defined as those families or persons whose annual income is equal to or less than the maximum amount which would make them eligible for [public housing] units....
>
> The original definition of low income should qualify a greater number of families and individuals with larger incomes under the category of low-income. This in turn should result in a lower cost of the total internal subsidy needed by a development to meet the requirement that 25 percent of the units be rented to low-income tenants.... by changing the present definition of "low-income" in the Agency's statute, the pool of low-income tenants is increased .... In light of the probable controversy that would be generated by such a proposal, an analysis should be made of how significant an effect this change is likely to have.

The Staff Task Force report traced the genesis of the concept to a proposal introduced into the Congress in 1979 and 1980 by Wisconsin's Democratic Senator, William

Proxmire. Proxmire had called for a Federal shallow subsidy program whereby the government would provide an annual interest rate subsidy "to lower the rate to six percent for a ten year period. The income limit for the program was to be set at 120 percent of median income." The Task Force recommended "that Senator Proxmire's program concept be the basis for a State interest rate subsidy program and that provisions be made for low-income people."

The mixed-income, skewed-rent project concept which was emerging within the framework of the housing Task Force deliberations, was something of a radical notion, according to EOCD officials. This was not because rent-skewing was a particularly novel or complicated concept: "the upward adjustment of "rentals ... on three units ... to obtain a sufficient 'subsidy' ... enables the fourth unit to be made available for low income persons".

The "radical" nature of the concept was that it targeted a government rental housing subsidy largely toward persons other than low-income tenants. Though in operation such a concept could produce signficant and positive results for assisted housing projects, it was also a concept which raised important and troublesome issues of law as well as public policy.

In 1969, these issues were tested as the Act survived a constitutional challenge aimed directly at its rent-skewing provisions. The legal basis for the challenge was essentially political, in the broadest sense of the word.

The Court's opinion in the case of Massachusetts Housing Finance Agency v. New England Merchants Bank, 356 Mass. 202 (1969) stated that

> It is not for this court to consider whether these contentions [MHFA's arguments that rent-skewing would help to prevent and eliminate slums] are sound as a matter of economics and public policy. That is a legislative matter.

In order to uphold the validity of the MHFA's enabling statutes ("the Act"), the Court nevertheless could not help but become enmeshed in the central "matter of economics and social policy" which underlay the Act:

> ... whether the Legislature reasonably could consider [the aforesaid contentions] to be valid and could rationally regard the provision of proper housing for low income families as the fundamental purpose of the Act and any benefits to persons of moderate income as only incidental to the primary objective, although contributing to its achievment.

MHFA's "primary objective" is expressed in Section 2 of the Act:

> It is ... imperative that the cost of mortgage financing, which materially affects rental levels ... be made lower so as to reduce rental levels for low income ... families ... and that private enterprise be encouraged to build housing which will prevent the recurrence of slum conditions .. by housing persons of varied economic means in the same projects ....

Further reinforcing the distinct social policy embodied in the Act -- that MHFA projects were not intended to become low-end economic ghettos -- Section 7 of the Act provided that tenant "income limits shall be sufficiently flexible to avoid undue economic homogeneity among ... tenants ...."

As recounted by the Court, MHFA's social policy argument embodied an ambitious social agenda:

> The Act is intended to accomplish slum clearance more effectively and more permanently than in earlier subsidized public housing by avoiding undue concentration of low income tenants and by achieving for such tenants 'exposure to and close contact in as many areas as possible with more successful members of society' ... The Legislature ... has made a 'determination to proceed with ... housing ... low income families in projects also inhabited by those somewhat more affluent....' '... [F]amilies with middle class property standards are more likely to ... assist in maintaining reasonable standards of ... property upkeep which will ... instruct low income families ... in how to take care of housing and ... insure that the project's basic value will not be radically lowered by tenant abuse.'

Since "prevention and elimination" of "slum conditions" was a long established, well accepted "public purpose", MHFA also argued that

> To the extent that the higher rental in these units [those rented to persons of moderate incomes] will be below what the free market would charge, a necessary inducement will be provided to families not of low income to live together with low income ... families in the project.... this inducement [may] counteract the fact that people do not normally choose to live in projects or neighborhoods with people of substantially lower incomes ... [or] to "subsidize" lesser rents charged in other units to make this possible. It is this kind of mixing of families of varied economic means which will provide for the prevention and hence "permanent elimination" of slum conditions in the project, which was expected in ... [earlier] days ... to occur simply through the construction of low-rent housing."

Given this heavy dose of sociology with which they were presented as the basis for the Act, and regardless of their protestations to the contrary, the Justices of the

Massachusetts Supreme Judicial Court could not, under the rubric of only dealing with narrow, legal issues, avoid dealing with the broad social policies embodied in the MHFA enabling statute:

> Despite the precautions taken in the Act to minimize benefits to tenants of moderate income, the question inevitably arises whether MHFA's lending (at lower than market interest rates) of money borrowed on tax exempt notes is for other than a public purpose because part of the housing and rent saving accrues to persons of moderate income not within the low income group usually regarded as suitable objects of public support.

These "suitable objects of public support" were described as "persons genuinely requiring assistance in obtaining proper housing because of poverty."

The inevitably intertwined nature of law and social policy in this area may be seen most clearly in the fact that these same Justices had previously concluded that while "the provision of proper housing available at low rentals to persons of low income 'could be for a public purpose'", they also "concluded that [an earlier draft of the MHFA enabling statute] was not confined to such a purpose because ... 'as many as seventy-five per cent of the apartment units in each project could be given to persons not of low income.'"

In Opinion of the Justices, 351 Mass. 716 (1966), the Court advised the legislature that

> So far as the purpose of ... [the original MHFA enabling statute] is to provide housing for families of moderate income, the bill does not appear to be confined to a public purpose.

> The possibility that the rents paid by moderate income families, possibly up to seventy-five per cent in a project, will subsidize lower rents paid by lower income families is too indirect and uncertain to enable us to say that expenditures of tax money under this bill will be for a public purpose.

Because a public purpose could not be demonstrated by its provisions, the Justices advised the legislature that the original draft of the MHFA enabling statute could not be found constitutional. While their formulation of the constitutional problem may appear to reflect an almost archaic, somewhat quaint, and puritanical view of the ethos of state housing assistance, the Justices were simply raising the same sort of policy issues which proponents of middle-income subsidies would expect to hear in the contemporary political arena.

Not surprisingly, in the New England Merchants Bank case, the 1968 MHFA statute, as amended by the Legislature in response to the Court's previous advisory opinion, was challenged on, among other grounds, the theory "that the Act is not supported by an proper public purpose within ... the Constitution of the Commonwealth, at least to the extent that the Act affords rental benefits to families of moderate income."

This time around however, the Justices, finding that "the legislative proposals ... have ben subsequently modified and clarified", declared: "We are of the opinion

that the Legislature may properly enact legislation which proceeds on the basis of the considerations for which MHFA contends."

What appeared to have swung the Court toward its holding that the Act was not unconstitutional were its findings that

> [1] The saving in interest [on account of MHFA's tax exempt bond issues] is to be applied ... to making possible lower rentals to "low income" tenants ... [2] most of that saving [the savings in interest available to a project owner from MHFA financing] will be applied to the reduction of rents payable by low income families, although there may also be smaller reduction, below general market levels, of rents for moderate income tenants ... [3] the Act ... provides for upward rent adjustments for moderate income tenants to prevent their receiving any undue part of the benefit of MHFA financing.... [4] the standards, expressly stated or implied in the Act, effectively require MHFA (a) to restrict loans to projects under the Act to such projects as are of substantial benefit to low income persons and families; and (b) to make sure that any benefit to tenants not within the low income category will be at most incidental to, and no greater than necessary for, achieving the Act's primary objective of proper housing in appropriate surroundings of persons of low income.

Given the legal climate, previous subsidy programs had been available only for wholly low-income projects. This effectively left middle-income people out in the cold. Their incomes were too low for them to be able to afford to rent market-rate units; at the same time their incomes were too high to qualify for then available government subsidy programs.

SUBSIDIZING MIDDLE-INCOME TENANTS: RENT-SKEWING

The new program recommended by the MHFA staff though, would be designed to "allow a significant segment of moderate-income families to afford shelter." The Staff Task Force reiterated that "It is important to clearly define moderate income as those families between 80 percent and 130 percent of median income." Because they were not -- for purposes of government means tests -- poor enough, these families had never before been eligible for government housing assistance. Now however, it was being proposed that these "middle-income" families were to become beneficiaries of a subsidy allowing them to rent apartments that, absent the subsidy, these families could not otherwise have been able to afford because they were not, in fact, rich enough.

The strategy embodied in these proposals would rely upon "rent-skewing" to produce an "internal subsidy", while employing two levels of "external" subsidy as well.

"Rent-skewing" to produce an "internal subsidy" simply means that income generated by market rate units is used to subsidize project income that is not generated by the lower income units. If there were a sufficient number of market rate units within a project, and high enough rents could be obtained from these units, "excess" income produced by these units -- that is, income in excess of what might be

required to meet debt service associated with those units -- could be applied as a subsidy from within the project toward the debt service associated with the low income units.

As for the "external" subsidies, the first would be the "shallow" interest rate subsidy targeted at middle-income tenants of market rate units. If projects consisted primarily of this type of units, a relatively modest level and aggregate amount of this subsidy would support a substantial number of market rate units.

The second level of subsidy would consist of federal or state rent subsidies targeted specifically at low income tenants. By applying these payments as an additional layer of subsidy for tenants of the low-income component, on top of the interest subsidy, the cost to the project of the low income units could be reduced considerably.

The table below demonstrates how in the case of a hypothetical 100 unit project (75 units market rate/25 units low-income) the combination of (1) a shallow interest rate subsidy, the effect of which is to reduce project debt service costs (interest only) to 6%; (2) the internal subsidy produced by rent-skewing; and (3) an additional, external subsidy, is utilized by, and is required to make the project pay for itself.

NOTE: The following table presents an extremely simplified, conceptual model of the workings of the type of subsidy program that was to become SHARP. This model presents only the barest outline of the financial components of a "real life" housing project. The calculations assume (for purposes of simplicity only) that the mortgage amount is equal to the full cost of the unit, and thus leaves aside altogether the many other significant equity-related components of the finances of a real project.

RENT SKEWING TO PRODUCE AN INTERNAL SUBSIDY

	MARKET RATE	LOW INCOME	TOTAL
- number of units:	75	25	100
- mortgage amount per unit:	$90,000	$90,000	$9,000,000
- tenant income @ 30% for rent:	$28,000	$16,000	
- monthly rent:	$700	$400	$62,500
- annual rent:	$8400	$4800	$750,000
- expenses per unit per year:	$2500	$2500	$250,000
- net income:	$442,500	$57,000	$500,000
- shallow interest subsidy (to 6%):	$3000	$3000	$300,000
- subsidized interest cost @ 6%:	$405,000	$135,000	$540,000
- cash flow after debt service:	$37,500	($77,500)	($40,000)
- internal subsidy per unit:	- 0 -	$1500	$37,500
- cash flow after internal subsidy:	- 0 -	($40,000)	($40,000)
- external subsidy required to break even:	- 0 -	$40,000	$40,000

The shallow interest subsidy of $3000 allows apartments to be rented to middle-income tenants at affordable levels. This shallow subsidy allows the low-income units to benefit from internal and external subsidies totalling twice as much, and renders them affordable to low-income families.

ACCOMODATING PUBLIC AND PRIVATE INTEREST: SHAPING THE NEW PROGRAM

The Staff Task Force, as noted above, proposed that "a new program" be considered to replace the traditionally employed -- but now vanishing -- federal and state deep subsidies for rental housing production, "one which resembles the program envisioned by the 1968 MHFA statute where the concept of rent skewing was introduced."

This piece of legislation, Section 6(b) of the 1968 amendments to the MHFA enabling statute, provided that in "each project financed [by MHFA] ... not less than twenty-five per cent of the units ... shall be rented at all times to low income ... families. ... The remaining units ...shall be made available at rentals not lower than the below-market rental for the unit and sufficiently high as determined by MHFA to achieve and maintain a fiscally sound project."

Section 6(c) further provided that "rentals received ... in excess of the below-market rental .. shall be applied, pursuant to [MHFA] regulations .. to reduce rentals from the below-market rental to achieve and reduce adjusted rentals" for low income persons. "Adjusted rentals" were defined in the Act as the "below-market rent" (in turn defined as fair-market rent reduced on account of MHFA's lower, tax-exempt bond interest rate) further reduced by 10%.

The Staff Task Force was exploring new program options in an era of diminished resources. Significant, and potentially controversial changes in MHFA's legislative

underpinnings were proposed in an effort to devise an effective mechanism for vigorously stimulating housing production -- a mechanism that would minimize the extent of the state's financial contribution, while at the same time maximize the number of units of production that would be stimulated by such contribution.

For example, the Staff Task Force recommended that the proportion of units required to be reserved for low-income tenants in a project be reduced from twenty-five percent to twenty percent.

> By reducing the percentage of units allocated to low-income families to 20 percent MHFA would still be in compliance with applicable federal legislation and regulations ... yet would reduce the burden on a development in terms of the number of units that must be subsidized. Although this reduction might cause some concern in light of the test cases upholding the constitutionality of the Agency's enabling statute, a reduction of five percent in the number of units allocated to low-income families probably would not by itself be enough to ... be deemed unconstitutional.

Noting that the MHFA enabling statute had been amended to require that low-income tenants in projects not including rent-skewing pay thirty percent of their incomes as rent, rather than twenty-five percent, the Staff Task Force recommended that low-income tenants in rent-skewed projects be required to pay the same thirty percent of their incomes as rent.

> By raising the percent of annual income of low-income tenants to a higher percentage, such as 30 percent, the internal subsidy requirement of a project using rent skewing would be reduced. Again, such a change might prove troublesome because

> existing case law supporting the constitutionality of the enabling statute is based on a different and more restrictive standard. However, Agency legal staff feels that the change would ultimately be sustained.

Ultimately, the Staff Task Force Report concluded with the recommendation that MHFA "Work with Administration officials and Legislative leaders to encourage housing production through legislation to implement a shallow subsidy rental housing program, reducing the interest rate on MHFA loans to six percent for a period of 15 years."

By late March, of 1983, the work of the Governor's Task Force had generated a number of drafts of proposed legislative language for the new program. Additionally, economic policy analysis of the proposed shallow interest subsidy program had been undertaken by housing finance experts in both the public and the private sectors.

Special Counsel Rod Solomon submitted a draft that included both the new "Declaration of Necessity" -- a document which would serve to provide a constitutionally adequate policy basis for the proposed new program -- as well as the statutory language embodying the subsidy program itself. Though Solomon's language underwent substantial revision during the course of legislative drafting, its essential substantive points, and its sparely worded program description remained as the fundamental basis of the SHARP legislation:

APARTMENT PRODUCTION ADVANCE PROGRAM

Section 25. Declaration of Necessity.

It is hereby declared that there continues to exist in many cities and towns in the Commonwealth, an acute shortage of decent, safe and sanitary housing available at rentals which persons and families with low and moderate incomes can afford. This shortage is inimical to the safety, health, morals and welfare of the residents of the Commonwealth and the sound growth of the community therein. The depressed state of the rental housing production industry in the Commonwealth also has caused high construction-related unemployment, with similar ill-effects on the Commonwealth and its residents. Private enterprise cannot achieve adequate levels of rental housing construction affordable by persons and families with low and moderate incomes without the assistance provided pursuant to Section 26 of this Chapter. While the Commonwealth provides some housing production assistance for low-rent housing projects, this instance of significantly lower amounts per unit for the production of moderate-income rental housing would also help to alleviate the shortage of affordable apartments. It is, therefore, imperative that the cost of mortgage financing, which materially affects rent levels in units built by private enterprise and the incentives for private enterprise to proceed with rental housing construction or rehabilitation projects, be made lower to the extent needed to at least allow affordability by moderate-income persons and families and to stimulate rental housing production.

Section 26. Apartment Production Advances

(a) In addition to its other powers and to the extent of appropriations or grants or other financial aid directed to the purpose, the Department [MHFA] may operate an apartment production advance program. Such a program, on behalf of low and moderate income families who will live in the apartments and pursuant to rules adopted by the department, shall provide annual advances to facilitate construction or rehabilitation of such apartments. Such annual advances shall be applied toward rent payments and shall not exceed the difference between that

> portion of the rental for such units which is attributable to the mortgagor's interest payments and the amount which would have been attributable if the interest rate were 5% per annum.
> (b) To be eligible for receipt of an advance authorized by this section, an apartment project must be financed with obligations which are exempt from federal taxation or which carry an interest rate comparable to such obligations ... and at all times must have not less than 20% of its units rented to low or moderate income persons or families. All such advances shall ... become immediately due and payable in full upon the sale or refinancing of the apartment project; provided that the Department may waive such payment wholly or in part if it determines in writing that such waiver would serve the interests of the apartment production program.

Pat Clancy's "first attempt at language" contained similar elements:

> Section 26.
>
> "Rental project" shall mean projects consisting of the construction and rehabilitation of ... dwelling units in which no less than 25% of the dwelling units shall at all times for a minmum of 15 years ... be rented to persons or families who at the time of such persons' or families' initial occupancy of such dwelling unit shall be of low income....
>
> "Annual advances" means an amount not to exceed the difference between the (a) rental ... amount necessary to pay debt service on a newly constructed, well planned and well designed dwelling unit ... at prevailing interest rates and (b) the rental ... amount necessary to pay debt service at an interest rate of 5%.

General agreement upon the broad policy and the specific, legal outlines of the proposed new program appeared to have been reached during March of 1983. Yet to be determined was the feasibility -- in business terms -- of what was being proposed.

In light of the new program proposals, MHFA's Feasibility Analysis section tested three projects -- the Cox Building, in Boston, North Stoughton Village, in Stoughton, and the Weeks School, in Newton. Each of these projects was then under review at the Agency. Three tests were applied, as follows:

Test 1 was an unsubsidized alternative which relied upon rent skewing to reduce 20% of the units to rent level of 30% of 80% of median income. In the instance of the Cox Building, the rent level on 20% of the units was the existing 707 FMR's. [Fair Market Rents as measured under the state Chapter 707 rent supplement program.] It was assumed that the maximum market rents could not exceed 130 percent of median income for the area. None of the developments satisfied this test.

Test 2 The North Stoughton and Weeks School alternatives lowered the loan to replacement ratio [NOTE: this means that the developer's equity must be increased.] until the 130 percent of median income rent levels were obtained. In the instance of the Cox Building alternative No. 2 was not tested due to the poor market location and the results of Test No. 1. Test 2A in the Weeks School alternative adjusted the loan to replacement cost level to a more acceptable level. This adjustment indicates that unsubsidized developments are feasible in strong market areas.

Test 3 added interest reduction subsidy to North Stoughton Village and the Cox Building. In the instance of the Cox Building interest subsidy levels were reduced to the one percent level to meet the perceived market rent levels at that location.

This analysis indicates that rather than specifying an interest reduction level statutorily, consideration should be given to allowing administrative discretion in settling rates to reflect the market location.

In each case, the aim of the test was to determine whether market rate and low income tenants could afford to pay the rent required to support the project under a variety of subsidized and non-subsidized scenarios. Were these projects financially viable?

As noted, the Cox Building analysis indicated that an unsubsidized project, where the mortgage amounted to 90% of replacement cost, was inherently unfeasible: it would have required rents in excess of 170% of median income.

Application of the proposed shallow interest rate subsidy, combined with restructuring of the mortgage to a level 75% of replacement cost was also deemed unfeasible. This scheme would require not only that the developer put back into the job as a cash contribution some 90% of syndication proceeds, but would also require an interest subsidy of some $2100 per unit per year, as well as Section 707 subsidies of some $1200 per unit per year as well. Developers would not be interested in a deal of this type.

At that point, the question was posed: "What level of interest subsidy would generate market rents at approximately 30% of 80% level [30% of 80% of median income paid as rent] and still produce a deal which is attractive to a developer?

The answer -- in the context of a deal where the developer's contribution would amount to only 52% of syndication proceeds -- was a subsidy of approximately $4000

per unit per year. This would amount to the level of subsidy required to reduce the effective mortgage interest rate to 1%, the unacceptably expensive "deep subsidy."

The North Stoughton Village tests again demonstrated that where market rate rents exceed 30% of 130% of median incomes, projects are unfeasible. Where rents at this level could be structured, projects might be feasible from the point of view of a prospective tenant, but not necessarily from that of the prospective developer.

Again, the issue was framed in terms of the proportion of syndication proceeds which the developer would have to contribute to the job. Where this proportion held at approximately the 50% level, it was assumed that developer interest could be stimulated.

If the market rate rent was found to be lower than 30% of 130% of median income, the MHFA Feasibility Analysis staff noted, "additional subsidy must be added." When a sufficient interest rate subsidy to reduce interest to 6% was added -- along with developer contribution of 42% of syndication proceeds -- rent levels were achieved which were deemed "probably feasible in market areas that are reasonably strong." These rent levels worked out to be 30% of median income. Addition of Section 707 subsidies to this level of interest rate subsidy would further reduce rents for applicable, low-income units to the point where they would be affordable for tenants paying as rent 20% of 80% of median income.

The analysis of the Weeks School site, in Newton also indicated that persons paying not more than 30% of 130% of median income could not afford to rent unsubsidized apartment units. Again, reducing the loan to replacement cost ratio generated rents within the acceptable range. However, the cash contribution by the developer would, in this case, amount to more than 80% of syndication proceeds, and thus "would not be attempted."

However, the MHFA staff posited that in "a very strong market area like Newton it may be possible to attain rents above 30% of 130%." Where rents could be attained in the 135% to 140% range, a slightly less reduced loan to replacement cost ratio, and a developer contribution of 55% of syndication proceeds would produce "a combination that is probably both feasible and attractive to [developers]." No further analysis of subsidy schemes at the Weeks School project was necessary "because we have a feasible project."

The Feasibility Analysis tests appeared to make clear that in order to achieve maximum leverage of the minimum amount of shallow subsidy (1) developers were going to have to put back into their projects a great deal more equity and syndication proceeds than they had ever been used to doing, and (2) these type of shallow subsidy projects were best located in areas of genuine market strength, where healthy fair-market rents could be attained. Additionally,

these tests recognized the level of economic incentive which developers would expect -- and the level of risk they would seek to avoid -- in order to participate in the new program.

The private sector also offered its own analysis of the program's feasibility. The analysis undertaken for the Governor's Task Force by David Smith, George Fantini, and Edward Carman, of Boston Financial Technology Group (BFTG), a leading Boston syndicator and mortgage banking firm, was not concerned with particular projects. Their analysis focused on the feasibility of the proposed program itself: would the program, as it was proposed, be likely to succeed in the real estate market-place?

Describing the program as "a mortgage reduction subsidy which permits construction of affordable moderate-income housing with some expectation that the Commonwealth will eventually recover some or all of its subsidy commitment", BFTG raised five major, interrelated questions with respect to the proposed program:

> (A) How can this program be made compatible with both (1) private lending activity and (2) Commonwealth-sponsored lending?
>
> (B) Will the Commonwealth be willing to rely upon the rental marketplace to produce appropriate moderate rents, or will it insist upon regulating the operations and disposition of the financed property?
>
> (C) Over what term will the subsidy be issued? Will it be fixed or will it phase out? If it phases out, will it be a fixed or variable phaseout?

(D) How should the repayment be structured, from both a legal and from an economic standpoint?

(E) Recognizing that syndication of tax benefits will be the primary investment motive for this type of housing, what are the tax ramifications of the different structures?

BFTG's commentary on the proposed program was distinctly "real world"-oriented. Noting that "There is little or no conventional money available for long-tern fixed-rate financing of residential apartments", BFTG's recommendations began with the admonition that if conventional debt markets improved, "the simpler the program the better. Lenders will want to make certain that they understand the program and can apply it on a cookie-cutter basis many times."

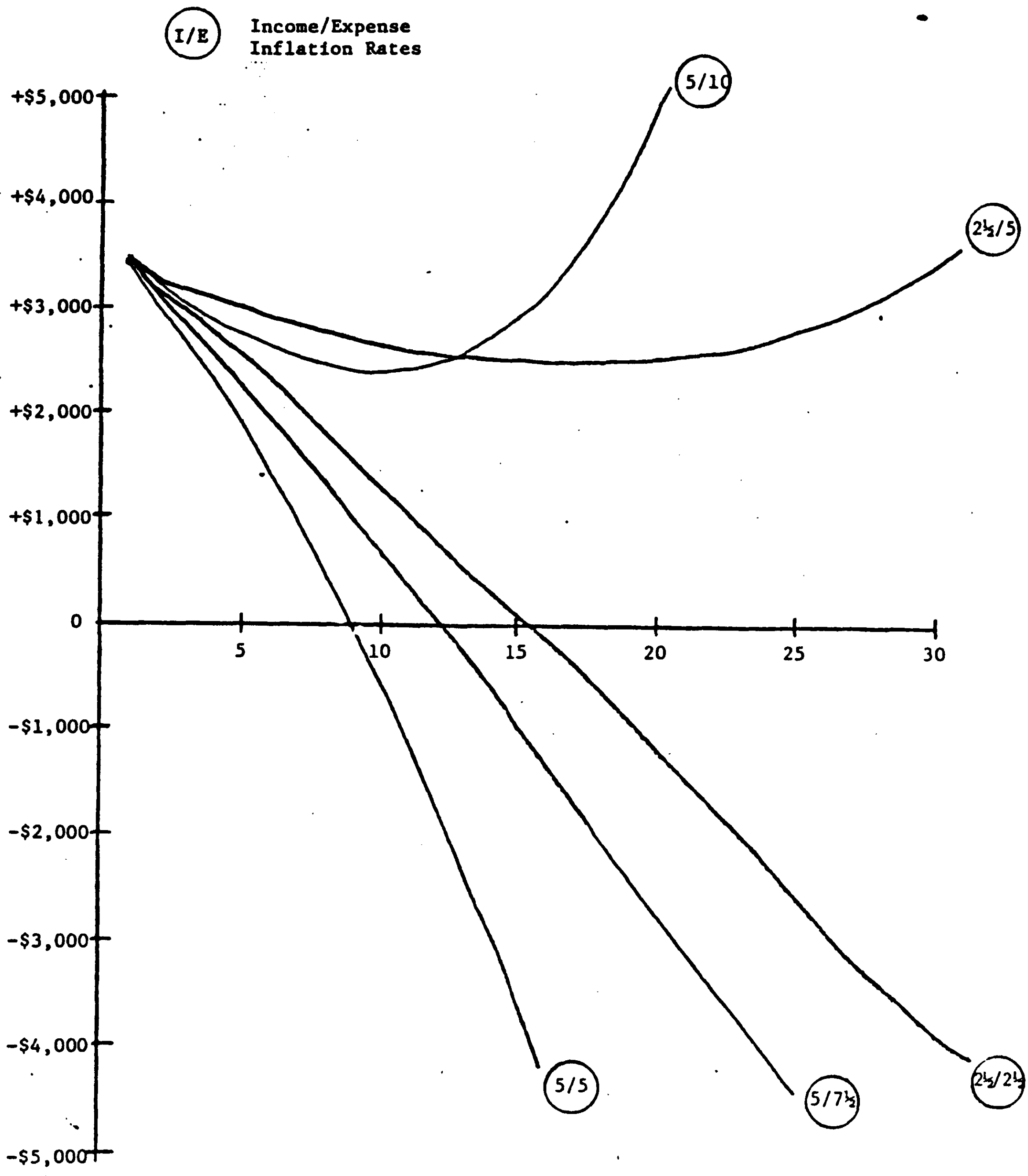
BFTG's views had been sought because of the firm's connections with the lending community, and because BFTG could be counted upon to present the views of the private housing finance community clearly and without equivocation.

> Lenders will make judgements based on conventional real estate analysis: coverage ratios of 1.25 or so, maximum leverage at some safe amount, and belief that the value of the assets exceeds the value of the loan. The regulatory instincts of the Commonwealth are generally incompatible with the idea of having substantial private lending.
>
> The Commonwealth may choose either of two mechanisms to regulate rents: (1) a regulatory agency, or (2) trusting the market. Letting the rental market dictate implies a belief that the rental market is like a tea kettle under pressure: building new units at whatever economic level will relieve the pressure across the board and lead to generally modulated rents. Insisting on government regulation is based upon a rejection of this premise.

> To induce private institutions to lend to properties which are encumbered by regulation, the lender will insist that the subsidy last the term of the mortgage. The lender will not accept the presumption that terminating the regulatory restrictions coterminously with the subsidy will automatically result in a sound property after the transaction (it's unreasonable to expect an entity which has been tied up for fifteeen years suddenly to begin flexing new muscles in the marketplace.) ... the Commonwealth, if it wishes to regulate operations of the property, must be prepared to subsidize in full the entire mortgage life. That avenue appears fiscally unacceptable, but the consequences of rejecting that road are significant. Specifically, if the Commonwealth insists on a subsidy phaseout, it must accept that it cannot regulate the operations of the property -- even a little bit. To a private lender or developer, there is no such thing as being "a little bit regulated" .... this further implies a legislative exemption from state or local rent control.

The control and regulation issue was a significant concern of the authors of the new program. After all, rent increases on the market-rate units were the central mechanism by which the program would allow the subsidy to phase itself out. Pat Clancy's earlier model for the subsidy program had posited that it would be "phased out by increased rents" over a fifteen year period, with annual rent increases limited to five percent, while Wes Finch's earlier model had proposed a ten year phase-out, relying on annual rent increases averaging approximately eight percent to reach this result.

The effect of varying rates of rent increases on the ability of a project to phase out its subsidy over time was illustrated in a graph that Bob Kuehn distributed to the Governor's Task Force at its February 25, 1983 meeting.



Annual Subsidy Cost/Unit
(13B interest rate reduction from 12% constant to 6.5% constant)

Kuehn's graph shows clearly how a subsidy amounting to $3,300 per year [sufficient to reduce interest costs from 12% to 6.5%] could be phased out entirely in less than ten years -- if rents were allowed to rise by 5% annually, and so long as expenses did not inflate at any faster rate than income [rents]. As the rate of expense inflation increased, the length of time it would take to phase-out the subsidy would also naturally increase. If the rate of expense inflation doubled the rate of income inflation however, the subsidy itself would inflate, and could never be phased out.

Since projects developed under the proposed program would depend upon internal subsidies generated by their primarily market-rate units, BFTG's point concerning rent controls and regulations was that these kind of devices that had the effect of suppressing rent increases, or encouraging expense increases, would be self-defeating, in terms of overall program aims.

BFTG pointed out that it was in the economic best interest of the program for the subsidy to phase out; that is, the cost of a subsidy which phased out amounted to approximately one-third (on a present value basis) the cost of providing a subsidy over the full term of the mortgage.

Additionally, BFTG noted that phasing out the subsidy (by raising rents and incomes) would encourage "developer profit". This phenomenon would, in BFTG's words, "provide optimum soundness" of the program's rental housing

portfolio. At the same time however, BFTG also took note of potential, negative public policy implications of the same phenomenon: encouraging developer profit "may be perceived as pro-landlord and politically unappealing."

BFTG also pointed out that phasing out the subsidy would "hold the developer to an increasing standard", by encouraging rents to rise until project net income reached "current market levels." If rents increased at a rate equal to the current rate of inflation, and expenses rose at the same rate, "the true cost of the housing (after inflation) would not increase yet the subsidy would phase out." As BFTG noted, "This is actually a plus -- it indicates that the program is feasible -- but would probably be perceived as a minus" (because it would appear to restrict rent increases).

BFTG looked at the subsidy phase-out issue from the point of view of the developer. The advantage to having the subsidy phased out over a fixed, fifteen year period, in level annual amounts, would be that such a program would be understandable, uniform, and lead to "maximum developer incentive." That is, developers who achieved income levels in excess of the subsidy requirements would gain larger profits. At the same time, failing to meet minimum income levels would mean that the subsidy would be insufficient, and the developer would have to inject further equity into such a project. As BFTG pointed out, such a rigid structure and schedule might "lead to early defaults" if projected income levels were not attained.

A variable phase-out of the subsidy -- that is, phasing out the subsidy by an amount which would differ from year to year, based upon actual project performance measured against initially projected performance -- would, in BFTG's view, also constitute an understandable program, and would also have the positive attribute of allowing "different properties to proceed at different rates."

Tying the phase-out to a performance standard which compared original projections against actual results would eliminate "the current unsatisfactory situation where, because syndication proceeds are a function of mortgage, [the larger the mortgage, the greater the syndication proceeds] developers have an economic incentive to inflate projected NOI by underestimating expenses and overestimating rents." BFTG's preferred variable phase-out scheme would operate in a manner that "holds the developer to the standard he himself set."

Such a performance-based program would require considerable monitoring, and would not be "as simple for a lender to understand." An additional draw-back, according to BFTG, was that the variable phase-out would be an "awkward mechanism if a property backslides or if the developer takes out all surplus cash in early years but cannot cope with decreasing subsidy."

Refelecting its knowledge of the culture of developers and lending institutions and developers, BFTG preferred the fixed phase-out "if only because of its simplicity, unambiguity and absence of reliance on regulation, monitoring or compliance." While the fixed phase-out mechanism would "probably [be] more marketable to private lenders", such a program would also be admittedly "less flexible."

Under either scheme, in BFTG's analysis, the need for rent increases in order to phase out the subsidy carried with it certain unavoidable public policy implications.

> Declining subsidy implies an absence of rent control, for two reasons: (a) declining subsidy implies consistently increasing NOI, which is antithetical to the principles of rent control; (b) declining subsidy is based on the judgement that the production of housing will modulate rents. Tainting this perception by permitting the introduction of rent control will tilt the risk/reward ratio and scare away developers -- in effect becoming a self-fulfilling prophecy....Therefore the legislation should incorporate specific exemption from all state or local rent control ordinances for any property constructed under the funding program. This is consistent with any rent control statutes now on the books, all of which exempt construction after a date certain.

While there were discussions during early stages of the development of the program about treating the subsidy as a grant (the 13A deep subsidy was a grant program), it was felt for both tax reasons and political reasons that the subsidies should be treated as loans.

As a grant, the subsidy might be subject to political attack, as overly generous to private developers. BFTG expressed its concern that "[the] Commonwealth could be perceived as simply providing cash flow straight through to [the] owner." [This is, of course, the phenomenon illsutrated by Pat Clancy's earlier examples.] BFTG warned that this would be "unappealing politically and hard to defend unless you understand the overall concept."

Developers active in the process of shaping the new program felt that if the program were structured as a loan rather than as a grant, it would be more likely to receive legislative approval.

From a constitutional, legal standpoint as well, treating the subsidy as a grant might be viewed as questionable. The Supreme Judicial Court had noted in the New England Merchants Bank case that MHFA could not impose upon its mortgagees terms that were "too burdensome." At the same time however, if MHFA's terms were "too favorable", in order to pass constitutional muster, any "excess profits must be applied to rent reductions" and "dividends" and "nondistributed profits" would have to be "restricted" and "regulated".

From the tax standpoint, the subsidy as a grant would simply increase project income, and would adversely affect the project's ability to generate the losses which would be counted upon to lure investors to the deals.

From the point of view of real estate financing however, an obligation to repay the subsidies if they were to be treated as loans -- particularly if such loans were to be interest-bearing -- could be troublesome. Such a repayment obligation might "eliminate residual potential for developers, a component believed to be integral to financially sound housing and private institutional lender participation."

As has been previously discussed, equity syndication was the mechanism by which developers under this program would be expected to raise the money representing not simply the difference between the mortgage which they would receive from MHFA (amounting to something less than 100% of replacement costs -- more likely in the 80% range), but also such money as would represent their profit.

BFTG noted that generally, in residential projects, syndication proceeds could be expected to represent roughly twenty to twenty-five percent of the mortgage amount. Treating the subsidy as a loan to be paid back in accordance with a properly structured mechanism could dramatically increase the value of the syndication. According to BFTG, treating the subsidy in this manner, depending on the amount of the subsidy, could increase the value of the syndication by some fifty to one hundred precent.

"It's evident," said BFTG (in the sort of language that by itself might have provoked the anti-tax shelter zeal of current tax reform efforts), "that the choice of mechanism has a compelling effect on syndication value to developers. Further, there seems no reason for the Commonwealth to seek to minimize developer profit: essentially, the increased syndication proceeds represent a de facto subsidy from the Federal government (IRS) to the property (owner)."

This was not to say that creating such a mechanism would be a simple matter. BFTG pointed out a number of serious legal and accounting problems which would afffect the favorable tax treatment of projects put together under the proposed new program. The implications of all of these were complicated, but these complicated implications were summed up by BFTG as follows: "Translation -- no deductions to sell to anybody."

BFTG drew its own conclusion as to what the program needed, and how this might be obtained: the program would "need some very smart tax lawyers" and would "also need IRS to provide a favorable on-point ruling before going forward -- or at least a binding indication." This latter item was "probably obtainable by political methods before legislation is approved."

The final draft of the Report of the Governor's Task Force was completed the first week of April, 1983. Examination of the final draft, and the two versions of the

Report drafted and negotiated during March, provides ample evidence of a significant process of give-and-take between the public and private sectors.

The areas where this process may be seen most clearly have to do with the length of the subsidy, the contribution by developers of "their own equity, as well as part of their syndication proceeds", allowable return on developers' equity, and the phase-out and pay-back of the subsidy loan.

The first draft of the Report sought to limit the "length of time for state commitment of subsidy ... to 10 (or at most 15) years." This was changed to a straight fifteen years in subsequent drafts. Developers favored a longer period of subsidy period, seeking the maximum insulation from market risk.

Each draft contained a statement of "Guiding Principles" that included the following language: "The commitment of state funds should leverage substantial private investment in housing." The first draft however, went on to state "developers should be required to invest their own equity, as well as part of their syndication proceeds, in the project."

By the second draft, the private sector developers had considerably watered down this language; the phrase now read: "developers may be required to invest ...."

The developers managed to kill it off altogether; all references to developer investment of any sort were dropped from the final draft.

This same issue was debated in the context of another section of the Report. In a section entitled "Financing Programs", the first draft, essentially reflecting staff views, contained the following: "Each project would need to be financially feasible and viable on its own. Developers would be required to invest their own equity, and syndication proceeds as well, as necessary, to make the project work."

Again, the subsequent draft expressed the developers' view. The language was changed to "... developers may be required to invest ...."

The final draft contained neither version, but instead completely re-wrote the second sentence of the paragraph. Further diluting any suggestion that developers might be "required" in any manner to invest "their own equity" or syndication proceeds, the final draft appeared to leave the decision whether to invest equity or syndication proceeds entirely up to the developers: "In order to satisfy underwriting standards, developers may need to invest their own equity, and syndication proceeds as well, as necessary, to make the project financially viable."

Reflecting staff views, the first draft contained no reference of any sort to developers' return on equity in the section entitled "Financing Programs." Deserving of at least a "nice try" -- particularly in light of their having already taken the bite out of any suggestion that they be required to invest any equity in the projects -- the developers inserted into the second draft the following bit of wishful thinking: "Since greater equity investments will be made by developers, the maximum allowable return on equity would be raised to 10%."

The same language appeared among the second draft's Proposed Legislative Changes section as well. Not surprisingly, the final draft contained none of this language.

The Proposed Legislative Changes section of the second and final drafts were quite different from each other in other respects as well. Each contained a sort of preamble in language almost identical in each draft:

> Some of the recommendations outlined above [in the body of the draft report] can be accomplished within the existing statutes; others will require legislative changes. The proposed legislative changes are outlined below. It should be noted that many of the specific program details are not included in the legislation.

The second draft added the following sentence: "The Task Force's recommendations on these programmatic issues will be embodied in a subsequent report."

Perhaps by the time the final draft was negotiated the Task Force members were no longer so eager to produce yet another report; their offer to do so did not reappear in that document. The final draft's Proposed Legislative Changes section did include a clear statement of the Task Force's concerns over the constitutional legal issues with which they were grappling:

> In order to avoid a possible constitutional challenge which would engender a court test, care should be taken in drafting the proposed legislation [within] the confines of existing case law. This required that projects be either: (1) located in blighted open areas or decadent or substandard areas; or (2) be primarily designed to serve low and moderate income persons.

The second draft listed, under Proposed Legislative Changes, a fairly detailed and legalistic summary of the new interest subsidy program, including, within quotation marks, specific legislative laguage for calculating the extent of the subsidy. Additionally, the draft prescribed the procedure whereby EOCD would "enter into contracts with developers of rental projects, in which 25% of the units serve low-income tenants for a minimum of 15 years" upon condition that the Secretary of EOCD make certain "findings":

> (a) there exists a shortage of decent, safe and sanitary housing at rents affordable by persons and families of low income within the general housing market area;
>
> (b) the project itself is designed to house persons and families of varied economic means, and will not contribute to undue concentration of low income families in any one neighborhood.

(c) the overall financial structure of the project will ensure that 25% of the units will be at rental levels that meet the requirements of state and federal rental assistance programs.

(d) the amount of the payment to be provided appears to be the minimum necessary to make the project feasible and able to meet the above conditions.

The final draft adopted a different approach, simply directing that "(1) A new state program to stimulate the development of mixed income rental housing projects should be established ... administered through EOCD ... financial assistance could be provided to qualifying projects ... financed through MHFA, other state agencies, ... pension funds, or private lending institutions."

Other terms and conditions were stated in general language:

(2) To qualify, rental projects should provide at least 25% of their units for low income tenants. (Note: Rental assistance would be provided through existing federal and state programs.)

(3) Projects should either be located in a "housing development area" (blighted open, decadent, or substandard areas), or (b) designed primarily to serve low and moderate income tenants.

(4) The financial assistance should be in the form of a loan, and should be subject to repayment, unless the Department provides an alternative repayment plan.

(5) The financial assistance should be provided for a term of up to 15 years, and should not exceed the difference between ... debt service ... at prevailing tax exempt rates ... and ... 5%. Typically payments would be scheduled so as to phase out over the term of the contract for assistance.

THE SHARP LEGACY

The end result of the negotiation of the drafts was the program that is embodied in the SHARP legislation. Regardless of whatever else the program accomplished, the program exemplified a most sophisticated financing vehicle for rental housing, expertly tailored to meet the tax Code-oriented requirements of the syndication-dependent "assisted housing junkies" (Bob Kuehn's phrase).

Additional losses on account of the accrual of interest on the SHARP subsidy loan, combined with losses thrown off on account of the fifteen year accelerated depreciation able to be taken by low-income housing deals, made SHARP projects the "perfect loss-driven syndication products", according to one developer.

This same developer however, noted that the program demanded more market-oriented skills than assisted housing developers had ever been required to attain.

As CHAPA's June 1983 newsletter noted, reporting on the work of the Governor's Task Force,

> The marketability of the units are the responsibility of the developer. To make these projects feasible, the task force estimates, the developer may have to begin with a greater equity investment than in the past, and he may have to use other resources, such as reinvesting some of the syndication proceeds, to lower the rents of the market units, and make the project marketable.

Traditionally, assisted housing developers had virtually no responsibility for "marketing" their units. Low-income tenants bearing government rent subsidies were abundantly available to fill up these projects. Thus assisted housing developers subjected themselves to virtually no risk, insulated as they were from the need to respond to market demands in order to attract tenants, and with virtually all their development costs covered by mortgages.

These developers were able to put up a Section 8 project, and walk away from the table having put into their pockets -- essentially as pure profit -- virtually the entire proceeds of the project's syndication. These proceeds would often amount to as much as thirty or forty percent of the project mortgage amount.

These deals neither required, nor encouraged developers to make money from the operation of their government-assisted properties. Investors sought only losses with which to shelter income from other sources. Government regulations limited cash flow to owners, capped rent increases (in some instances, even where expenses, as in the case of the mid-1970's oil price shock, escalated wildly), and locked in these, and all manner of other controls on the properties for twenty years or more. Under these circumstances, developers could not have been expected to have dealt with their properties with much of an eye toward future, residual values.

Yet SHARP demanded that these same developers adapt to what was essentially a new, and far riskier culture: one that was income-oriented, attuned to the marketplace, and focused toward building genuine residual value. Developers would be entering into fifteen year contracts with the state that would, to be sure, provide the developer with an annual SHARP subsidy that was agreed to in advance for the full fifteen year term. This annual subsidy payment was based entirely upon the developer's projections of future project performance however, and was programmed to shrink, year by year, until the subsidy completely disappeared.

To the extent that Massachusetts has continued to enjoy its healthy economy, and to the extent that this condition translates into robust rental housing markets, the assisted housing developer's transition from the risk-free, pre-Reagan world to the more perilous, performance-driven, market-oriented world of the pre-tax reform SHARP program may have been facilitated. After all, SHARP deals were structured to work best in a world where the future always exceeds projections.

The development community appears to have responded to the challenge. MHFA's most recent report indicates that as of June 30, 1986, sixty-four SHARP projects, encompassing 7,707 new and rehabilitated apartment units -- some 2,000 of which would be reserved for low-income tenants -- had been

approved for funding in the course of three, annual approval cycles. Absent tax reform, had all these projected SHARP deals proceeded on schedule, annual appropriations to fund the subsidy payments over the fifteen year period ending in the year 2000 would total in excess of $153,000,000.

What is unremarkable about this large number is how small it really is, in relation to what it might have accomplished. After all, the $153,000,000 total represents an average annual subsidy of less than $1400 per unit per year; less than $20,000 per unit, in total over the fifteen year life of each subsidy. What is remarkable though, is that such small numbers stimulated such a rapid and productive developer response to the state's acute shortage of affordable housing.

This response is the true legacy of SHARP.

A P P E N D I X

Revised 1/17/86

PROGRAM GUIDELINES

State Housing Assistance for Rental Production (SHARP)

Commonwealth of Massachusetts
Michael S. Dukakis, Governor

Executive Office of Communities and Development
Amy S. Anthony, Secretary

Massachusetts Housing Finance Agency
Bernard Singer, Chairman

January 1986

I. BASIC PROGRAM OUTLINE

State Housing Assistance for Rental Production (SHARP) is a State program enacted in December, 1983 by the Legislature and signed into law by Governor Dukakis. The program was established to address the critical and growing need for affordable rental housing in the Commonwealth, while recognizing the limitations of the State's ability to subsidize private housing development.

The need to stimulate the development of additional rental housing is widely recognized. While the State's population growth has stabilized, the rate of growth of households continues--with an 18% increase over the past decade --and overall demand for housing has escalated. At the same time, new housing production has not kept pace with demand, particularly in the area of rental housing.

The primary purpose of SHARP, therefore, is to expand the supply of rental housing in the Commonwealth. The program is designed to encourage types of housing development which the private sector could not accomplish without some form of government aid. Since there is an overwhelming need for housing which is available to low income households, SHARP requires that 25% of the units in each project be available to such households. **In general, occupancy may not be limited to particular types of households, such as the elderly.**

SHARP projects should add units to the housing stock. The program is not geared toward the repair of basically sound existing housing. Generally, projects receiving SHARP subsidy should involve new construction or substantial rehabilitation of vacant structures. Relatively moderate improvements to occupied (or partially occupied) buildings will be permitted only when SHARP subsidy constitutes the only way to prevent imminent loss of the units from the housing stock.

The Massachusetts Housing Finance Agency (MHFA) will provide permanent financing and EOCD will provide SHARP funds to write down the cost of interest payments to a level generally no lower than 5% (annual percentage rate), for a term of no more than 15 years. It is expected that most SHARP projects should become self-sustaining over this 15 year time frame. The state subsidy is a loan, not a grant, and must be repaid to MHFA; however, the statute allows repayments to be recycled back to a project when such a plan will clearly benefit low and moderate income tenants. In all cases, the subsidy must be the "minimum amount necessary" to ensure project feasibility.

Developers may submit proposals to MHFA at any time. The Agency will at that time conduct a threshold review of each project, after which MHFA may grant the project "Official Action Status"-(OAS) . This status will, in no way, confer upon the proposal any priority for--or guarantee of--SHARP subsidy. OAS indicates only that MHFA has granted preliminary approval to the development team, the proposed site, the development concept, and the marketability of the units. No underwriting of project feasibility will be carried out at this stage. No OAS's will be granted once a competitive review is underway (see below).

From time to time, EOCD and MHFA will announce a deadline for a competitive funding round. In order to be considered for SHARP funding, all applicants must submit complete SHARP proposals as specified for the current funding competition. This applies to all proposals, including those that may have already received OAS. The competition will involve: (a) a review against minimum standards; (b) a ranking of those proposals meeting minimum standards according to established selection criteria; and (c) a final selection for funding. Any special funding priority will be identified in the announcement. For those projects selected, MHFA will reserve SHARP subsidy, subject to full underwriting review, and will invite the developer to submit a full mortgage application. MHFA may also select projects to receive priority status for future funding availability.

In order to assure that SHARP funds are used as efficiently as possible - and generate actual housing development as quickly as possible - MHFA will carefully evaluate the likelihood of the project reaching a construction start in the near future. Proposals which have received required local approvals in advance of the SHARP competition will be in a better competitive position.

Section III (Project Selection Criteria) contains a more detailed explanation of the review procedures and the standard funding priority considerations.

II. FINANCING

By statute, the SHARP program may only provide "the minimum amount necessary to make the proposed rental housing project feasible, and to ensure that 25% of the units will be occupied by persons and families who are, at the time of initial occupancy, of low income."

SHARP provides an interest-reduction subsidy designed to bridge the gap between "cost-based rent" and "attainable rent." "Cost--based rent" is defined as the rent needed to support the mortgage

loan and operating cost of a project. "Attainable rent" is defined as the maximum rent at which units can be rented on the open market; in the case of units set aside for low income households, the attainable rent shall be no higher than the published Section 8 Existing Fair Market Rents, with allowance for a maximum annual trending rate of five percent. The low income portion of the develoment will be available for households which hold Section 8 or Chapter 707 rental assistance certificates. Developers will market these units to current holders of Section 8 and Chapter 707 certificates. However, should the developer be unable to fill all low-income units with current certificate holders, EOCD will assign Chapter 707 rental assistance funds to any unrented low-income units in order to prevent the loss of rental income.

In computing the replacement cost of a project, a developer should consider generally accepted development costs such as acquisition, rehabilitation and construction costs, site clearance and preparation, as well as architectural/ engineering fees, bond fees, legal and accounting expenses, construction loan interest, real estate taxes paid during construction, insurance, title costs, developer's fee, and MHFA and other financing fees.

Equity participation by general partners must comply with the following MHFA/EOCD policy for the SHARP program. The owner's contribution in SHARP developments will approximate twenty percent of the total project cost or project value and will consist of the following:

1. The developer's fee of ten percent of project costs exclusive of land allowance.

2. Standard cash required at initial closing, expected to approximate two percent of the mortgage amount.

3. Standard operating period letter of credit in a minimum amount of four percent of the mortgage amount, which can decline by one percent per year after each full year of operations at positive cash flow.

4. Additional operating letter of credit for a term of five years in the amount of four percent of the mortgage amount. The amount of this letter of credit may be reduced by any developer's initial closing cash contribution in excess of two percent or by the present value of any direct operating subsidy that the developer will guarantee to

provide to the development. Any balance remaining after five years of operations will be applied for the benefit of the development, in a manner acceptable to the Agency such as to build up reserves or to pay back or reduce SHARP payments.

Compliance with this policy will enable MHFA and EOCD to make the required statutory finding on the minimum SHARP amount necessary. Public funds from programs such as UDAG, HODAG, and CDBG cannot be considered as owner's contributions or equity. However, non-profit or other developers with limited equity resources may use contributions from foundations or other sources as a portion of equity. During mortgage application processing following the award of SHARP, the Agency may require a higher level of equity contribution if necessary to achieve project feasibility and to meet financing program requirements.

Operating costs should include the cost of project administration, management fee (to be established as six percent of gross rents excluding subsidy, or five percent of gross rents including subsidy with a minimum requirement of $300 per unit) routine and preventive maintenance, utilities, insurance, security, and real estate taxes. A replacement reserve of 3/4 percent of the direct construction cost with a minimum of $275 per unit should also be included. The developer should build in a vacancy allowance of at least five percent. Adequate provision should be made to meet 110 percent debt service coverage requirements. Net income for return on equity should not exceed 6%. The applicant should submit a market analysis indicating number and type of units and indicating that the actual project rents to be charged after inclusion of a SHARP subsidy are supportable in the market area.

According to the statute, the SHARP subsidy "shall not exceed in any one year, on a per unit basis, the difference between the amount determined by EOCD to be necessary to pay debt service on a typical, newly constructed rental housing project at prevailing interest rates on bonds whose interest is tax exempt from federal or state taxation, and the amount necessary to pay such debt service at 5% per annum."

For example, let us assume that the typical mortgage loan for a newly constructed two-bedroom unit is $60,000, and the prevailing tax exempt interest rate is 11%. Annual debt service on such a unit is $6,901; annual debt service on the same unit would be $3,903 at 5% annual percentage rate. The difference, or $2,998 per annum, would be the maximum allowable SHARP subsidy. Periodically, EOCD and MHFA will issue a schedule of maximum permissible SHARP subsidies by bedroom size. This schedule will be

updated when necessary to reflect significant changes in construction costs and the level of tax-exempt interest rates.

The Commonwealth may grant SHARP subsidies up to the maximum level described above even if development costs are lower than those for a typical, newly constructed project. For example, the infusion of a subsidy (such as Community Development Block Grant or an Urban Development Action Grant) or the use of lower-cost construction methods may reduce the development cost per unit without reducing the maximum permissible SHARP subsidy. In any case, the developer must provide evidence to MHFA to demonstrate that the requested SHARP subsidy is the minimum amount necessary to ensure project feasibility and to make the rents marketable in the given area.

Since the term of a permanent mortgage may significantly exceed fifteen years, the project should be self-sustaining during the later years of permanent financing. Typically, it could be projected that supportable attainable rents will grow more quickly over the term of the permanent mortgage than cost-based rents, which are closely tied to fixed debt service costs. Not only should this trend allow a project to become self-sustaining by its fifteenth year (or earlier) but it should also allow the "minimum amount necessary" to decline during the term of the subsidy. The decline in the "minimum amount necessary" to ensure project feasibility will allow a gradual reduction in SHARP subsidy during the period for which subsidy is granted.

An applicant should build the gradual reduction of SHARP subsidy into the proposal's projected long-term operating budget. Gradual increases in "attainable rents" may be fixed to a specific percent, or pegged to a commonly accepted index. If assumptions about inflation prove accurate, then the reduction in subsidy will be possible. Further, if net income is higher than anticipated, the additional income will serve to reduce the amount of future SHARP required.

For example, let us assume that a project receives a SHARP subsidy of $2,998 per unit during its initial year. The developers, anticipating increased "attainable rents" during the remaining years, may suggest a gradual reduction in SHARP subsidy throughout the fifteen-year term of the subsidy. Consider the following example, in which the subsidy declines by 6.6% annually:

Project Year	SHARP Subsidy/Unit
1	$2,998

2	2,798
3	2,598
4	2,398
5	2,199
6	1,999
7	1,799
8	1,599
9	1,399
10	1,199
11	999
12	799
13	600
14	400
15	200

Under another scenario, the level of SHARP may be lower initially and may decline more slowly during the later years of the fifteen-year term. Consider the following example:

Project Year	SHARP Subsidy/Unit
1	$2,298
2	2,198
3	2,098
4	1,998
5	1,899
6	1,799
7	1,699
8	1,599
9	1,499
10	1,399
11	1,299
12	1,199
13	1,100
14	1,000
15	900

Note that in each of the above cases, the total SHARP subsidy per unit is $23,984, for the full fifteen-year term, and the average annual SHARP subsidy per unit is $1,599. Developers should recommend subsidy reduction schemes which suit their project needs, as long as the total subsidy per unit is the minimum amount necessary in accordance with the objectives of the statute. The contracted first year's SHARP total will be the maximum permitted for any one year over the term of the contract. Further, waivers to the developer's proposed schedule for SHARP decline will be considered on a case-by-case basis only where general market conditions beyond the developer's control have

jeopardized project viability.

SHARP is designed as a loan, not a grant. Developers should expect to repay the subsidy at some point in the future. However, in order to protect the financial integrity of the project, there will not be a requirement of a "balloon" repayment at the end of the fifteen-year term. Instead, SHARP subsidies will be repaid as the project can afford to do so, but in any event at sale and/or refinancing, which may take place at termination of the SHARP subsidy or later during the term of the mortgage. At that point, MHFA will recover either the full outstanding balance due of SHARP subsidy, or a negotiated percentage of at least fifty percent of the sale proceeds, whichever is lesser. If this payment does not cover the entire repayment of SHARP subsidy, then the unpaid remainder will be scheduled for later payment. Interest on the SHARP loan will be calculated at a rate of five percent per year, except that this rate may be reduced by the EOCD and the Agency depending on the need for such funding to protect low-income residents after the SHARP subsidy ends.

The statute requires that the proceeds of repayment "shall be used for the benefit of low and moderate income tenants pursuant to this program." This means that MHFA may allow the repayment proceeds to be used to maintain the low income component of the development. Applicants may recommend such a "recycling" of all or part of the repayment proceeds when they can justify that such recycling is necessary for the benefit of low and moderate income households, in accordance with the provisions of the statute.

When applying for SHARP, developers should explain how the interest of low income residents of the development will be protected after the SHARP subsidy ends. For example, if the development will be converted to condominiums, the developer might develop a program to assist the low income tenants to purchase their units, or to retain them as reasonably priced rental units. Under another scenario, the developer might transfer the units to the local housing authority at sale or refinancing. If the developer is requesting a recycling of SHARP repayment proceeds, he should explain specifically how the funds would be used to prevent displacement of the low income tenants.

III. PROJECT SELECTION CRITERIA

SHARP applications will be reviewed via a three-tier process. When MHFA receives a SHARP application, it will determine if the application meets the minimum requirements for the program. These requirements will be those normally applied when reviewing applications for OAS, plus others which relate to the particular stipulations of the SHARP statute. The second phase of the

competitive review will involve a ranking according to established selection criteria. The third phase will be the final project selection. Only after this selection will applicants be asked to submit a mortgage application for underwriting review.

Minimum Standards:

All projects must meet the following statutory criteria, according to the legislation creating the SHARP program. Several of these criteria are described in more detail in the Financing section of these guidelines.

a. Fifteen-year term: The project must demonstrate that it will be able to sustain itself after the term of the SHARP subsidy has run out (this may not exceed fifteen years). This will be determined based upon the applicant's submission of operating pro forma statements for three years beyond the final year of SHARP subsidy acceptance.

b. Maximum per unit subsidy: The amount of SHARP subsidy "shall not exceed in any one year, on a per unit basis, the difference between the amount determined by EOCD to be necessary to pay debt service on a typical, newly constructed rental housing project at prevailing interest rates on bonds whose interest is exempt from federal or state taxation, and the amount necessary to pay such debt service at an interest rate of 5% per annum". Periodically EOCD and MHFA will issue a schedule of maximum permissible SHARP subsidies by bedroom size. This schedule will be updated to reflect significant changes in construction cost and the level of tax-exempt interest rates.

c. Minimum amount necessary to ensure feasibility and 25% low income occupancy: The SHARP subsidy shall be "the minimum amount necessary to make the proposed rental housing project feasible, and to ensure that 25% of the units in such a project be occupied by persons and families, who are, at the time of initial occupancy, of low income." Requests for SHARP subsidy will be considered the "minimum amount necessary" only if the developer is investing an equity amount determined in accordance with the owners' contribution standards outlined herein. **Only developments which require SHARP for economic feasibility can be considered for award of funds.**

d. Location of project: The project must be located in a "housing development area," as defined by the statute, or the project must be "a low and moderate income rental housing project," as defined by the statute. A housing development area is "any blighted open area, or any decadent area, or any substandard area" as defined in Chapter 121B of the General Laws. To obtain designation as a housing development area, the developer must submit appropriate information, along with certification from local officials, to MHFA; MHFA in turn will request the required designation from EOCD during mortgage commitment processing. (In certain cases, EOCD may waive the need for local certifications.)

e. Undue concentration: MHFA must be satisfied that it can certify that the proposed project is itself designed to house persons and families of varied economic means, and will not contribute to undue concentration of low-income persons and families in any one neighborhood.

f. Repayment: A SHARP subsidy repayment plan must be developed and submitted to MHFA following the format shown in the Appendix. If a developer proposes a recycling of the repayment back to the project, this plan should indicate how the repayment will benefit the low- and moderate-income tenants.

In addition to the statutory requirements listed above, minimum standards will include several other elements:

a. Quality of development team: MHFA will assure that the development team is complete, and that it consists of experienced and responsible members. The team should include a mortgagor/owner, developer, contractor, architect, management agent, and attorney. The development team must be current in all its obligations to MHFA and must have the financial resources, acceptable credit history, measurable acceptable housing experience in both development and management, acceptable equal opportunity track record, and adequate staff to carry out the proposal.

b. Preliminary site review: MHFA will determine whether the proposed site is suitable for the suggested development. It must have available, or planned, all necessary and appropriate utilities

and community facilities. The developer must demonstrate control of the site.

c. Marketability of units: Rent levels and area demand for the market units must ensure that they are marketable, considering project location and the quality of the units to be produced. **In general, occupancy may not be restricted to the elderly. Further, based upon marketing experience to date in the program, in general we will not permit 0-bedroom units to be planned for low-income occupancy (except for the preservation of current single-room occupancy housing where a need for such housing exits), and will limit the number of one-bedroom units so designated. Subject to these limitations low-income units should be distributed proportionately across unit sizes.**

d. Affirmative Action: The proposal should contain plans from the developer to affirmatively seek minorities and women for professional services,construction and permanent jobs and contracts, and to develop an acceptable affirmative fair housing marketing plan for rental of the apartment units.

NOTE: Misrepresentation of any material element in the proposal may be grounds for rejection.

Selection Criteria

During the competitive review, projects will also be reviewed and scored to determine how well they meet certain policy objectives of the SHARP program. This review will cover the following objectives in three categories:

A. Development Quality Goals: **10 points each, maximum of 50 points. Projects must score a minimum of 30 points and have an acceptable design in order to remain in the competition. The Agency reserves the right to reject proposals that appear to be inherently economically infeasible.**

1. Design. The quality of the proposed design, including life cycle costs and the treatment of special environmental conditions, will be reviewed for each project.

2. Development Team. The track record and capacity of the development team will be carefully reviewed. Successful experience with similar or larger sized projects of comparable complexity will be a critical element of the review.

3. Site. The proposed site should be suitable for housing. The necessary utilities and amenities should be presently available, or planned as part of the development. Zoning and site control will be reviewed.

4. Management. The prospective manageability of the development, the quality of the management plan, and the experience and capacity of the management agent will be carefully evaluated.

5. Marketability. The likely ability of the units to be marketed at the proposed rents will be carefully reviewed.

B. Overall Impact Goals: 10 points each, maximum of 40 points

1. Community impacts. Projects with demonstrable favorable impacts upon the community and neighborhood, in support of local policies, shall be given preference. Such projects include those which would encourage rehabilitation of nearby development, or promote investment in a locally targetted revitalization district, or provide new types of housing opportunities in the area to be served. Projects should not involve displacement. Projects which increase the supply of affordable housing in areas suffering displacement will be given favorable consideration. Evidence of local support would include permissive zoning and financial or other contributions to the project by the community.

2. Meet Housing Needs. Most favorable consideration will be given to projects which best meet the overall housing needs of communities in which they will be located. In most parts of the Commonwealth, the need for three-bedroom units is particularly pressing and the provision of 3-BR units will increase the proposal's point score. Similarly, points will be reduced if 1-BR units are proposed for an area showing relatively little need for

1-BR's. See also the comments relative to marketability under minimum standards.

3. Affirmative Action. SHARP encourages developers to provide housing and job opportunities to minorities as well as utilizing minority professional services and other businesses and suppliers. Applications which propose vigorous affirmative action and affirmative fair housing marketing efforts, beyond the minimum requirements considered during the OAS review, will be given special preference.

4. Readiness to Move to Contruction. Proposals which are ready to move quickly to construction should receive more favorable consideration. Evidence of readiness would include proper zoning for the proposal, advanced design documents, building permits etc.

C. Minimal SHARP Subsidy Goal: Projects which require less than the maximum permitted amount of SHARP subsidy in the first year, as well as over the proposed term of the subsidy agreement, may earn up to 10 additional points

This criterion is consistent with a desire to generate the greatest level of housing production for the amount of SHARP funds authorized by the Legislature. However, MHFA must determine that the proposal does in fact need SHARP subsidy for economic feasibility. (Proposals which do not require SHARP should be considered by MHFA for financing under the "80/20" program. Please consult MHFA staff for a full program description.

Maximum Total Possible Points: 100

Final Project Selection

After the projects are all scored and ranked, MHFA will select the highest ranked projects to receive awards of SHARP subsidy subject to consideration of two additional key program objectives. Some of the selected projects should complement efforts to revitalize urban neighborhoods, and there also should be a reasonable distribution of selected projects throughout the Commonwealth. Further, MHFA reserves the right to limit the

number of awards to any one developer. SHARP decisions made at this time represent <u>interim</u> awards subject to MHFA determination of project feasibility, as described below.

<u>Underwriting Review</u>

Following selection of a proposal for SHARP funding, the developer will be required to submit to MHFA a full mortgage application based on the proposal and a mortgage commitment processing fee. **(The mortgage application must be submitted within 3 months of SHARP award. You may wish to refer to the MHFA processing fee schedule.)** The MHFA review will be geared to determining the technical acceptability of the project, the financial feasibility of the requested loan, and the value and marketability of the completed housing. Significant changes in the proposal will not be allowed. Any change that would have affected the proposal's ranking will be considered to be a significant change and could be grounds for recapture of the SHARP subsidy awarded. **Failure to submit the required mortgage application within this deadline and/or a determination of mortgage infeasibility by MHFA may also result in subsidy recapture.** All proposals are expected to be able to reach a construction start within nine months of the date of the selection for SHARP funding.

The staff will inform developers of any special requirements of potential financing programs. In the event that actual financing rates are more than or less than the estimated rates used in evaluating project feasibility, the financial impact of such changes will be analyzed on a case-by-case basis. In no event, however, will the amount of owner's contribution (equity) be reduced.