Right-Sizing Subsidy

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Affordable housing developers need local government subsidy for two reasons: (1) to meet local government contribution requirements for making applications for other funds and (2) to close the gap in financing needed to meet the real costs of the development. How will local governments know what the right amount of subsidy is? Local governments need to provide enough subsidy to make the deal work; they want and need affordable housing developments. However, suppose they over-subsidize the development by providing more funding than the developer needs. In that case, fewer units will be built in their community since that funding could have been used to help an additional development.

Right-sizing subsidy means providing not too little and not too much government subsidy for each affordable housing development. For some local governments, the concept of over-subsidizing a development may seem improbable as meager resources are often not enough to fill the ever-growing gap in costs to affordability. However, it is for this very reason it is essential to understand how subsidies, small or large, actively contribute to the viability of a development.

The Importance of Subsidy

Developers cannot compete for SAIL and competitive tax credits from Florida Housing Finance Corporation without subsidy from local governments. Whether the local contribution is the minimum required to achieve the maximum number of points or the greater amount needed for the local preference for 9% tax credits (Local Government Area of Opportunity Funding), neither of these is the focus of rightsizing. FHFC established the required contribution level, and the local government must provide those funds.

Right-sizing subsidy focuses on gap financing, where requests can be for millions of dollars. Local governments must take a deep dive into the costs of development and the income, expense, net operating income, and debt sizing. Identifying the right size of a subsidy requires understanding many factors like development and operating costs, sources of revenue, and construction financing.

The developer's process may start with the costs to build the desired development, followed by creating an operating budget to address income and expenses, hard debt sizing based on those income sources and expenses, and finally, anticipated sources starting with the maximum amount of hard debt. Your review should follow the same process:

❖ Beginning with a look at development costs to determine if they are reasonable on a per-unit basis.

❖ Continue with a look at the operating budget to be sure that the unit mix and rents align with anticipated requirements for the Florida Housing request for applications and your local requirements. Operating expenses should also be reasonable as a percentage of income.

❖ Finally, you will want to look at sources. Check to see if the debt is properly sized based on current market terms, if housing credit equity is accurately estimated (or supported by a letter from an investor), and if requirements of other proposed sources, such as the deferred developer fee, can be met by the development.

This is a simplified explanation of a very detailed review, which, like the developer's process, may require several iterations to get to the right level of subsidy.

An Example

Let's apply this knowledge to the following scenario: A developer uses tax-exempt financing, SAIL, and 4% tax credits. Your local government uses tax increment finance funds from its CRA to provide additional gap financing beyond the minimum local contribution required to apply for SAIL. The developer approaches the local government and states that costs have increased, and the development needs an additional $4 million to fill the gap.

In this real-world example, the City and County turned to the local Housing Finance Authority, who engaged their credit underwriter to review the numbers. The credit underwriter found that while the cost increase was accurate, the need for gap financing was only $1 million — saving the local governments $3 million that could be used to assist other developments.

Why was the difference between the requested subsidy and the needed subsidy so great? The credit underwriter found that the developer was not maximizing the first mortgage debt or the deferred developer fee. The analysis showed that net operating income was understated.

This is just one example of the benefits of right-sizing subsidy. Again, it involves a comprehensive examination of many factors like development and operating costs, sources of revenue, and construction financing. The timing of local government review often occurs before Florida Housing and other funders complete the detailed underwriting. Therefore, it is recommended that right-sizing subsidy be made a policy and programmatic priority for local governments, addressing both the success of individual developments, and maximizing the production of housing units at a time of unprecedented need and challenges. If your local government does not have the benefit of a Local HFA or the in-house expertise to complete this level of review, we encourage you to please contact the Florida Housing Coalition. Our staff is capable and willing to help you with this vital work.

Ashon Nesbitt is Chief Programs Officer and Technical Advisor for the Florida Housing Coalition. Ashon leads the Coalition's nonprofit capacity building work, community land trusts, and the center for racial equity. Ashon helps local governments with land use tools and creative models for affordable housing development and finance, such as adaptive reuse. Ashon has professional experience in local government program administration, tax credit finance, and rental development, as well as a master's in Urban and Regional Planning and Real Estate from the University of Florida, and a bachelor's in Architectural Studies from Florida A&M University.