Keys to the RAD Capital Stack

Section 18 & Rent Bundling

By Scott Beyer

Since its launch in 2011, the Rental Assistance Demonstration program (RAD) has put hundreds of thousands of public housing units under private management, across 44 states plus DC. All this activity was spurred by HUD's change in incentives – after decades of defunding public housing, HUD decided to allocate money for RAD, showing that privatization is the agency's preferred future model. But RAD has also shot off because it's being blended with other HUD tools that better enable public housing repair and conversion. Two of these tools are Section 18 and Rent Bundling.

One person who has expertise in both is Kathie Soroka. She was senior counsel to the general counsel at HUD during the Obama Administration, serving as an architect behind the RAD policy. She now works in New York City as counsel in Nixon Peabody's Affordable Housing practice group, helping public housing agencies (PHAs) and affordable housing developers with closings, deed transfers, regulatory compliance and other legal matters.

I spoke with Soroka about how PHAs and developers can use both Section 18 and Rent Bundling to facilitate RAD conversions, creating better-quality affordable housing.

Section 18

Section 18 of the 1937 Housing Act removes, according to the HUD website, "the one for one public housing replacement requirement and provides broad authority to PHAs to demolish or dispose of public housing." The law is commonly referred to as "demo/dispo" – the "demolition" part is self-explanatory, referring to the destruction of the housing; the "disposition" means the transferring of public housing to private developers for market-rate use. As with RAD, Section 18 is viewed as a public-private alternative to public housing, leveraging outside capital to make needed repairs.

When a project is approved for Section 18, it qualifies for Section 8 project-based vouchers (PBV). While Section 8 is more widely known as a way to let tenants shop the open rental market, PBVs must be used on specific projects. By tying Section 18 to PBVs, it guarantees for developers long-term cash flow that will help them underwrite projects and obtain the capital needed for repairs.

Soroka says that Section 18 has been particularly effective at this, because it allows owners or PHAs to collect fair market rents, or what HUD determines is the going rental rates for similar units in that metro area. This is different than other affordable housing programs, where rents are often capped, and has made Section 18 a popular tool. Prior to RAD, it had facilitated the demolition or conversion of over 200,000 units.

When RAD was introduced, developers began combining the new policy with Section 18. After all, RAD's funding model is also voucher based, available to tenants who use PBVs or project-based rental assistance (PBRA). Together, they expose owners or PHAs to a wider voucher subsidy apparatus.

HUD was at first not a fan of this RAD-Section 18 blending, according to Soroka, but eventually decided to make it part of the strategy. Public housing projects can now have a 75/25 split, where if 75 percent is being converted to RAD (and doing substantial rehab or new construction without using nine percent Low Income Housing Tax Credits), the remaining 25 percent of units can be Section 18. Projects can also qualify for Section 18 if they are part of PHAs with portfolios less than 50 units; part of scattered sites with non-contiguous buildings of less than four units; or are committing over 60 percent of expenses to what HUD defines as "hard construction costs."

Another way projects can qualify is when "redevelopment out of public housing allows for greater efficiency and effectiveness." Achieving this was really the point of RAD all along; but the rent caps and relative modesty of four percent LIHTC means that it doesn't always spur quality repairs. Section 18 is one way to fill the gaps, and Soroka says it has led to project execution in New York City, Illinois and elsewhere across the U.S.

"The largest obstacle to a RAD program is that the RAD rents are so low. So this is a tool to boost the rents in a RAD project. If you have more income, you can leverage more," explains Soroka. "[It] has really made a difference in the number of transactions that have been able to get over the line, and in the quality of the rehab in those transactions."

Rent Bundling

Rent bundling lets PHAs "bundle" rents across two or more projects. This means units that are more modern, and thus command higher rents, can cross-subsidize projects that are falling into disrepair and have lower rents.

As the financial advisory firm BDO explains on its website: "Assume that a PHA is considering bundling two identical projects, both consisting of 100 units. In Project A, the contract rent is $500; and in Project B, the contract rent is $600. The PHA could bundle the two projects such that the initial contract rents for both projects will be $550."

This increases the revenue stream for the lesser-value project, so that the owner or PHA can more easily underwrite its repairs.

Rent bundling has been a feature of RAD from the start, but has been expanded to include non-RAD units, further reinforcing how different units across a PHA portfolio can now be combined for financing purposes. The new guidelines allow rents to be averaged out among RAD and non-RAD PBV projects, with rent in the former reduced by the equivalent increase of the latter.

HUD's RAD Rent Bundling Worksheet lets developers enter the reasonable rents, fair market rents and utility allowance of their housing bundles to test their proposed rents against the PBV or PBRA rent caps. Developers fill in this information on excel and submit it to HUD for approval.

As with Section 18, says Soroka, this rent bundling strategy "has been successful in the RAD context in terms of allowing projects to underwrite on their own. It's a very powerful tool." **TCA**

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