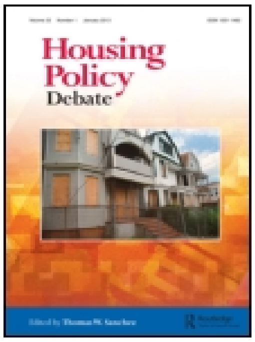

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A New Look at Creative Finance

Roberto G. Quercia and William M. Rohe
University of North Carolina at Chapel Hill

Diane K. Levy
The Urban Institute

Abstract

In his seminal work, Stegman contended that creative finance is an inefficient means of financing low-income housing production. As evidence, he cited the high transaction costs associated with the complex financing structures that make a low-income housing development feasible. In this article, we extend Stegman's work by examining the impacts of creative finance over time. We rely on data gathered as part of an evaluation of 36 housing developments sponsored by nonprofits.

The data indicate that most of the developments in our study remained financially viable in part because of their reliance on creative finance. We find evidence supporting three positive impacts of creative finance: the establishment of long-term partnerships, the increased community acceptance of low-income housing developments, and the improved technical skills of organization staff. We also find that none of the long-term negative impacts are inherent in creative finance and offer four suggestions on minimizing them.

Keywords: Low-income housing; Nonprofit sector

Introduction

In all likelihood, the term "creative finance" acquired its notoriety in the national housing policy debate with the publication of the often quoted work on the subject by Stegman (1991). Although Stegman provides no clear definition of creative finance, he used the term to refer to the practice of using multiple sources of funding, including moneys from federal, state, local, philanthropic, private for-profit, and/or nonprofit sources, to finance low-income housing projects. In his article, he implicitly contrasted the disadvantages of creative finance with the advantages of the traditional model of relying on the federal government as a long-term lender and subsidy provider.

More broadly, the term creative finance was first used to refer to new patterns of home finance that developed in California during the 1970s (Stegman 1991). At that time, increased housing demand caused California home prices to soar. Lenders were unable to meet the demand for mortgage money at terms that most home buyers could afford. As a result, by 1982, up to 16 percent of all homes in California were subject to liens held by their former owners (Lowry 1984). The typical seller lien had a term of 10 years, after which it had to be repaid or financed, thereby creating a potentially risky situation. In addition to seller loans, other commonly used financing mechanisms included assumed loans, all-inclusive trust deeds, land contracts, junior liens, unamortized short-term loans, graduated payments, and graduated interest rates. All of these mechanisms became associated with creative finance. Stegman noted that, in the California context in which it evolved, creative finance was an ad hoc, costly, and potentially dangerous set of financing alternatives. Although the dangers believed inherent never fully materialized, Stegman cautioned in 1991 against using creative finance as a basis for national policy.

Creative finance has been institutionalized as a de facto mechanism for providing affordable housing nationwide. The scaling back of the federal government from its historic role as a long-term lender and housing subsidy provider resulted in this institutionalization. Underlying this process was the assumption that state and local governments could take on the role of long-term lender/subsidy provider, if they so desired.

Consistent with the view of many during the early years of the program, Stegman (1991) saw the Low-Income Housing Tax Credit (LIHTC) program as an example of the inefficiencies and risks inherent in creative finance. As evidence, he cited the high transaction costs associated with 24 creatively financed projects that relied on the LIHTC. He found that these projects had an average of five separate funding sources. Those recently completed projects were regarded as state-of-the-art deals. More broadly, he contended that creatively financed developments relied on multiple layers of financing, were thinly capitalized, and suffered from uncertain long-term affordability. These concerns are important because, since Stegman's work was published, the LIHTC has become the main financing mechanism for the development of low-income rental housing.

Stegman implicitly compared the disadvantages of creative finance with the many advantages of the traditional model that relied on the federal government. Low-income housing developers needed to secure only one source of funding: Federal funding was enough to make a project viable. Federal subsidies were committed for relatively long periods, up to 30 or 40 years in some cases. This extended funding guaranteed the affordability of subsidized units, as well as increased the viability of developments over time. Unfortunately, the traditional model also had drawbacks. Because funding came from Washington, DC, the traditional model did not require low-income housing developers to search for local and other partners or to secure local support for their projects to the extent required when creative finance is used. In addition, relying on a single source of funding meant that when federal housing subsidy programs were changed or cut, no other sources were available to take their place.

In any case, it is unlikely that the federal government will reassume its former role as the sole long-term lender and subsidy provider. This raises the question of whether it is possible to develop a coherent national housing policy that relies on creative finance, not by default, but by design. To answer this question, we must first identify the ways in which creative finance may affect the performance of developments over time.

In this article, therefore, we take a new look at creative finance. We extend Stegman's work by examining the impact of creative finance on affordable housing developments over time. We conduct a longitudinal examination of some of the developments Stegman reviewed, as well as others. In particular, we address the following questions: What is the impact of creative finance on the financial health of low-income housing developments over time? Broadly defined, what are the positive effects of creative finance? Can the negative effects be ameliorated? To address these questions, we present data gathered as part of our evaluation of the sustainability of nonprofit-sponsored housing developments (Rohe et al. 1998). Our sample included developments that the Fannie Mae Foundation recognized with the Maxwell Award of Excellence for their innovative financing, design, or services.

We emphasize that this study is not designed or intended to prove that the creative finance model is better or worse than the traditional single source model or to counter Stegman's contentions. More narrowly, we take the creative finance model as a given, identify its long-term impacts, and explore the ways in which it can be improved to address its shortcomings. We identify issues and raise questions rather than provide definite answers. The study is exploratory. Ideally, the insights gained will constitute the basis for a later, more comprehensive research effort.

The rest of this article is divided into four sections. First, we present a background discussion of the potential impacts (positive and negative) of creative finance on housing developments over time. Next, we describe the methodology and data used to examine potential key impacts. Following the methodology section, we present our findings. In the final section, we derive implications for policy and research.

The impacts of creative finance

Creative finance has two types of impacts: short term and long term. In the short term, creative finance may raise (or lower) the cost of producing a low-income unit relative to some market benchmark or make it more difficult (or easier) to serve low-income households. In the long term, creative finance may have direct and indirect impacts on the viability of the development, or the sponsoring organization, or both.

Although Stegman did not provide comparable benchmark information, he expressed several short-term concerns, including the inappropriate targeting of benefits, insufficient monitoring, and high transaction costs of the LIHTC program. Since his article, the first two concerns have been addressed[1]; his concern about short-term high transaction costs, however, may still be relevant. Unfortunately, to our knowledge, no one has examined the transaction costs in low-income housing developments financed by the traditional federal government–centered model relative to those relying on creative finance.

Even if creative finance is associated with higher short-term transaction costs, long-term benefits might still outweigh these initial disadvantages. As mentioned earlier, long-term benefits may be direct or indirect. Directly, creative finance may positively affect the financial health of developments or allow rents to be kept low. These impacts can be measured if the financial health of developments can be attributed to the use of creative finance.

Indirectly, creative finance may have an impact on sponsoring organizations and their staff. First, creative finance requires the establishment of partnerships with other institutional actors. Such partnerships may help sponsoring organizations achieve goals beyond the original development. Second, the development of local partnerships through creative finance may counteract NIMBY (not in my backyard) forces because of the high visibility, publicity, and media coverage that typically emphasize the positive aspects of the proposed development and its residents. Third, local partnerships may provide a means for different parties to work together to better understand the goals of the development and to address residents' and other concerns. If this is the case, organizations may have a greater ability to develop and locate other affordable housing in the area. Finally, over time, creative finance will probably increase the technical competence of the staff at the sponsoring organizations. Acquired skills are likely to include generic skills that may be useful in a wide range of activities, as well as specific skills that may not be transferable beyond applying for a specific program like the LIHTC. Moreover, the skills acquired by staff to structure, attract, and secure complex financial deals with multiple layers of financing may increase the long-term sustainability of affordable housing developments. A more competent, confident staff may be better able to address future problems, including securing additional sources of funding.

[1] Since the publication of Stegman's article, changes to the LIHTC program extended affordability restrictions to 30 years, improved targeting of benefits, and tightened monitoring requirements.

The above contentions suggest that creative finance may have complex and long-lasting effects. The data and methodology used to examine these contentions are described below. It should be emphasized that the goal of this research was not to examine the efficiency of creative finance as a means of producing low-income housing nor to examine the whole range of long-term cost and benefits associated with it. More narrowly, the goal was to identify the important long-term impacts of creative finance, as evinced in part from the insights of key staff at the nonprofit organizations responsible for developing and managing creatively financed developments.

Data and methodology

We examined the impact of creative finance on 20 developments that received the Maxwell Award of Excellence from 1989 to 1994. These include 10 rental and 10 special-needs developments.[2] Each year the Fannie Mae Foundation recognizes six innovative affordable housing developments with Maxwell Awards, which are intended to identify, recognize, and showcase the outstanding work of nonprofit organizations in developing and maintaining housing for low-income Americans. A committee of prominent professionals in the housing field selects the winners from a large number of applicants. In his analysis, Stegman (1991) used information from a sample of 24 organizations that had applied for Maxwell Awards.

In our study, we obtained data on Maxwell Award developments in three ways. First, we collected financial information from the original Maxwell Award application prepared by each sponsoring organization. We used this information to identify the financial structure of each project and to develop baseline performance data. Second, we conducted telephone interviews with representatives of the sponsoring organizations to obtain information on the long-term performance of the developments and the impact of creative finance. Finally, we visited eight of the developments to further understand the factors affecting performance over time.[3]

This data set provides a unique opportunity for analysis. First, the 20 developments in the sample were recognized for the innovative design

[2] Two other rental developments and two other special-needs projects were contacted, but for a variety of reasons the sponsoring organizations declined to participate. Data on rental and special-needs developments were separated by type of housing because the latter were considered unique in that they have to secure funding over time for the services offered.

[3] The eight sites chosen represented developments in urban and rural areas throughout the country. Moreover, the telephone interviews indicated that the selected sites represented successful developments as well as those that had experienced problems.

and financing that made them affordable to low-income households. By definition, innovative financing is creative, but success at origination does not guarantee long-term viability. Second, the developments varied greatly in terms of geography, community size, and project type, thus providing diversity. Third, the developments had been in operation from 4 to 10 years, making it possible to gauge long-term impacts. Finally, extensive data were available on the developments, both from the original Maxwell Award applications and from follow-up contacts.

This sample does have some drawbacks. Primarily, the nonrandom nature of the sample limits the generalizability of the findings. The sample may not be representative of all housing developments that rely on creative finance; further, the relatively small sample size precludes all but the most basic quantitative analyses of the data collected.

General description of the developments

The developments examined are diverse in several respects (table 1): their financial structure; the location, size, and configuration of the units; the characteristics of the families served; and the range of supportive services provided.[4]

The rental developments, ranging in size from 16 to 119 units, were located in communities of all sizes. They included high-rise and low-rise buildings, town houses, and single-family detached homes. Seven of the 10 rental developments were new construction; the rest involved rehabilitating existing structures. The average tenant income in all rental developments was less than 50 percent of the area median income.[5] In general, tenants represented the racial and ethnic characteristics of the surrounding communities. Also, most were single-parent households.

Similarly, the special-needs developments[6] ranged in size from 9 to 189 units (table 2) and were located in each region of the country and in communities of all sizes, although most were in urban areas. Most were single structures; four were newly constructed and six involved rehabilitation. Three of the developments provided transitional housing and five offered permanent housing for homeless persons or people with HIV

[4] It should be noted that we describe rental and special-needs developments separately to account for the fact that the viability of special-needs developments is often tied to the provision of services, which is not directly linked to creative finance.

[5] Area median income figures refer to a household of four, except for one area, in which the area median income figure refers to a household of one.

[6] The majority of special-needs housing developments are SRO or group-living developments that provide support services to individuals or households.

Table 1. **Characteristics of the Rental Developments**

Project Name	Sponsoring Organization (State)	Units Created	Type of Construction	Year Occupied
Village Commons	Anchorage Neighborhood Housing Services, Inc. (AK)	103	Rehabilitation	1991
Coleridge Park Homes	Bernal Heights Neighborhood Center/BRIDGE Housing Corporation (CA)	49	New	1989
Guyon Towers	Bethel New Life (IL)	114	Rehabilitation	1988
Rancho Sespe Farm Worker Family Housing	Cabrillo Economic Development Corporation (CA)	50	New	1990
West Side Development	Community Service Programs of West Alabama, Inc. (AL)	38	New	1990
Frank G. Mar Community Housing	East Bay Asian Local Development Corporation/BRIDGE Housing Corporation (CA)	119	New	1990
Eastside Day Care Homes Cooperative	Eastside Community Investments, Inc. (IN)	16	Rehabilitation	1989
Griffin-Mandela Complex	Federation of Southern Cooperatives Land Assistance Fund (AL)	30	New	1988
Quality Heights	Kansas City Neighborhood Alliance (MO)	40	New	1988
Casa Loma	New Economics for Women (CA)	110	New	1993

Table 2. **Characteristics of the Special-Needs Developments**

Project Name	Sponsoring Organization (State)	Units Created	Type of Construction	Year Occupied
Bailey-Boushay House	AIDS Housing of Washington (WA)	35	New	1991
Brooklyn Gardens	Brooklyn Community Housing and Services (NY)	136	Rehabilitation	1991
Peter Claver Community	Catholic Charities of San Francisco (CA)	32	Rehabilitation	1988
Bishop Street House	Committee to End Elder Homelessness, Inc. (MA)	9	Rehabilitation	1992
H.E.L.P. 1	H.E.L.P. (NY)	189	New	1987
West Central Wisconsin Housing Renewal Project	Impact 7 (WI)	50	New	1989
The Initiative	The Initiative, Inc. (MS)	13	New	1992
Rose Apartments	REACH Community Development, Inc. (OR)	57	Rehabilitation	1988
Community Re-Entry Project	Regional Economic Community Action Program, Inc. (NY)	26	Rehabilitation	1990
Pershing/Roma Hotel	Las Familias del Pueblo/Skid Row Housing Trust (CA)	69	Rehabilitation	1989

or AIDS. The remainder provided a mix of permanent and transitional housing. All residents had incomes below 50 percent of the surrounding area median income.

Characteristics of the financing

As with most low-income housing developments built in recent years, those in our sample relied on multiple sources of financing. The average development had five different sources, while the maximum was eight. The characteristics of the financing for each type of development are described next.

Rental developments

The financial structures of the rental developments are summarized in table 3. On average, a rental development received funding from 4.3 different sources. Eight of the rental developments relied on outright grants to cover a portion of their development costs, thus enabling them to serve lower-income households. Seven of the rental developments relied on at least one federal source, including the three from the now defunct Housing Development Action Grant (HODAG), and one from the defunct Rental Rehabilitation program.

State and localities were also important sources of permanent financing. The host city and/or state provided loans or grants to nine of the rental developments. In many cases, these loans had below-market rates or were silent loans, in which payments were deferred until a future time. For example, in the Casa Loma development, all three loans from the state of California carried a 3 percent interest rate and had deferred payment schedules.

The LIHTC program also played an important role in financing rental developments, greatly reducing the amount of money that had to be borrowed. Seven developments had equity investments made by corporations or equity funds, such as the National Equity Fund and the Chicago Equity Fund.

Special-needs developments

The sponsoring organizations brought together a range of public and private resources to initiate and maintain the special-needs developments over time (see table 4). On average, a special-needs development received funding from 5.5 different sources. Pershing/Roma Hotel and the Peter Claver Community raised equity for their developments

Table 3. **Permanent Financing of the Rental Developments**

Village Commons					
Sources	Federal Home Loan Bank	Alaska Housing Finance Corporation (AHFC) Bond			
Types/terms	Grant	Bond/loan, 7.5%, 30 year			
Amount	$200,000	$3,006,369			
Coleridge Park Homes					
Sources	Metropolitan Life Foundation	HUD HODAG	City of San Francisco	Local Initiatives Support Corporation (LISC)	Standard Brands Paint
Types/terms	Loan, 6%, 20 year	Loan, 5%, 30 year, deferred	Loan, 0%, 20 year, surplus cash only	Equity	Grant
Amount	$2,000,000	$1,449,792	$1,313,998	$1,489,825	$231,000
Guyon Towers					
Sources	Harris Bank	City of Chicago	Illinois Development Action Grant	Chicago Equity Fund	
Types/terms	Loan, 8%, 30 year	Loan, 0%, 30 year	Loan, 3%, 30 year, deferred	Equity	
Amount	$1,549,588	$1,960,626	$1,000,000	$1,262,720	
Rancho Sespe Farm Worker Family Housing					
Sources	Farmers Home Administration Section 516	Farmers Home Administration Section 514	Campaign for Human Development	State of California Housing Community Development Grant	County of Ventura Community Development Block Grant (CDBG)
Types/terms	Grant	Loan, 1%, 33 year	Grant	Grant	Grant
Amount	$1,200,000	$2,345,620	$100,000	$500,000	$76,000

Table 3. **Permanent Financing of the Rental Developments** *(continued)*

West Side Development						
Sources	City of Tuscaloosa CDBG	State of Alabama	First Alabama Bank	Bank of Tuscaloosa		
Types/terms	Grant	Grant	Equity	Equity		
Amount	$150,000	$40,000	$1,358,425	$166,608		
Frank G. Mar Community Housing						
Sources	Citibank	HUD HODAG	City of Oakland Parking Authority	U.S. Department of Health and Human Services	Redevelopment Agency	Equity
Types/terms	Loan, 10.47%, 30 year	Loan, 3%, 30 year, deferred	Equity	Grant	Loan, 3%, 50 year, deferred	Equity
Amount	$3,350,000	$5,523,579	$3,400,000	$500,000	$4,000,000	$507,636
Eastside Day Care Homes Cooperative						
Sources	Union Federal Savings Bank	ECI Inc.	CDBG	HUD Rental Rehabilitation	NEF Ltd. Partnership	
Types/terms	Loan, 8%, 30 year	Loan, 8%, 30 year, based on surplus	Loan, 0%, 17 year, deferred	Grant	Equity	
Amount	$254,900	$51,200	$33,700	$50,600	$238,450	
Griffin-Mandela Complex						
Sources	Section 515	Rural Housing Service	Alabama Gas Company	Federation of Southern Cooperatives		
Types/terms	Loan, 1%, 50 year	Bridge loan	Grant	Grant		
Amount	$912,000	$70,000	$15,000	$43,000		

Table 3. **Permanent Financing of the Rental Developments** *(continued)*

Quality Heights				
Sources	Missouri Housing Development Commission	HUD HODAG	National Equity Fund	LISC
Types/terms	Loan, 4%, 30 year	Second mortgage, deferred	Equity	Grant
Amount	$800,000	$750,000	$612,000	$49,000
Casa Loma				
Sources	Rental Housing Construction Funds	Century Freeway Housing Program	Community Redevelopment Agency	Syndication
Types/terms	Loan, 3%, 30 year, deferred	Loan, 3%, 30 year, deferred	Loan, 3%, 30 year, deferred	Equity
Amount	$3,595,000	$2,948,841	$4,941,954	$4,300,000

through the sale of tax credits. Eight of the developments took loans with favorable terms from banks, city or state agencies, or foundations. For example, two loans to Brooklyn Gardens were forgivable and a third (renewable) loan required no payments. One development, The Initiative, was debt free because it was financed solely through grants and donations. Seven of the developments received grants from local or national foundations. Most of the organizations sought and received donations of money, materials, and in-kind services from individuals and corporations.

It is important to point out that these special-needs developments also relied on creative finance to cover social services and other operating costs. Four of the developments received HUD Section 8 subsidies, mostly project-based subsidies, although there were exceptions. The Initiative secured both project- and tenant-based subsidies. This arrangement enabled residents to take their certificates with them when they moved into permanent housing. Residents of the Community Re-Entry Project received tenant-based Section 8. Both H.E.L.P. and the Community Re-Entry Project arranged for city, county, or state funds to be rerouted to the development from shelters or welfare hotels. These public funds covered all or a portion of rent and costs for support services. H.E.L.P. estimated that its facility provides housing and services at approximately two-thirds the cost of welfare hotels, which provide only housing. Bailey-Boushay House received Social Security Disability Insurance payments for residents, plus funds from a state insurance program for people with HIV/AIDS, to cover costs.

An examination of developments' financial health over time can provide a direct indication of the long-term impact of creative finance. The long-term financial performance of rental and special-needs developments is described in the next section.

Long-term financial performance

Rohe et al. (1998) rely on four indicators to assess the long-term performance of low-income housing developments: (1) fiscal health, including currency of mortgage, utility, and other payments, adequacy of reserve accounts, and the percentage of the rent roll collected; (2) the physical condition of the properties, including the building and the landscaping; (3) management performance, including occupancy rates, percentage of units that turned over in the previous year, and time to prepare units for occupancy; and (4) resident satisfaction. Of the four, we consider fiscal health the best direct indicator of the impact of creative finance on the developments over time. The physical condition of the property, however, can be considered an indirect indicator because lack of maintenance can be used to compensate for insufficient resources. Not per-

Table 4. **Permanent Financing of the Special-Needs Developments**

Bailey-Boushay House								
Sources	City of Seattle Special Needs Housing Levy	Robert Wood Johnson Foundation	Kresge Foundation	State Health Department	State Housing Trust Fund	Three county sources	Individual donors	Corporate donors
Types/terms	Forgivable loan	Loan, 3%	Challenge grant	Two grants	Grant	Grants	Donations	Donations
Amount	$1.65 million	$1.5 million	$500,000	$950,000	$250,000	$462,000	$630,000	$312,000
Brooklyn Gardens								
Sources	New York State Homeless Assistance Program	State Office of Mental Health	State Division of Housing and Community Renewal's Housing Trust Fund					
Types/terms	Forgivable loan	Forgivable loan	$0 payment, renewable loan					
Amount	$4,722,710	$404,000	$883,290					
Peter Claver Community								
Sources	City of San Francisco (CDBG)	Savings Association Mortgage Company		Irvine Foundation	Koret Foundation	Macy's	Private donor	
Types/terms	Conventional loan	Conventional mortgage	Syndication proceeds from tax credits	Grant	Grant	Grant	Donation	
Amount	$400,000	$355,000	$830,460	$50,000	$20,000	$18,000	$800,000	

Table 4. **Permanent Financing of the Special-Needs Developments** *(continued)*

Bishop Street House								
Sources	Federal Home Loan Bank Affordable Housing Progam	CDBG	Roslindale Bank	Local foundations and individuals				
Terms/types	Loan converts to grant	Conventional loan, 3%	Conventional loan, 8.5%	Grant				
Amount	\$80,000	\$136,321	\$150,000	\$145,185				
H.E.L.P. 1								
Sources	New York state							
Types/terms	Tax-exempt revenue bonds							
Amount	\$13,965,000							
West Central Wisconsin Housing Renewal Project								
Sources	HUD Section 202	Osprey, Inc.	Bank of Turtle Lake	Wisconsin Housing and Economic Development Foundation	Impact Seven, Inc.	Village of Glen Flora	Individuals	Glen Flora Lutheran Church
Types/terms	NA*	NA*	NA*	NA*	Loan and equity	NA*	Donations	NA*
Amount	NA*	NA*	NA*	NA*	NA*	NA*	NA*	NA*

Table 4. **Permanent Financing of the Special-Needs Developments** *(continued)*

The Initiative								
Sources	Mississippi Department of Economic and Community Development	Vicksburg CDBG	Vicksburg General Fund	Warren County Supervisors	Energy Corporation	Region VI Public Housing Authority	Federal Home Loan Bank, Dallas	City/county in-kind preconstruction
Types/terms	Grant	Grant	Grant	Grant	Grant/contract/ heating system	Grant	Grant	Grant
Amount	$553,743	$117,829	$260,000	$30,000	$62,400	$30,282	$15,000	$54,404
Rose Apartments								
Sources	Citizen's S&L	Portland Development Commission	Portland Development Commission	Community Action Agency				
Types/terms	Conventional loan, 9.5%	Two deferred loans, 3%	Deferred loan, 3%	Grant				
Amount	$270,000	$464,350	$115,000	$442,831				
Community Re-Entry Project								
Sources	New York State Housing Finance Agency	New York State Department of Social Services, Homeless Housing Assistance Programs	New York State Division of Housing and Community Renewal	NA*	Orange County Office of Community Development			
Types/terms	Conventional loan, 8.25%	Grant	Grant	Equity	Rehabilitation loans and bridge loans			
Amount	$1,000,000	$666,250	$110,000	$183,421	NA*			

Table 4. **Permanent Financing of the Special-Needs Developments** *(continued)*

Pershing/Roma Hotel							
Sources	First Nationwide Bank	California Department of Housing and Community Development	Los Angeles Redevelopment Agency	California Housing Rehabilitation Fund	California Equity Fund	Ahmanson Foundation	Developer contribution
Types/terms	Conventional mortgage loan	Deferred loan, 3%	Loan (3%)	Deferred loan, 3%	Proceeds from tax credits	Grant	Grant
Amount	$1,001,650	$945,000	$1,846,987	$150,000	$2,415,546	$35,000	$301,847

* Not available.

forming necessary maintenance is likely to lead to deteriorating physical conditions.

On the basis of the financial health indicators, we find that the impacts of creative finance are complex. All of the developments continued to serve low-income households at the time of the study. Similarly, none has deteriorated below an acceptable standard of repair.[7] Moreover, all but two of the developments were current on all their payments, and most had rent collections in line with market standards.[8] A number of developments, however, were found to lack adequate reserves to cover operating, repair, and maintenance costs.

Financial performance of rental developments

Three indicators of the financial health of rental developments were examined: currency of payments, adequacy of reserves, and percentage of the rent roll collected.[9]

One of the basic indicators of the financial performance of rental projects is the currency of mortgage, tax, and other payments. Of the nine developments reporting information, seven were current on all payments

[7] Information on the acceptable level of repair for all developments was obtained from telephone interviews. Sponsors were asked about the level of repair at the time of the interview relative to the time when the project was developed. In addition, the authors inspected eight sites using a checklist of building and grounds elements. The self-reported level of repair was found to be an accurate indicator of the ratings made through direct observation.

[8] Stockard (1993) suggests a 95 percent rent collection standard. Of the nine rental developments for which information is available, six met this standard. Of the eight special-needs developments for which information is available, four met this standard.

[9] The ratio of rental income to operating expenses is another way to assess the financial health of housing developments. As noted by Bratt et al. (1995), it is possible for developments to take in less in rental income than is spent on a short-term basis, but this is not sustainable over the longer term unless other sources of income are available. Two such ratios were also examined: net rental income as a percentage of total operating expenses and gross potential income as a percentage of total operating expenses. The figure for net rental income as a percentage of total operating expenses will be influenced by both the occupancy rate and management's success in collecting rents. But in some instances the rent being charged may simply be too low to cover operating expenses. The measure of gross potential rent as a percentage of operating expenses indicates whether the development is financially sustainable even at full occupancy and 100 percent rent collection. Among the six rental developments with audits, only one, Guyon Towers, had rental income that was less than operating costs for the previous year (as indicated by values under 100 percent). The other five developments had rental income that was greater than operating costs (as indicated by values over 100 percent). Moreover, Guyon Towers would have had less rental income than operating expenses even at full occupancy and 100 percent rent collection.

Table 5. **Financial Indicators for the Rental Developments**

	Village Commons	Coleridge Park Homes	Guyon Towers	Rancho Sespe Farm Worker Family Housing	West Side Development	Frank G. Mar Community Housing	Griffin-Mandela Complex	Quality Heights	Casa Loma
Currency of payments									
Mortgage payments in arrears	$0	$0	$0	$0	$0	$0	$0	$0	$0
Tax payments in arrears	$0	$0	$0	$0	$0	$0	$0	$0	$0
Other payments in arrears	$0	$0	$59,603	$0	$0	$0	$0	$22,113	$0
Adequacy of reserves									
Amount of operating reserves	NA*	$15,974	$0	$300,000	$50,000	$229,398	$0	$0	$349,882
Amount of replacement reserves	NA*	$198,509	$0	NA*	$50,000	$268,476	$35,440	$14,159	$190,378
Rent collection									
Percentage of rent roll collected	95.2%	99.8%	82.1%	98.8%	96.3%	97.3%	98.0%	90.2%	59.8%

* Not available.

(table 5). Of the other two, Guyon Towers in Chicago was in arrears on tax and service and material payments amounting to approximately $60,000. For the past several years, rents had not covered the development's expenses because of high vacancy rates and low rents. The limited partner, the Chicago Equity Fund, had to contribute approximately $60,000 for the previous several years to keep the development above water. The other development in arrears, Quality Heights in Kansas City, was approximately $22,000 behind on payments to service and material providers. Again, the limited partner, the National Equity Fund, provided assistance by making a $40,000 grant to the development to pay its bills and build up a reserve account.

An important indicator of financial health is the amount of reserves. All rental developments should have operating reserves to be used for unexpected increases in operating expenses, such as higher heating fuel costs. Developments should also hold replacement reserves to be used when a major structural or mechanical system, such as the furnace, needs to be repaired or replaced. Operating reserves should be between 20 percent and 50 percent of the annual operating budget (Stockard 1993). Capital or replacement reserves should total between 5 and 20 percent of the entire replacement cost (Stockard 1993).

Unfortunately, 4 of the 10 sponsoring organizations could not provide development audits. In most instances, the organizations had conducted organization-wide audits that did not break out individual developments. Among the six developments for which we had audits, the amounts in operating reserve accounts varied greatly. Three developments had no funds in operating reserve accounts, one had operating reserves equal to 6 percent of annual operating expenses, and the remaining two had operating reserves in excess of 20 percent of annual operating expenses, the lower limit suggested by Stockard (1993).

Turning to capital replacement reserve accounts, one development had no capital reserves. The remaining five had amounts ranging from 1 to 4 percent of replacement costs, all below the range suggested by Stockard (1993).

The final indicator of financial performance to be considered is the percentage of rent roll collected. Stockard (1993) suggests that 95 percent of a development's monthly maximum potential rent roll should be collected. Six of the nine developments that collected rent met this standard in 1996. Not surprisingly, two of the three developments with lower rent collections (Guyon Towers and Quality Heights) were also behind on their payments. Casa Loma had the lowest rent collection, 60 percent of maximum potential rent. Fortunately, Casa Loma has considerable balances in its operating, replacement, and service reserve accounts. Guyon Towers had an 82 percent collection rate in 1996, but at the time of our site visit, this situation had improved markedly.

Financial performance of special-needs developments

We will now examine the same three indicators of the financial health of special-needs developments. With regard to the first indicator, all 10 special-needs developments were current in their mortgage, tax, and other payments (table 6).

With regard to the adequacy of reserve accounts, the findings are not so reassuring. Information on reserves was obtained via telephone interviews except for the Impact Seven sites.[10] Because we did not have data on the developments' annual operating expenses or replacement costs, we could not calculate the adequacy of reserves except for the Impact Seven sites, whose reserves of 5, 6, and 8 percent were within the standard range suggested by Stockard (1993). Information provided in the telephone interviews with the other developments suggests that a number of them may be at financial risk because of their small or nonexistent reserves.

Reserves for two developments, Bailey-Boushay House and H.E.L.P. 1, were covered by large accounts that the managing or sponsoring organizations established to cover all of their developments. In the case of Bailey-Boushay, Virginia Mason Medical Center's reserve account of $500,000 could be drawn on if needed. One development had an operating reserve account, and four had only replacement reserve accounts. Three developments indicated that their reserve accounts could be tapped for either operating or replacement expenses.

Two developments, Brooklyn Gardens and The Initiative, had no reserve accounts of any kind. Because state and local government funding agencies considered Brooklyn Gardens a service provider rather than a housing provider, it was not allowed to establish reserve accounts. When The Initiative needs repairs or replacements, it must rely on community assistance. At the time of our visit, staff and board members were discussing ways to establish an account that would cover maintenance and repair costs.

The third financial indicator is the percentage of rent roll collected by each development. A total of 9 of the 10 developments collected rent from the residents or from the city. Of these 9, 3 collected 96 percent or more of the possible rent roll during the previous fiscal year, thus exceeding the 95 percent standard suggested by Stockard (1993). Two developments collected between 90 and 92 percent of their rent roll, and two collected less than 90 percent. Two of the three Impact Seven sites

[10] We received three organizational audits and three audits for developments. Only one of the development audits contained the information needed to calculate adequacy of reserves and the percentage of rent roll collected.

Table 6. **Financial Indicators for the Special-Needs Developments**

	Bailey-Boushay House	Brooklyn Gardens	Peter Claver Community	Bishop Street House	H.E.L.P. 1	West Central Wisconsin Housing Renewal Project	The Initiative	Rose Apartments	Community Re-Entry Project	Pershing/ Roma Hotel
Currency of payments										
Mortgage payments in arrears	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Tax payments in arrears	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Other payments in arrears	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Adequacy of reserves										
Amount of operating reserves	$500,000[a]	$0	$0	$0	$1,300,000[b]	$0	$0	[b, c]	$0	$22,000
Amount of replacement reserves	NA[d]	$0	[c]	$2,500	NA[d]	$15,424 GF[e, f] $52,716 W $37,705 M	$0	NA[d]	~$35,000	$0
Rent collection										
Percentage of rent roll collected	[g]	[c]	90%–92%	100%	>97%[h]	92% GF[e, f] 97% W 96% M	87%	96%	90%	89%

[a] Virginia Mason Center has this amount in reserves for all its sites.
[b] Reserves can be used for operating and replacement costs.
[c] Information not available.
[d] Not applicable.
[e] Source: Project audits.
[f] GF = Glen Flora, W = Wausau, M = Menomonie.
[g] No rent is collected. The state pays a daily rate to the facility for each client. If a client receives public assistance, he or she signs the amount over to the state.
[h] Residents do not pay rent. New York City is the tenant and guarantees payment for 97% occupancy.

collected more than 95 percent of their rent rolls, while the other collected 92 percent.

Other impacts of creative finance on rental and special-needs developments

In addition to the more objective indicators of financial health, sponsoring organizations were asked more subjective questions. Their responses were used to further assess the impact of creative finance over time. In both telephone and on-site interviews, respondents were asked directly to assess the positive and negative impact of a variety of factors on long-term development performance, including the characteristics of the project finance.[11] Respondents were also asked what about the development worked well. Several respondents identified issues related to or derived from the use of creative finance.[12]

Rental developments

Most respondents believed that project financing characteristics had a very strong positive impact on the performance of rental developments. They noted that various subsidies made the developments affordable to low-, or in some instances, very low income families. City or state agencies provided grants or silent second mortgages. When these funds were combined with equity investments from the LIHTC program or other shallower subsidies, it was possible to keep rents low. For example, the financing package for Casa Loma entailed no mortgage payments at all. This not only kept rents low, but it left funds for on-site day care, job training, and other resident services.

[11] Respondents were asked three questions: (1) In what ways has the development's financing had a positive effect on project success? (2) In what ways has the financing had a negative effect on project success? (3) Do you anticipate any problems in the future due to aspects of the financing package? In addition, telephone interview respondents were also asked to rate the impact of the development's finance and other factors on a scale from –5 to +5, with negative numbers indicating a negative impact, 0 no impact, and positive numbers a positive impact. For the relative importance of each factor, the absolute value of the rating was then averaged across all the developments. Factors with average ratings of 4 or more were considered to have a strong impact on performance, average ratings between 3 and 3.99 were considered to have moderate impact, and average ratings above 0 but below 3 were said to have a low impact.

[12] It should be noted that most respondents did not link their responses to the use of creative finance. We derive the link logically from their responses. For instance, one respondent stated that learning to work with partners had been valuable. This respondent also said that the organization has continued to rely on these partnerships to implement other projects. In this case, we link the establishment of partnerships to the requirements of creative finance.

In identifying what worked well, several respondents emphasized impacts on what might be called the "social capital" of the sponsoring agencies, impacts that can be linked to creative finance.[13] Six out of eight respondents identified such impacts. The process of securing financing from several sources led to long-term relationships with city agencies, financial institutions, equity investors, and other organizations. These relationships have been instrumental in other housing and neighborhood improvement activities undertaken by the sponsoring nonprofits. Further, the partnerships strengthened the reputation of sponsoring organizations and enhanced their credibility.

Creative finance also helped develop mutual interest among the various funders. Once foundations, government entities, and private lenders contribute financially, they are believed to have an interest in the sponsoring organizations' overall success.[14] The mutual interest and the financial nexus act as a safeguard if additional resources are needed, thus improving the sustainability of the development over time.[15] In our sample, for example, two developments received additional subsidies from equity investors to see them through difficult times.

Conversely, several aspects of financing were believed to have had negative impacts on the projects. Several respondents indicated that problems were created by having multiple sources of financing. First, the reporting requirements placed on management were extensive and burdensome. Various funders required different information or the same information presented in a different format. Second, in many cases, any amendments to leases, occupancy agreements, and other rules and procedures had to be reviewed and approved by all funding sources. This was a difficult and uncertain process that discouraged some management entities from making what they thought would be positive changes. For example, the staff of the East Bay Asian Local Development Corporation wanted to change screening procedures to include home visits with prospective tenants. However, this would have required a change in the management plan, which would have to be approved by the many lenders.

[13] Respondents did not use the term "social capital." They mentioned, however, relationships that serve as resources and can be drawn on when needed. Such expressions are similar to the definition of social capital proposed by Coleman (1988).

[14] Thus, creative finance can be considered instrumental in developing a financial nexus among private lenders, state housing finance agencies, equity investors, and others who may face significant losses if the development fails.

[15] Keyes et al. (1996) identified similar issues in their discussion of the nonprofit sector. We believe that it is the use of creative finance by the nonprofit sector that results in these positive externalities.

The difficulties of dealing with multiple sources of financing seem to be accentuated further by a typical lack of predevelopment support, that is, money to support predevelopment activities. Sponsoring organizations reported that already overworked staff had to be pulled from other responsibilities to focus their energies on securing multiple sources of finance, with their complex and often conflicting requirements. This lack must be considered an important omission since Rohe et al. (1998) found that predevelopment activities have a strong impact on the performance of housing developments over time.

Respondents identified the tenant income restrictions imposed by financing sources as another negative impact. These restrictions made it difficult to find tenants who meet the income requirements and can still pay the rent needed to keep the development financially viable. In some markets, the income differential between qualifying for a development and being able to afford it is very narrow. In several cases, for example, unexpectedly high utility costs have necessitated rent increases that have created hardships for tenants. Inadequate budgets also had negative impacts on project performance. In several instances, an expense that turned out to be a major operating cost was not included in original budget projections. For example, the need for security guards was not anticipated at either Guyon Towers or Frank G. Mar Community Housing. The expense of providing security added substantially to operating costs.[16]

Finally, inadequate capitalization of the reserve accounts at the development's inception also had negative impacts. As noted earlier, many developments had little or no funds in reserve accounts for unforeseen capital, replacement, or operating costs. Instead, they expected to build these accounts from operating surpluses, which never materialized in a number of instances. Although the extent to which these last two impacts are due to creative finance is unclear, they are consistent with Stegman's concerns.

Special-needs developments

Most organizations sponsoring special-needs developments believed that creative financing had only a moderate impact on the performance of their housing developments.[17] Only 4 of the 10 special-needs developments rated financing as having a strong impact. Aspects that were seen as beneficial include having federal Section 8 subsidies available

[16] It is not known whether the omission of such expenses from original budgets was the result of restrictions imposed by funding sources or simply an oversight on the part of sponsoring organizations.

[17] See footnote 6 for a description of how these ratings were done.

to cover a portion of the rent, using bond financing, and having a number of funding sources rather than just one. For instance, H.E.L.P. 1 was funded with tax-exempt revenue bonds, which are obligations of the city and state. Because of this bond financing, the development does not collect rent from residents. A number of government grants and city contracts cover H.E.L.P. 1's operating and service costs. The Initiative, however, has been able to survive cutbacks in funding by depending on more than one source of funds. While specific aspects of the project financing might have worked well so far, many sponsoring organizations expressed serious concerns about the long-term funding of services and operating costs.

Little can be said about potential positive impacts of creative finance on the social capital of special-needs organizations. In contrast to sponsors of rental developments, only 3 out of 10 special-needs respondents identified impacts on the social capital of the organization as aspects of the development that worked well. Thus, we find little evidence that creative finance might be linked to the creation of partnerships and other aspects of the social capital of special-needs organizations involved in housing development. It may be possible that because of the need for support and other services, these organizations are more likely than rental developments to have partnerships in place. This area should be explored in future research.

Two negative aspects of creative financing in special-needs developments were reported: concerns about multiple (and often contradictory) reporting requirements and uncertainty of future funding. For instance, because Brooklyn Gardens is seen by its financial supporters as a service provider instead of a housing provider, it has not been allowed to establish reserve accounts. Consequently, it has had to apply for grants from funders whenever money was needed for major repairs. Brooklyn Gardens also discovered the flip side of multiple sources of funds; each agency involved in the financing had its own set of regulations, some of which contradicted the others. This issue was further complicated because each wing of the three-wing development had its own operating contract.

Especially troublesome for five of the special-needs developments was the future of Section 8 subsidies. The initial subsidy agreement for most of the developments was 10 years. A number were approaching their 10th year and were unsure of the future of the subsidies because of the move to yearly renewal of Section 8 commitments.

Building on the strengths and minimizing the weaknesses of creative finance

On the basis of the above information, we conclude that the impact of creative finance over time is more complex than previously believed. On the positive side, the developments we examined continue to provide decent, affordable housing to low-income households. No one has foreclosed on any of the developments in our study. None of them has altered its focus on serving low-income households or deteriorated below an acceptable standard of repair. On the negative side, not all projects have avoided financial or other problems. One rental development has, in fact, experienced serious financial problems that have not been severe enough to lead to foreclosure, abandonment, or a change in the income levels of the households served, however.

Overall, it seems fair to conclude that the developments examined have met their original objective of providing decent, affordable housing to low-income persons in part because of their reliance on creative finance. Moreover, although the evidence is only indirect, creative finance appears to increase the social capital of sponsoring organizations in important ways, including the establishment of partnerships with public, private, and nonprofit entities that may enhance the long-term viability of sponsored developments and other organizational efforts. This last point should not be underestimated since it is at the core of the increasing importance of nonprofit networks in providing affordable housing (Keyes et al. 1996).

However, there is still reason for concern about the future of many of the developments in our study. In particular, a number of them have grossly inadequate financial reserves. These projects may be one major repair or one unexpectedly high utility bill away from financial crisis. As developments age, the need for major repairs will grow. An additional concern, of particular importance for special-needs developments, is the uncertainty of funding for tenant-based assistance and the social services that are such an integral part of many developments. Finally, the reliance on several layers of finance is accompanied by complicated and often contradictory reporting requirements. This added bureaucracy taxes often overcommitted staff.

We do not believe that these concerns are inherent in the nature of creative finance. On the contrary, we believe that they can be minimized through policy intervention. We therefore make four suggestions.[18]

[18] Whether or not these recommendations are easier to implement under the traditional single source (federal government) approach is not relevant here. Although this is an important question, it is beyond the scope of the research presented here. Instead, the recommendations are derived logically to address the concerns about the use of creative finance raised by the sponsoring organizations contacted.

First, public and private funders should provide support for the predevelopment activities of nonprofit organizations. Such work has a strong impact on the performance of housing developments over time, but funding seems to be increasingly difficult to obtain. Predevelopment support is particularly important due to the difficulties inherent in securing multiple sources of finance. Thus, we recommend that both government organizations and foundations develop programs to provide funds for predevelopment activities. Such programs would help expand the number of affordable housing developments and improve their quality.

Second, long-term funding uncertainty should be minimized. Many developments rely on government subsidies, such as Section 8 assistance, to make developments affordable to low-income households. This assistance is crucial to tenants' ability to pay the rent and developments' ability to secure funds to cover operating expenses. Unfortunately, annual renewal of Section 8 assistance leaves recipients uncertain about whether they will be able to stay in their units and leaves rental and special-needs developments uncertain about whether they will be able to maintain their rent revenues. Providing longer-term commitments would minimize that uncertainty.

Third, public and private funders should establish a program to help developments experiencing financial problems.[19] Federal, state, and local governments as well as private entities have made substantial investments in affordable housing developments across the country. To protect those investments, a program to provide a limited amount of additional support to developments headed for financial crisis should be developed. For instance, such a program could create operational and replacement reserves in the form of an insurance pool.

Finally, the various funders of low-income housing need to come together and develop a model unified reporting system. Representatives of the major financial contributors to low-income rental and special-needs developments, including federal and state governments and foundations, should develop one reporting system and work toward having it adopted by the various funders. This would go a long way toward simplifying the reporting burden now placed on the managers of low-income housing.

Our findings suggest that creative finance has some disadvantages but also important advantages compared with the traditional housing finance model centered around the federal government as the sole lender and subsidy provider. As Stegman feared, we find creative finance to be associated with complicated schemes that are difficult to secure and

[19] Such a program should be developed to avoid rewarding poor management practices. It should incorporate a system of both rewards and penalties.

arrange, and with developments that are thinly capitalized and typically lack adequate reserves. However, we also find that sponsoring organizations believe that creative finance is associated with developments' long-term financial viability and greater affordability. Moreover, we find evidence suggesting that creative finance is associated with increases in social capital that may have important positive impacts on the organizations themselves and their efforts. The traditional model did nothing to strengthen this aspect of low-income housing development and therefore has left traditionally financed developments vulnerable to budget cuts and program changes over time.

The study's two methodological shortcomings may limit the generalizability of the findings, however. First, developments that were recognized for their excellence, like the Maxwell award winners, may perform better than low-income housing developments in general. This may result in an overestimation of the positive impact of creative finance. Second, the lack of a comparison group limits interpretation of the findings.

Despite these limitations, the findings suggest a more constructive treatment of creative finance in policy formulation. Instead of relying on creative finance as a de facto policy, it should be incorporated into policy by design to build on its strengths and minimize its negative impacts.

It should be noted that we do not contend that creative finance is the best approach to develop affordable housing or that the federal government has no role to play, although we do believe that the government is unlikely to reassume the role of sole funder of affordable housing in the foreseeable future. If our findings were later substantiated in more generalizable work, they would justify designing a housing policy for the 21st century that incorporates, by design and not de facto, creative finance (plus our four policy recommendations) as a core component with federal money used to leverage state/local and private resources.

Authors

Roberto G. Quercia is Assistant Professor of City and Regional Planning at the University of North Carolina at Chapel Hill. William M. Rohe is a Professor of City and Regional Planning and Director of the Center for Urban and Regional Studies at the University of North Carolina at Chapel Hill. Diane K. Levy is a Research Associate at the Metropolitan Housing and Communities Policy Center at The Urban Institute.

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