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Preserving the largest and most at-risk supply of affordable housing

In the United States, naturally occurring affordable housing (NOAH) is at risk. To protect this critical asset class, stakeholders for federal, state, and local housing can all play a role.

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The United States faces an affordable-housing crisis that is being exacerbated by the COVID-19 pandemic. As we enter the second year of the pandemic, more than ten million households are behind on rent—more than three times the historical rate. While the extension of federal renter-eviction moratoriums have provided much needed support to renters, an estimated $57 billion in back rent is now owed by US households,[1] and as a result landlords are increasingly at risk of falling behind on mortgage payments and losing their properties. While steps have been taken at the federal level to address this domino effect, even the $25 billion federal rental assistance program passed by Congress at the beginning of the year will cover less than half of what renters owe.

As the prolonged economic fallout of the COVID-19 pandemic continues to strain millions of households and their landlords, the need for cities to support affordable housing options will be more pressing than ever. While many governments and housing stakeholders have started to focus on how to increase the supply of new affordable housing, few have put as much effort into preserving the largest existing supply of affordable housing—naturally occurring affordable housing (NOAH). NOAH is the term for existing multifamily rental properties that are affordable without public subsidy to low-income households. Understanding and identifying NOAH within communities is more important than ever, as the prolonged economic fallout of the COVID-19 pandemic will push millions more American households toward being rent burdened.[2] NOAH will be a critical factor in maintaining affordable-housing options.

Nationwide, NOAH constitutes the largest supply of affordable units; yet, as an asset class, NOAH is not well defined, tracked, or understood. NOAH renters are predominately low-income people of color who have been disproportionately affected by the economic shocks of the pandemic. In addition, the properties themselves are often financially fragile and more sensitive to economic shocks, and ownership turnover can create instability within communities as renters are displaced. NOAH assets are also typically older and more likely to be redeveloped when sold, increasing the rate at which NOAH units are being lost and further shrinking the supply of affordable housing.

These factors all point to a growing need to stabilize and preserve the affordability of NOAH homes. While continuing to expand the supply of new affordable housing remains a critical priority for cities, preservation could also be added to the solution set. The good news is that there are relatively low-cost ways to do so—the cost of preserving an existing NOAH unit is a fraction of the cost of building new affordable-housing supply. A combination of renter, owner, and financing interventions, and a commitment from stakeholders for federal, state, and local housing to support NOAH preservation can bring visibility to this pressing issue.

Understanding NOAH is more important now than ever

NOAH accounts for the lion's share of affordable-housing units across the United States and is a key piece of the affordable-housing ecosystem. In 2020, we studied the incidence of NOAH in Los Angeles County, California (see sidebar, "Defining and identifying naturally occurring affordable housing in Los Angeles County"). We found that NOAH accounts for 80 percent of all affordable units in the region—five times more supply than subsidized affordable housing. It has been estimated that NOAH accounts for a similar share of affordable housing in other large markets and approximately 75 percent of all affordable-housing units in the United States.[3] Successful efforts for NOAH preservation require bringing visibility to these assets and the households that depend on them.

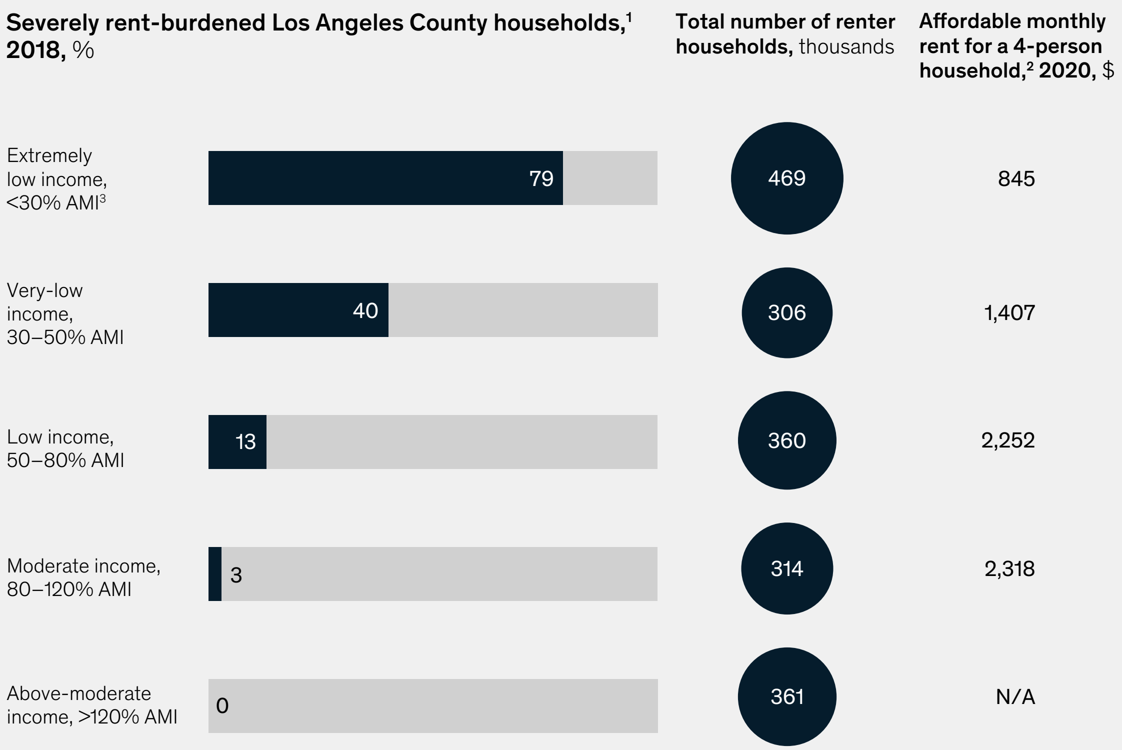
[1] Jim Parrott and Mark Zandi, *Averting an eviction crisis*, Moody's Analytics, January 2021, moodysanalytics.com.
[2] According to the US Department of Housing and Urban Development (HUD), rent-burdened households are those that "pay more than 30 percent of their income for housing" and as a result "may have difficulty affording necessities such as food, clothing, transportation, and medical care."
[3] A 2016 analysis by Urban Land Institute and CoStar Realty Information determined that NOAH accounts for approximately 76 percent of affordable housing in the United States.

Defining and identifying naturally occurring affordable housing in Los Angeles County

In Los Angeles County, California, the area median income (AMI) in 2020 for a family of four was $77,300, meaning affordable rent—paying no more than 30 percent of gross income for housing—equates to approximately $1,930 per month. In Los Angeles County, the demand for affordable housing significantly outweighs the available supply, and the lower a household's income the larger the affordability gap, and the more likely its members are to be severely rent burdened—spending more than 50 percent of their gross household income on housing. In this county, there are more than 500,000 severely rent-burdened households (Exhibit A).

Exhibit A

There are more than 500,000 severely rent-burdened households in Los Angeles County, CA, paying more than 50 percent of income on housing costs.



[1]Severe rent burden is defined as spending more than 50% of household income on housing costs.
[2]Affordability defined as rent equating to 30% of gross income, calculated based on annual income figures for Los Angeles County ("State income limits for 2020," California Department of Housing and Community Development, April 30, 2020, hcd.ca.gov).
[3]Area median income.
Source: *2020 Los Angeles County annual affordable housing outcomes report*, California Housing Partnership, April 30, 2020, chpc.net

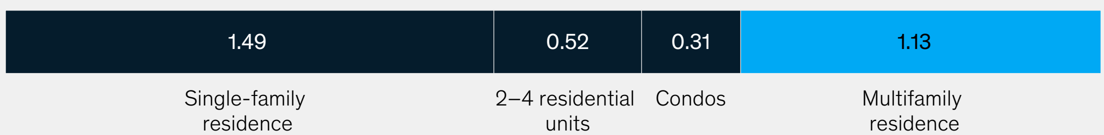
Defining and identifying naturally occurring affordable housing in Los Angeles County (continued)

For our Los Angeles County research, we defined naturally occurring affordable housing (NOAH) as multifamily residential properties without government or nonprofit subsidies and with rents that are affordable to households at 80 percent of the AMI. NOAH properties in Los Angeles County are typically Class B and Class C, small to medium multifamily properties (between five and 25 units) built between 1940 and 1990. Unlike federally subsidized housing, NOAH units do not have affordability covenants and do not receive tax credits or abatements. Using that definition, our analysis identified 541,000 NOAH units in LA County out of 645,000 total affordable units (Exhibit B).

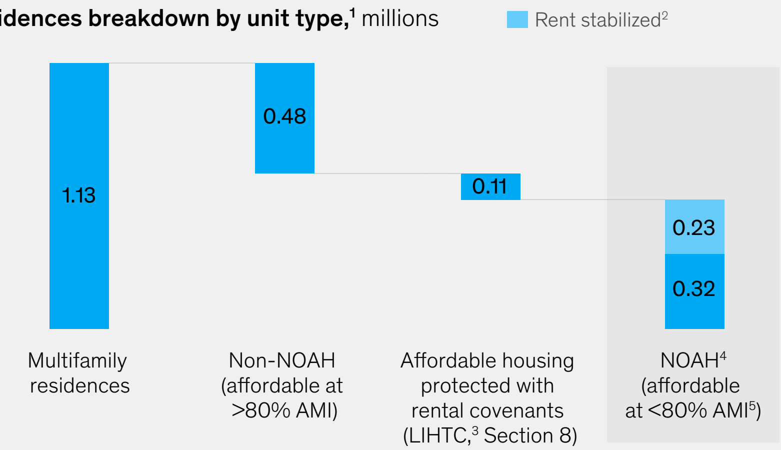
Exhibit B

Naturally occurring affordable housing represents 80 percent of the affordable-housing supply in Los Angeles County.

Los Angeles County housing supply by unit type,[1] millions



Multifamily residences breakdown by unit type,[1] millions



[1]Parcels excluded from assessor's data include commercial/industrial (136,000 properties; 225,000 units), vacant (171,000 properties; 4,000 units), and other (38,000 properties; 1,500 units).
[2]Units in Los Angeles City built before 1978 have annual rent-control protections under the city's Rent Stabilization Ordinance (RSO).
[3]Low-income-housing tax-credit program.
[4]Naturally occurring affordable housing.
[5]Area median income.
Source: CoStar Realty Information; Los Angeles County Office of the Assessor, Parcel Data, 2019

A lack of covenants and subsidies has always, by nature, made NOAH assets vulnerable to either redevelopment or disrepair. Now, the economic effects of the pandemic are having a disproportionate impact on NOAH renters and owners, predominantly people of color, which could accelerate the loss of affordable housing across high-cost metro areas. There are several important reasons to better understand and protect NOAH across the United States:

— *NOAH renters are predominantly low-income people of color.* The combination of sustained unemployment and the expiration of rental relief and unemployment benefits will put more NOAH households at risk. Severely rent-burdened households comprised 50 percent of low-income households in Los Angeles County prior to the COVID-19 pandemic, a number that has likely increased during the pandemic. Our research indicates that in Los Angeles County, 62 percent of NOAH supply—approximately 320,000 units—is located in zip codes where more than half of residents are people of color.

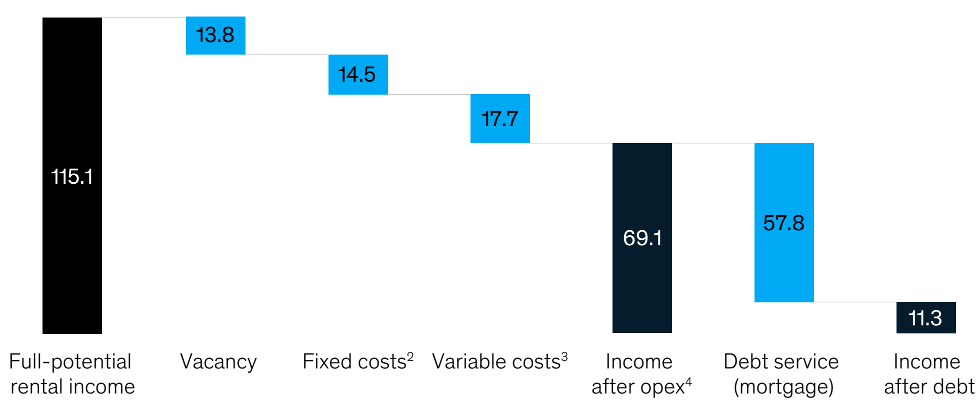
— *NOAH properties represent a key source of wealth in low-income communities.* In Los Angeles County, individual landlords own 76 percent of all NOAH properties.[4] These landlords are often local community members using small multifamily properties as their primary source of wealth creation and, often, their only source of retirement income. When NOAH properties fall into disrepair or are redeveloped, it represents a lost opportunity for wealth creation in these low-income communities.

— *NOAH assets are often financially fragile and more sensitive to economic shocks.* The economics of low-income housing often leave minimal cash flow for reserve funds. For example, if a landlord is unable to collect rent from one unit in an eight-unit building, the landlord's post-mortgage returns are halved. If two units are unable to pay rent, a landlord could experience a net loss for the month (Exhibit 1). Even prior to the pandemic, NOAH properties were more likely to lack reserve funds and underinvest in maintenance and property management.

Exhibit 1

Opportunity exists to make naturally occurring affordable-housing assets more financially stable and easier to maintain.

Rental income on an 8-unit NOAH[1] property in Los Angeles County, CA, $ thousands



[1]Naturally occurring affordable housing.
[2]Examples include property tax, professional services (eg, accounting), and insurance.
[3]Examples include water utilities, maintenance, and landscaping.
[4]Operating expenditures.
Source: 2018 Rental Housing Finance Survey (assumes $1,200 monthly rent and 12% delinquency; does not include management fees or capital expense); 2019 State of Independent Landlord Survey, n = 709; survey of California independent landlords, n = 43; expert interviews

[4]CoStar Realty Information; Los Angeles County Office of the Assessor, Parcel Data, 2019; US Census Rental Housing Finance Survey.

Indeed, unexpected capital expenses are one of the leading reasons why small-scale property owners sell their NOAH properties.

— *NOAH ownership turnover often results in renter displacement.* A pattern of ownership turnover and tenant displacement has been widely documented across the Unites States. When landlords are unable to collect rent on NOAH units and properties go into distress, all tenants are at risk of losing their homes. When a landlord sells a NOAH asset, market-rate developers may redevelop the property to increase rents or create a "cash for keys" program—where rather than evict a tenant, a landlord offers an incentive payment for them to move out—to replace existing tenants.

How to protect NOAH assets

While there are a few examples of successful projects and one-off solutions, McKinsey research indicates that, on the whole, cities lack holistic NOAH-preservation strategies. To support renters and owners and incentivize developers to acquire and preserve NOAH, cities can consider a set of interventions.

A combination of renter, owner, and financing interventions

Preserving NOAH will require a holistic approach with a variety of interventions. Efforts to stabilize independent NOAH owners represent lower-cost interventions to preserve supply in the near term. When the sale of a NOAH asset is inevitable, financing interventions can give mission-driven developers access to the capital and financing needed to compete with market-rate developers and preserve long-term affordability. The following three interventions can help preserve NOAH:

— *Renter interventions* provide direct assistance to renters facing economic distress to stabilize households and properties, either directly through local rental-subsidy programs or indirectly through federal support, such as benefits from the 2020 CARES Act. For example, in 2020, the City of Los Angeles created the Emergency Rental Assistance Subsidy Program, which allocated $100 million in temporary rent subsidies to low-income households affected by the COVID-19 pandemic. The program provided a grant of up to $1,000 per month paid directly to the landlord on the tenant's behalf to cover rent and was estimated to assist 50,000 Los Angeles households.

— *Owner interventions* provide a path for local governments and nonprofits to stabilize at-risk NOAH housing and preserve affordability by keeping the units in the same owners' hands. Our research in Los Angeles indicates that a majority of NOAH properties contain fewer than 25 units and are owned by individual landlords. As tenants are unable to pay rent, many owners will be unable to meet their financial obligations. Examples of owner interventions include energy-efficiency programs, low-interest loans, grants for maintenance and functional upgrades, property-management resources, tax abatements through nonprofit partnerships, and access to attractive refinancing resources—all with the goal of stabilizing the property.

— *Financing interventions,* when done effectively, can preserve NOAH by directly financing the purchase and stabilization of properties with the goal of maintaining long-term affordability. Across the country, a variety of models are increasing the competitiveness of developers who are committed to the community and seek to buy or renovate affordable properties. Well-capitalized impact investors have demonstrated the ability to preserve long-term affordability with NOAH-focused acquisition funds, although to date these models have been focused on large 50-plus-unit properties, professionally owned and managed. One example is the Turner Multifamily Impact Fund, which has the goal of investing $2 billion in NOAH preservation and to date has acquired and operates more than 10,000 NOAH units nationally. This innovative model supports investments in tenant services as well as retrofitting and maintenance projects to reduce both turnover and operating costs. Although financing interventions require significant capital, with the right affordability controls, the right focus on supply (as opposed to demand), and appropriate visibility and accessibility to local owners, they can preserve long-term affordability.

Local, state, and federal players can act to support NOAH preservation

Scope exists for local, state, and federal governments to help preserve NOAH. Given the historical lack of attention and investment in NOAH, local, state, and federal players have the opportunity to meet the moment by reducing the barriers and pain points to preservation (Exhibit 2) and spurring innovation and engagement in the space. Since changing property owners leads to rent increases and tenant displacement, governments can consider ways to keep NOAH properties with their current owners, such as by increasing financial and operational capacity of owners and developers committed to affordability and by incentivizing new financing solutions and capital sources. We see a broad spectrum of opportunities for governments across local, state, and federal levels to support nonprofits and have an impact on investors, owners committed to affordability, and developers in NOAH preservation.

1. Local opportunities

Cities and planning agencies have an opportunity to put more emphasis on the full spectrum of affordable-housing supply and develop preservation plans and policies to increase the property-development and management capacity of small NOAH owners and developers committed to affordability. Local opportunities include the following:

— *Include NOAH supply in local affordable-housing goals.* Only by identifying and understanding the supply of NOAH can a region create a holistic view of housing affordability and begin making informed decisions on how to both support new and preserve existing supply. The Atlanta Housing Affordability Tracker is a great example of setting and tracking affordable-housing goals, with clear and transparent supply and funding targets and up-to-date tracking that includes both new and preserved housing. However, to date, the city's goal and database only includes government-supported affordable units.

Exhibit 2

Currently, owners and developers of naturally occurring affordable housing face several pain points.

Independent landlords

- Small-scale and older properties have a high per-unit operating expense
- Lack of preventative maintenance leads to higher maintenance costs and repairs, often leading to large out-of-pocket capital expenses for emergency repairs and property upgrades
- Limited awareness of resources available to support maintenance and preservation of their properties
- Lack of awareness and access to attractive refinancing resources
- Limited knowledge and transparency around the ecosystem of potential buyers and pathways to liquidity

Affordable-housing developers

- Limited experience and expertise in NOAH[1] preservation—historically focused on projects supported by federal tax credits
- Limited visibility to potential NOAH preservation projects in their region
- Limited development and property-management capacity to operate additional small-scale properties

[1]Naturally occurring affordable housing.

- *Offer grants and low-interest loans for energy efficiency and functional upgrades.* Access to maintenance capital, especially for preventive maintenance, is a key issue for NOAH owners and a main reason for the sale of assets. Expanding programs that finance property maintenance in return for affordability covenants could keep properties with local owners while preserving affordability. For example, Washington, DC, recently created a grant program targeting small-scale properties. The city's Small Building Program provides grants for property maintenance, repairs, and systems replacement to small-property owners with five to 20 affordable units. The maintenance grants, up to $25,000 per unit, improve property conditions for tenants while lowering operating costs for owners, and thus preserving the stock of affordable units.

- *Expand and simplify tax-abatement programs.* One way local governments can preserve NOAH is by increasing the financial capacity of owners and developers committed to the community. Expanding tax-abatement programs—and, critically, making them easier to access—in exchange for maintaining affordability is one approach jurisdictions could consider. Tax abatements are often complicated and challenging even for well-established developers to navigate. Affordable-housing developers in Los Angeles cited the time, cost, and complexity of receiving tax abatements as one of the main obstacles limiting their ability to expand their portfolios and preserve more housing units. Yet the cost reduction from tax incentives is significant and often required for owners and developers to maintain affordability while operating the property. Expanding tax-abatement programs while reducing the friction by streamlining the approval process could create capacity and spur increased investment in NOAH preservation.

2. State opportunities

States could contribute to preserving NOAH by creating tools and databases that increase the visibility of property-preservation opportunities for stakeholders and by supporting targeted investment funds that incentivize affordability. These steps are outlined below:

- *Increase visibility of NOAH for developers committed to affordability.* A statewide focus and database could provide a more holistic view of housing affordability across regions and enable better coordination between stakeholders committed to preservation. Our research indicates that community developers and local owners with capacity to expand their portfolios are often not aware of opportunities for NOAH acquisition and primarily rely on word of mouth and existing relationships. Opportunity exists to bring visibility to the pipeline of at-risk NOAH properties and encourage better collaboration and communication between current owners and potential developers committed to supporting affordable supply.

- *Support NOAH-dedicated investment funds.* A variety of models exist for the public sector to partner with well-capitalized nonprofits and impact investors to preserve housing affordability, including government-sponsored funds, financial institutions committed to community development, and public–private impact funds. One of the leading national examples is the NOAH Impact Fund in the Twin Cities region. This NOAH-dedicated housing fund was created by the leading state-housing nonprofit, the Greater Minnesota Housing Fund, with investments from the state, county, foundations, and community banks. The $50 million public–private partnership makes direct-equity investments into NOAH properties, enabling developers to achieve attractive returns while still maintaining affordability. The NOAH Impact Fund has set a goal of preserving 2,000 at-risk NOAH units across the Twin Cities metro area and to date has deployed $25 million to preserve more than 1,000 units. With a $25,000 equity investment per unit, the cost of preservation can be a fraction of the investment needed to build new supply.[5]

— *Expand low-income housing tax credit programs.* Our research identified 18 states currently operating low-income housing tax-credit programs; however, subsidies today are often designed only to augment the federal low-income housing tax-credit (LIHTC) program. For example, the California Tax Credit Allocation Committee (CTCAC) administers low-income housing tax credits annually to encourage private investment in affordable rental housing, and credits are available for new construction projects or preservation of existing properties. However, California's state tax-credit program is currently only available for projects already awarded federal LIHTC subsidies. Opportunities exist to expand the scope of state tax-credit programs to include preservation of NOAH properties.

3. Federal opportunities

Federal stakeholders could encourage NOAH owners to refinance and spur private capital toward preservation by codifying NOAH as an asset class and expanding financing incentives in the following ways:

— *Define and standardize NOAH as an investible asset class.* Institutional investors, affordable-housing developers, and nonprofits have historically had limited focus on NOAH, in part because it hasn't been a clearly defined and understood asset class. Federal housing programs and underwriters could take steps to standardize NOAH definitions across markets by clarifying relevant property types (for example, size, age, and class), affordability thresholds (for example, affordable to households at 80 percent of area median income), and inclusion of affordability covenants (for example, local rent control or restrictions). Federal efforts to bring more visibility and structure to the asset class could unlock more resources and support for owners, and encourage more capital to flow into preservation.

— *Expand underwriting programs for the preservation of NOAH properties.* Federal agencies and housing programs could create more competitive advantages for owners and developers interested in acquiring and preserving NOAH. Underwriting levers include providing low-interest loans, reducing underwriting fees, expediting the application and approval process, increasing allowances for property maintenance and rehabilitation, and expanding access and eligibility for preferential underwriting to a broader set of developers committed to the community. Innovative financing facilities could spur private-sector investment by enabling the execution of attractive and scalable investment strategies for NOAH in return for long-term affordability restrictions.

— *Encourage NOAH owners to refinance at historically low rates.* Access to capital and refinancing resources was a key pain point identified for small-scale NOAH owners. Opportunity exists for NOAH owners to refinance their properties, with the support of federal multifamily programs, to take advantage of the low-interest-rate environment. Lower debt service would immediately help stabilize properties and reduce pressure to raise rents. Federal stakeholders could support an owner-outreach campaign to encourage

[5] NOAH Impact Fund, a subsidiary of the Greater Minnesota Housing Fund, noahimpactfund.com.

owners in rent-burdened communities to take action and get locked into long-term low rates.

The complexity and cost of developing new affordable housing in high-cost markets makes maintaining the existing supply critical. While many cities and states have taken action and successfully preserved at-risk LIHTC and Section 8 affordable housing, many markets across the United States have already lost thousands of NOAH units over the past decade and are on track to lose thousands more if interventions aren’t put into place.

Millions of low-income households across the country depend on NOAH for housing stability. The lack of understanding and visibility into NOAH highlights the need for stakeholders at all levels to better recognize and support this crucial piece of the affordable-housing ecosystem. With the right collaboration and support, the impact could be substantial. Fewer tenants will be displaced, fewer landlords of small-scale properties will be forced to sell, and fewer affordable units will be lost.

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