Construction of Affordable Rental Housing under the USDA 538 Program

Special Studies November 1, 2016
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INTRODUCTION

In recent years, housing affordability has emerged as a growing concern. Rising house prices and, until very recently, stagnant household income growth combined to put pressure on affordability of single-family homes and condominiums. At the same time, strong demand has pushed down vacancy rates and contributed to soaring rental prices.

In rural areas, the U.S. Department of Agriculture (USDA) supports affordable rental housing by guaranteeing multifamily loans under its Multifamily Housing Loan Guarantee Program, also known as the 538 Guaranteed Rural Rental Housing program. The loans guaranteed under this program can be used to build new apartment buildings as well as to repair/rehabilitate old ones.

New data released by the USDA shows in 2014, $93 million in guaranteed loans were obligated and ultimately closed for the construction of 77 new multifamily projects. The loans covered about one-fifth of development costs. On average the projects contained 56 rental apartments, three-fourths of which were one- or two-bedroom. Average rent for a two-bedroom apartment was $581. In contrast, median asking rent for new unsubsidized apartments has been running over $1,400[1]. The gross potential rent is 4.5 percent of development costs, below the average capitalization rate of 6.0 percent for all properties[2]. Most of these averages have changed significantly over the programs life.

The results suggest that the 538 program is a cost-effective way to encourage the production of affordable housing. The data indicate that the average guaranteed closed loan accounts for only 20 percent of a new project's total development cost. At the same time, the Budget of the U.S. Government records the subsidy rate on the 538 program as -0.19 in 2014[3]. The negative subsidy rate has grown larger in recent years to -1.27 percent in 2015 and -2.97 percent in 2016[4]. A program has a negative subsidy rate when the estimated cost to the government of guaranteeing credit is less than the estimated collections from repayments, interest, and fees. For example, in 2014, the -0.19 percent subsidy rate reflected a default rate of 7.93 percent but a fees and other collections rate of 8.12 percent [5].

BACKGROUND

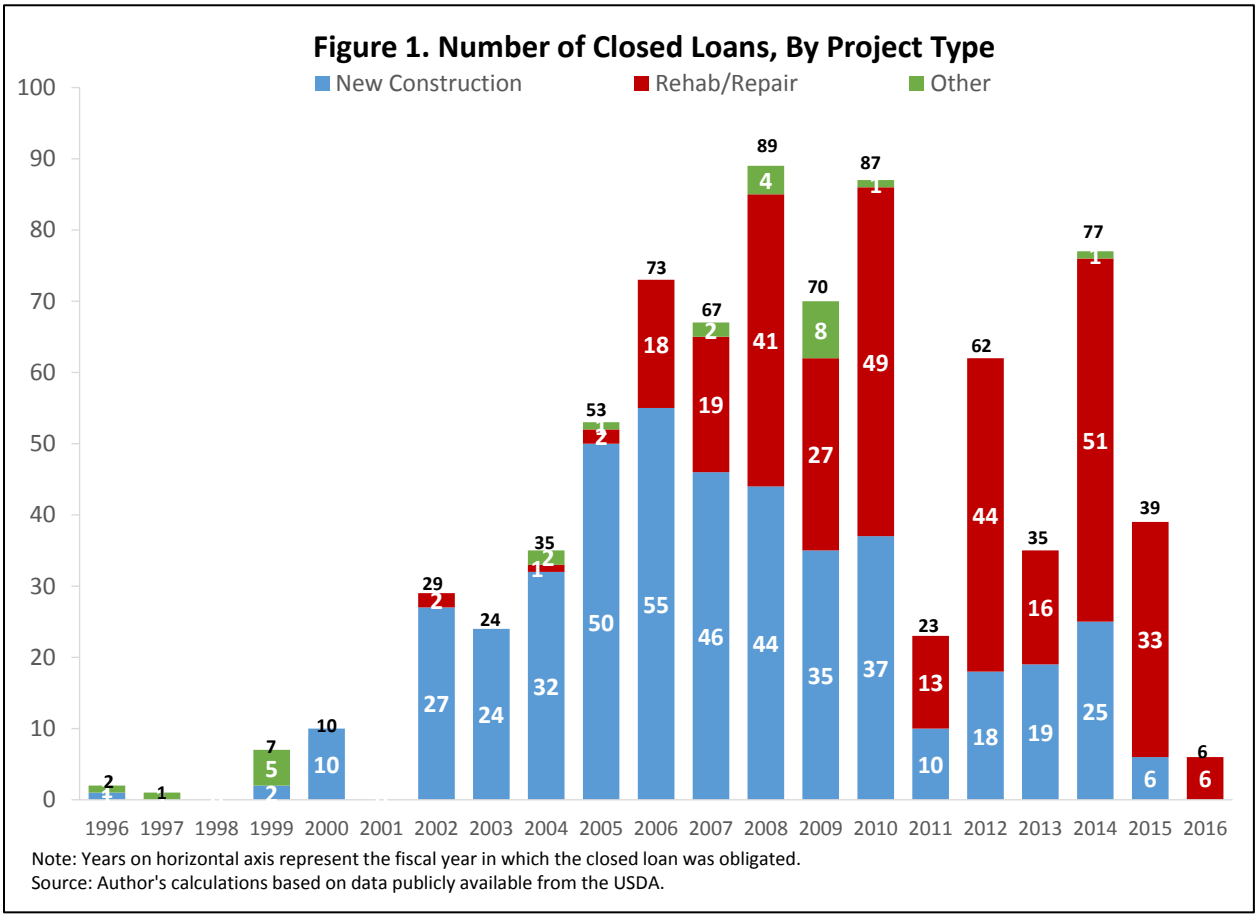
The United States Department of Agriculture's (USDA) 538 Guaranteed Rural Rental Housing program was created by Congress in 1996, guarantees the loans made by eligible private lenders to an eligible borrower[6]. Eligible borrowers include state and local governmental entities, non-profit organizations, for-profit organizations, and federally recognized tribes.

For-profit entities may borrow up to 90 percent and non-profit entities can borrow up to 97 percent of the total development cost or appraised value, whichever is less. The funds may be used for construction, improvement or rehabilitation, and purchase of multifamily rental housing. Rent for individual units is capped at 30 percent of 115 percent of area median income. Meanwhile, average rent for an entire project cannot exceed 30 percent of 100 percent of area median income, after adjusting for family size.

This report uses a new publicly available dataset to look at new construction supported by the program. The dataset was recently provided by the United States Department of Agriculture's Rural Development (USDA RD) in support of the White House's Open Government Initiative. The data contain information pertaining to closed loans on 789 projects with 34 characteristics for each project covering the fiscal years 1996 to the first nine months of fiscal year 2016. This report assesses trends over the years in which the closed loans were obligated. Closed loans in fiscal years 2015 and 2016 are likely not totals for those years because a portion of the loans obligated then may not close until a future date. The characteristics provided in the dataset include the loan amount, the total development cost, the total units in the project, the number of bedrooms in each unit and the average contract rent for each size unit.

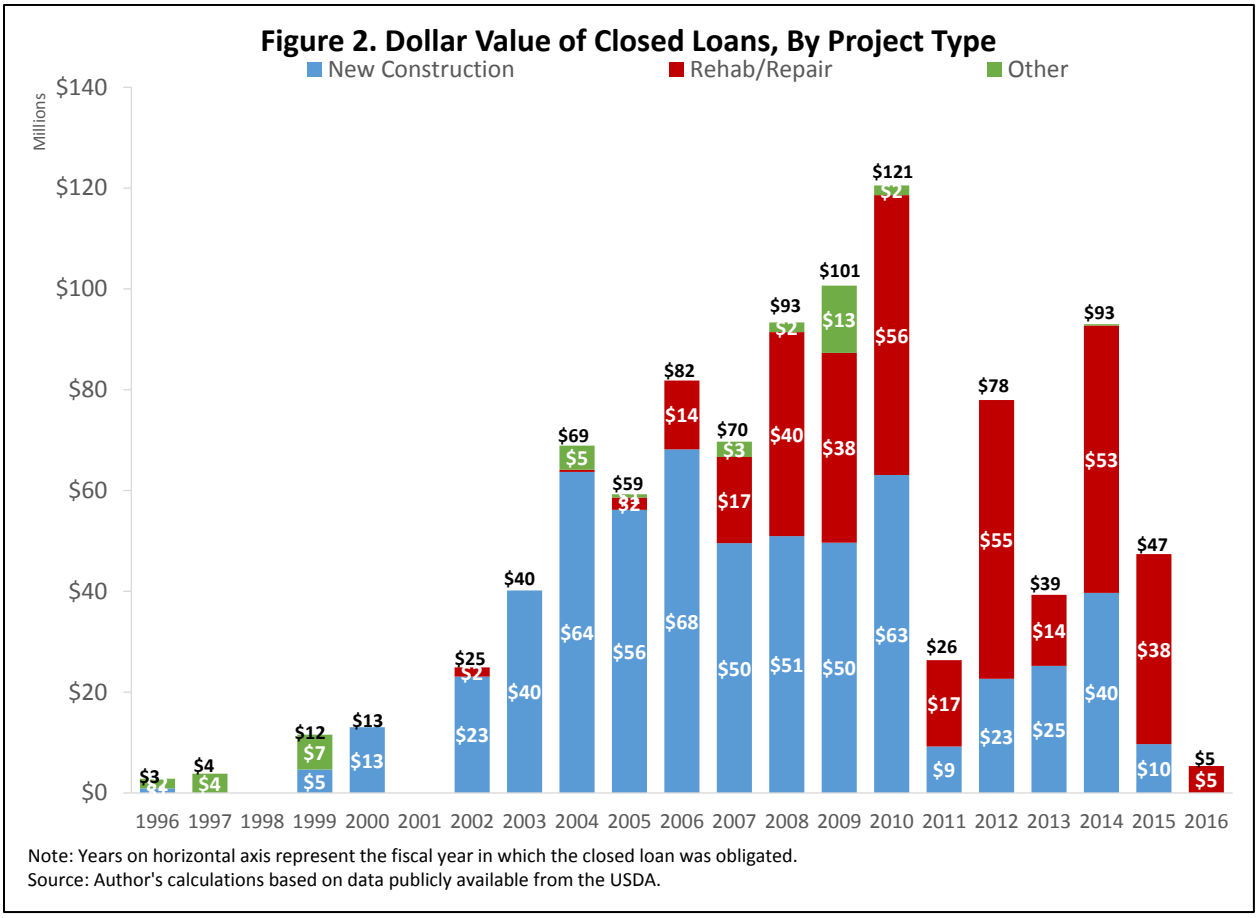
SIZE OF PROGRAM

As Figure 1 illustrates, the number of guaranteed loans closed was sporadic in the early years of the program, 2 loans in 1996, 1 in 1997 and 0 in 1998. However, 1999 and 2000 saw 7 and 10 loans respectively. Beginning in 2002, the loan program began to see general expansion, from 29 loans in 2002 to 89 by 2008. Since 2010, there has been volatility in the number of projects. The years 2011 and 2013 saw fewer than 40 loans, 23 in 2011 and 35 in 2012, but in the years 2012 and 2014 there were more than 60 loans recorded, 62 in 2012 and 77 in 2014. In 2015 there were 39 loans closed and in 2016 6 loans closed. However, these figures do not reflect all of activity because a portion of the closed loans obligated in these years have not yet closed.



Note: Years on horizontal axis represent the fiscal year in which the closed loan was obligated.
Source: Author's calculations based on data publicly available from the USDA.

New construction accounted for a sizeable portion of guaranteed loans in the years leading up to the housing bust, but in subsequent years, a greater share of projects were rehabilitation and repair. Since 2009, new construction projects were the majority category in only one year, 2013. In each year since 2009, excluding 2013, guaranteed loans for rehabilitation and repairs accounted for most projects. However, after reaching a cycle low in 2011, the volume of guaranteed loans in each successive year ending in 2014 has exceeded its level in the previous year.



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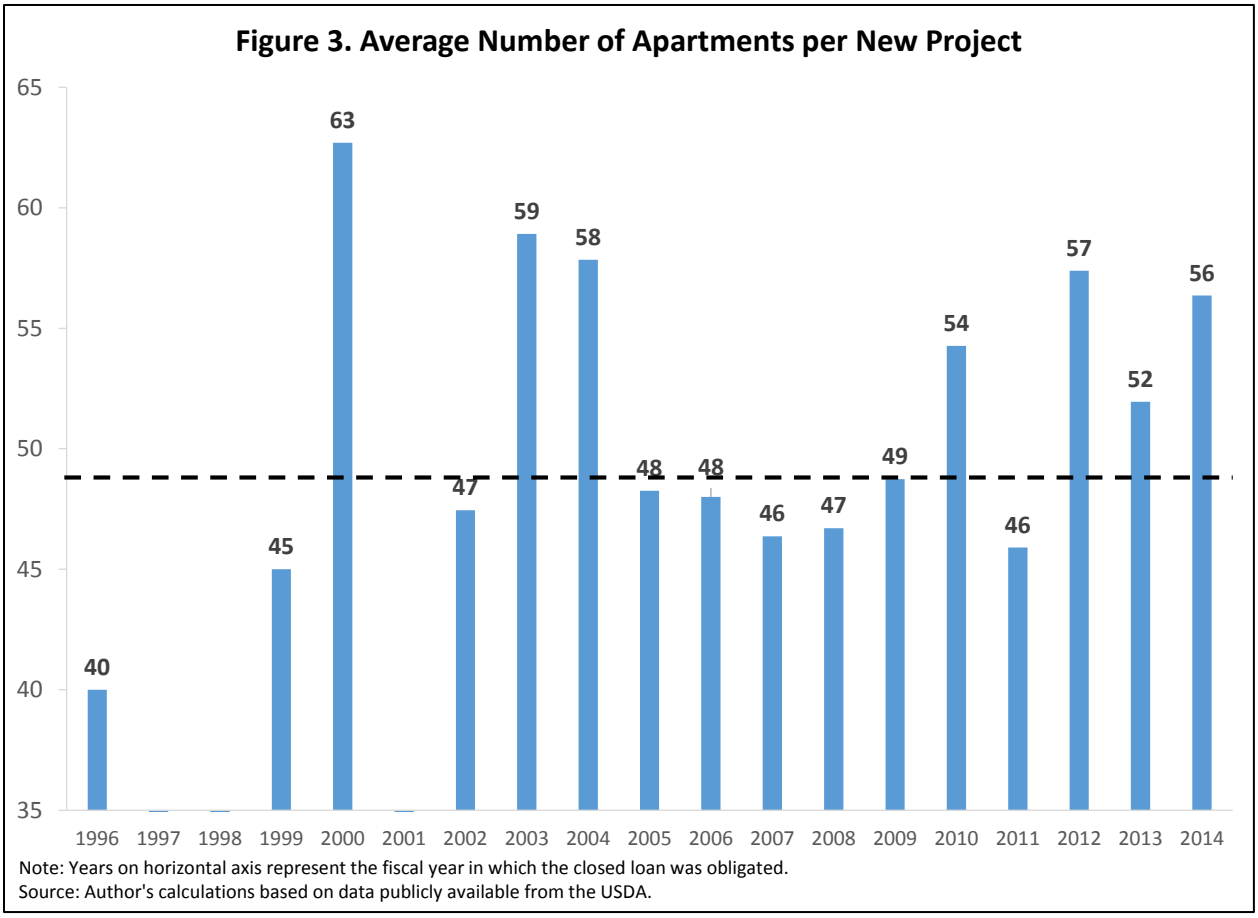
Loan volume tells a similar story. The dollar value of guaranteed loans were on an upward trend between 1996 and 2010 and loan volume for new construction projects was the leading component. In 1996, guaranteed loans in the program totaled $3 million and reached $121 million by 2010. However, since 2010, loan volume has been lower, especially for new construction. However, there are indications that a recovery is underway. Nevertheless, the year-to-year volume of loans guaranteed has also been quite volatile.

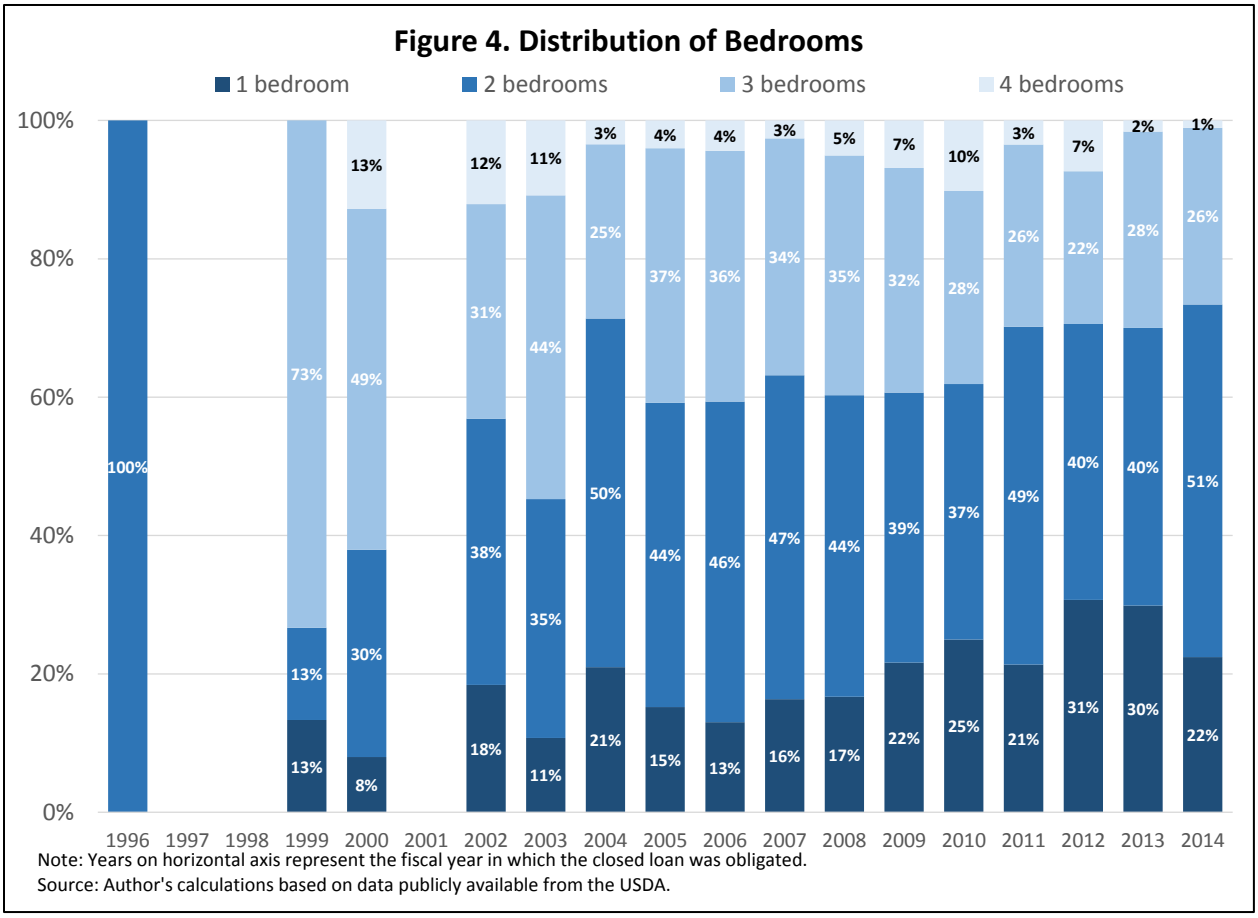
CHARACTERISTICS OF NEW CONSTRUCTION PROJECTS

The average size of new projects using the 538 program has hovered around 50 apartments per project. The average project size was higher in the early 2000s and in the post-boom period, but lower at the height of the boom (Figure 3).



There were three years between 2000 and 2004 in which the average number of units in a new construction project exceeded 50. In 2001 there were no loans guaranteed for new construction and 2002 the average size of a new construction project was 47 units. Over the 2005 to 2009 period the average number of units in a new construction project was routinely under 50. Beginning with 2010 the average size for a new construction project exceeded 50 in each year except 2011[7].

The size of the units, as measured by the number of bedrooms in each unit, began to shrink in the post-boom years. In the years 1996, 1999, and 2000, the distribution of units in new construction projects by bedroom size was erratic. However, beginning with 2002, a clear trend emerged. The share of units with two or more bedrooms typically accounted for 80% or more of all units in a new construction project. Although in 2004 this group of units accounted for 79% of units.



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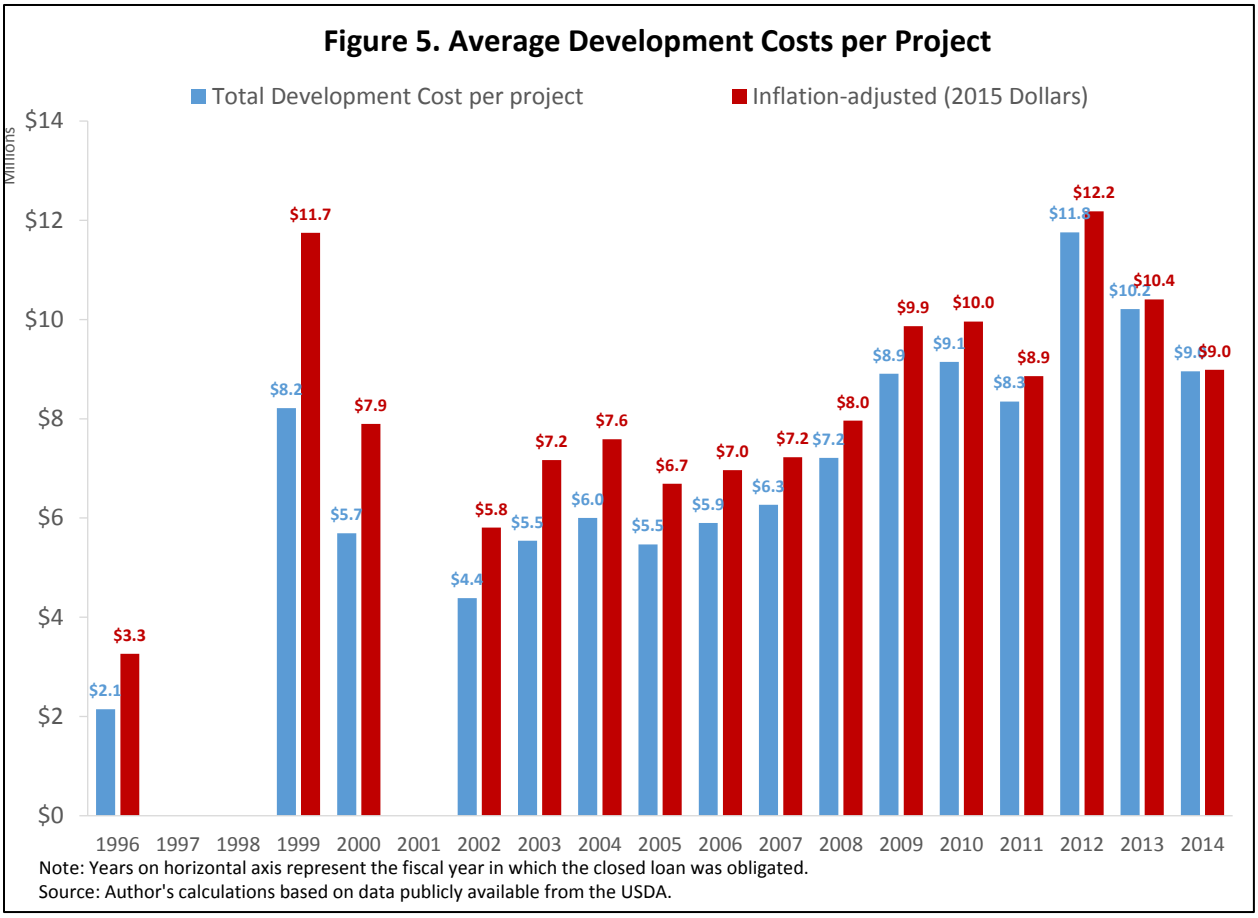
Source: Author's calculations based on data publicly available from the USDA.

However, beginning in 2009, the number of one-bedroom units sustained a share above 20%. The larger footprint of one bedroom units was partially offset by a smaller percentage of units with three or more bedrooms. In 2008, units with three or more bedrooms accounted for 40% of all units in new construction projects. However, by 2014 its share fell to 27% of all units.

Average development costs, both in nominal and real terms, generally rose over the 2002 to 2012 period. Over this timeframe, average development costs for new construction projects recorded year-over-year growth in each year except 2005. The decline in development costs from 2004 to 2005 was sufficiently great that costs did not recover in nominal terms until 2007 and in real terms a recovery was not reached until 2008.



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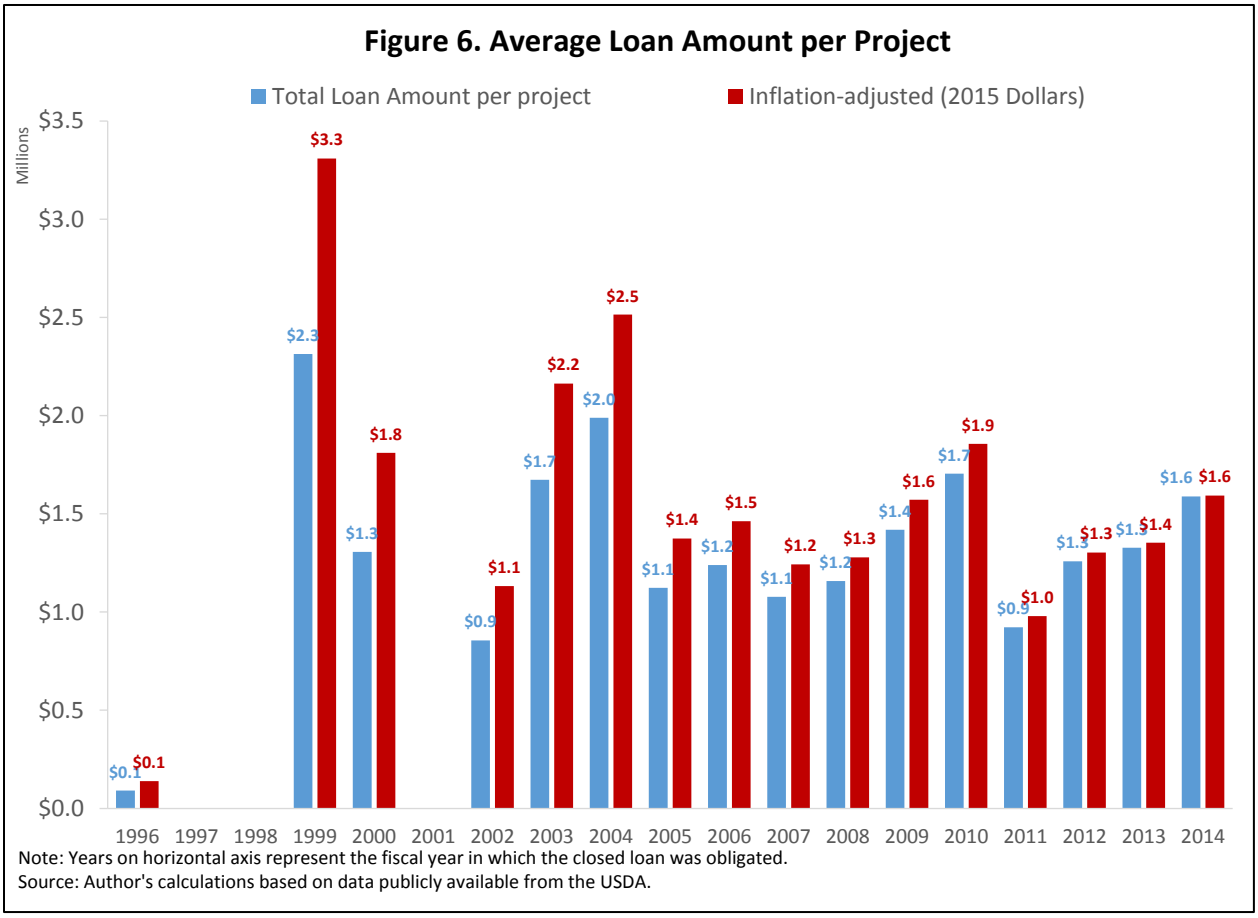
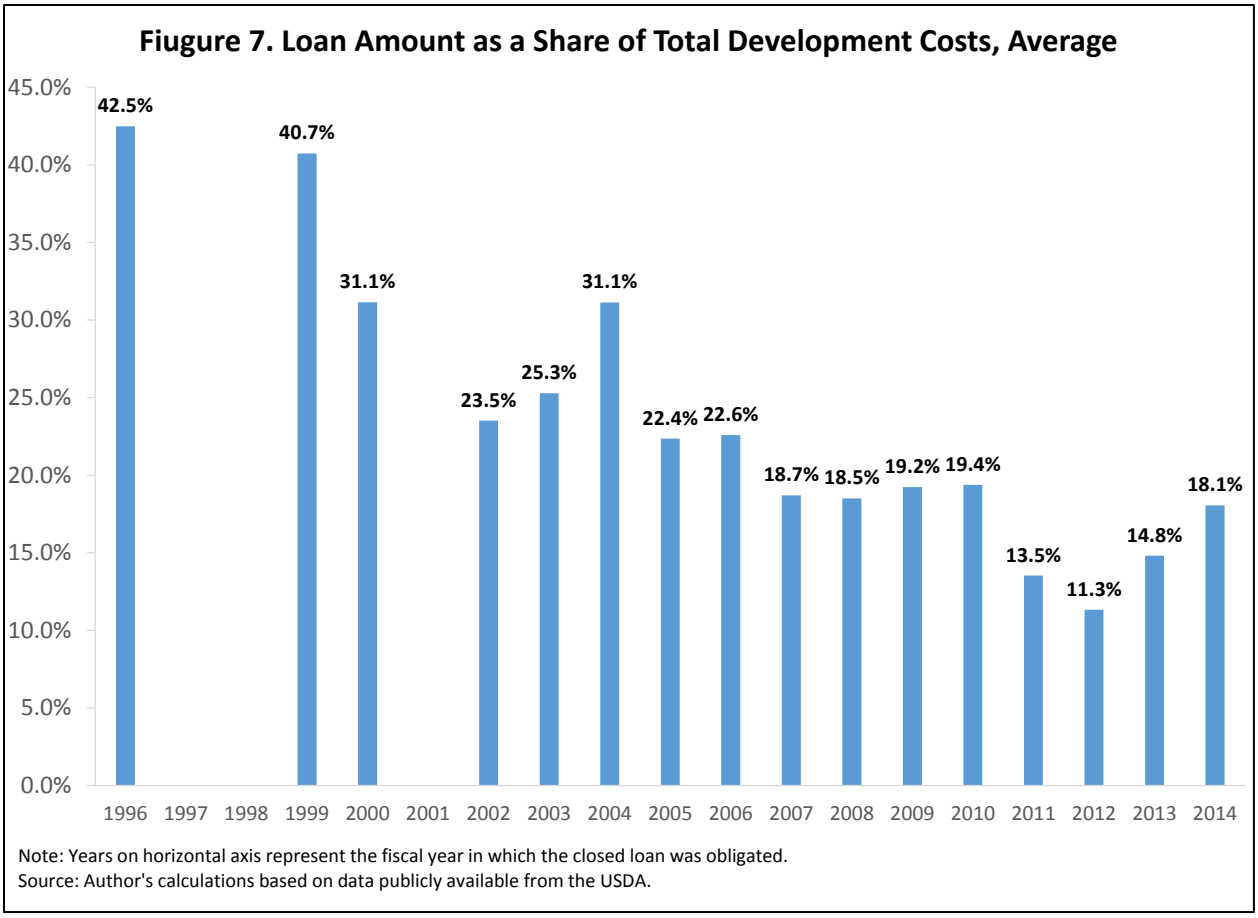
Source: Author's calculations based on data publicly available from the USDA.

However, following a peak in 2012, average development costs began to decline. In 2012 average development costs for a new construction project totaled $11.8 million in nominal terms, $12.2 million in real terms. By 2014 average development costs had fallen to $9.0 million. The decline in development costs may partly reflect the decline in the percentage of units with three or more bedrooms. Despite a slight uptick between 2012 and 2013, the share of units with three or more bedrooms fell between 2012 and 2014.

Average loan amount, also measured in both nominal and real terms, see-sawed over the 2002-2014 period. Following the 2001 recession, where no new construction projects in the USDA RD's multifamily guaranteed loan program, the average loan amount rose between 2002 and 2004 before declining in 2005. Over the rest of the housing boom period through 2007, the average loan amount remained roughly constant, ranging between $1.2 million and $1.5 million. However, the onset of the recession coincided with an increase in the average loan amount for new construction projects between 2008 and 2010, peaking at $1.9 million, before a 46 percent decline in 2011, 47 percent in real terms. Since the decline, average project loan amounts have begun a resurgence, but its level in 2014, $1.6 million remains 5 percent below its level in 2010 and 19 percent below its level in 2004, 13 percent and 36 percent in real terms.



As a share of total development costs, the average loan amount has trended downward up to 2012. Short periods of small increases have been more than offset by the declines. In 1996, the average loan amount accounted for a 42.5 percent of total development costs. In 1999, its share fell to 40.7 percent and again to 31.1 percent in 2000. After falling to 23.5 percent in 2002, from 2000, the average loan amount relative to the average total development cost for a project rose reflecting the increase in the average loan amount per project. However, in 2005 the 8.7 percentage point drop made the loan amount share in 2005 reach a new low.

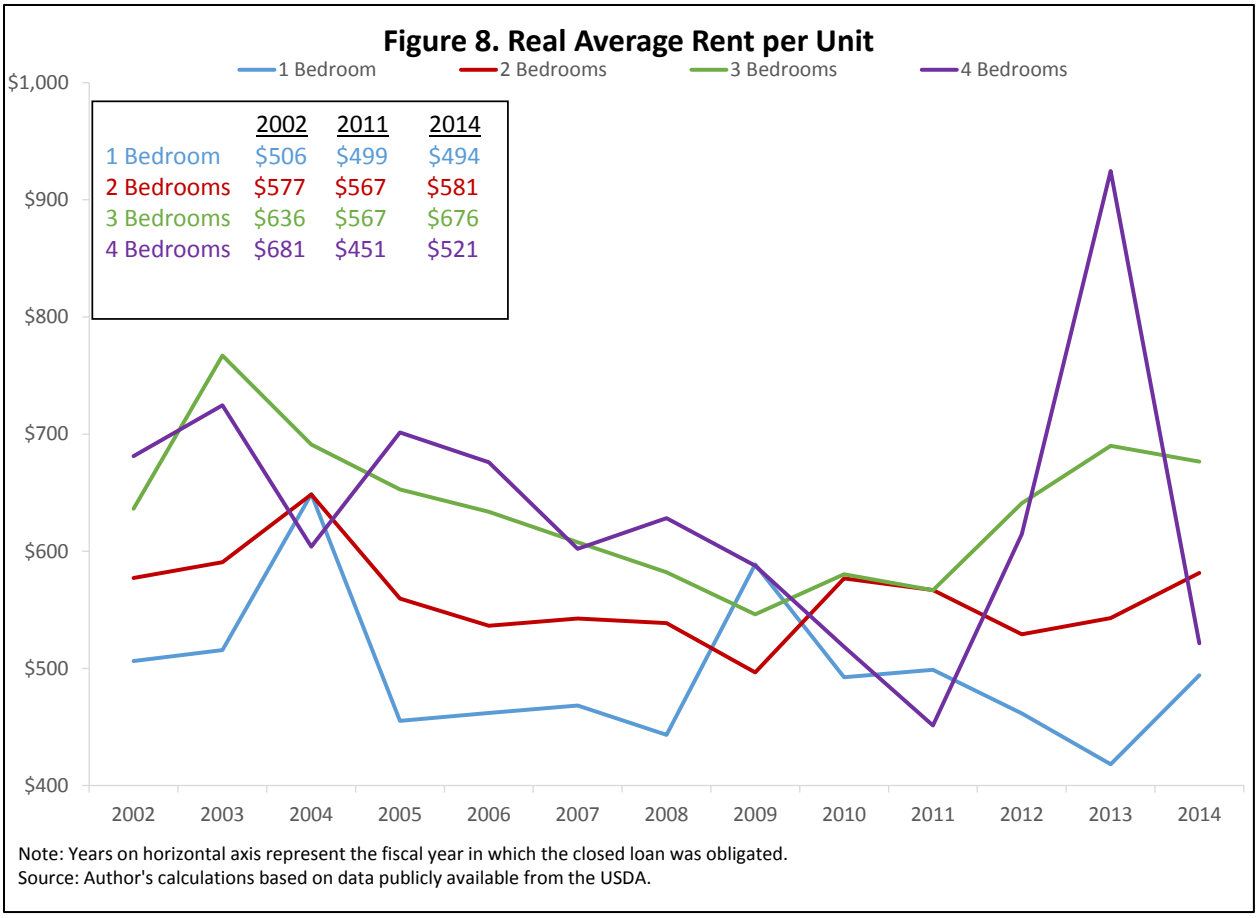


The decline in the loan amount share fell from 2006 to 2008 reflecting an increase in average total development costs as the per-project average loan amount remained relative constant. After two years of increases, the average loan amount as share of total development costs reached a low of 11.3 percent in 2012, the peak in the average total development costs for new construction projects. Since 2012 loan amounts as a percentage of total development costs began to grow again as total development costs fell and loan amounts increased.

The low percentages may reflect a divergence between the value of the property and the total development costs. The value of the project is typically much less than its development costs. The gap between the project's value and its development costs reflect restricted use provisions associated with the project. The program provisions make rental prices of each unit affordable, contributing to a comparatively lower value for the property overall.

Average rent prices vary by unit size, the number of bedrooms in the unit. However, as Figure 8 illustrates, real rents, rental prices adjusted for inflation, declined noticeably between 2002 and 2011 for larger-sized apartments but remained constant for smaller-sized units. Over the 2002 to 2014 period rents for smaller-sized apartments varied less than that of larger-sized units.

Between 2002 and 2011, real average rents for one-bedroom units fell from $506 to $499, a drop of 1 percent while the average real rent for two bedroom units dropped 2 percent, from $577 to $567. However, the average rent, after adjusting for inflation, of three bedroom units declined by 11 percent, from $636 to $567 and the real rental prices for four bedroom units were 34 percent lower than their 2002 level of $681.



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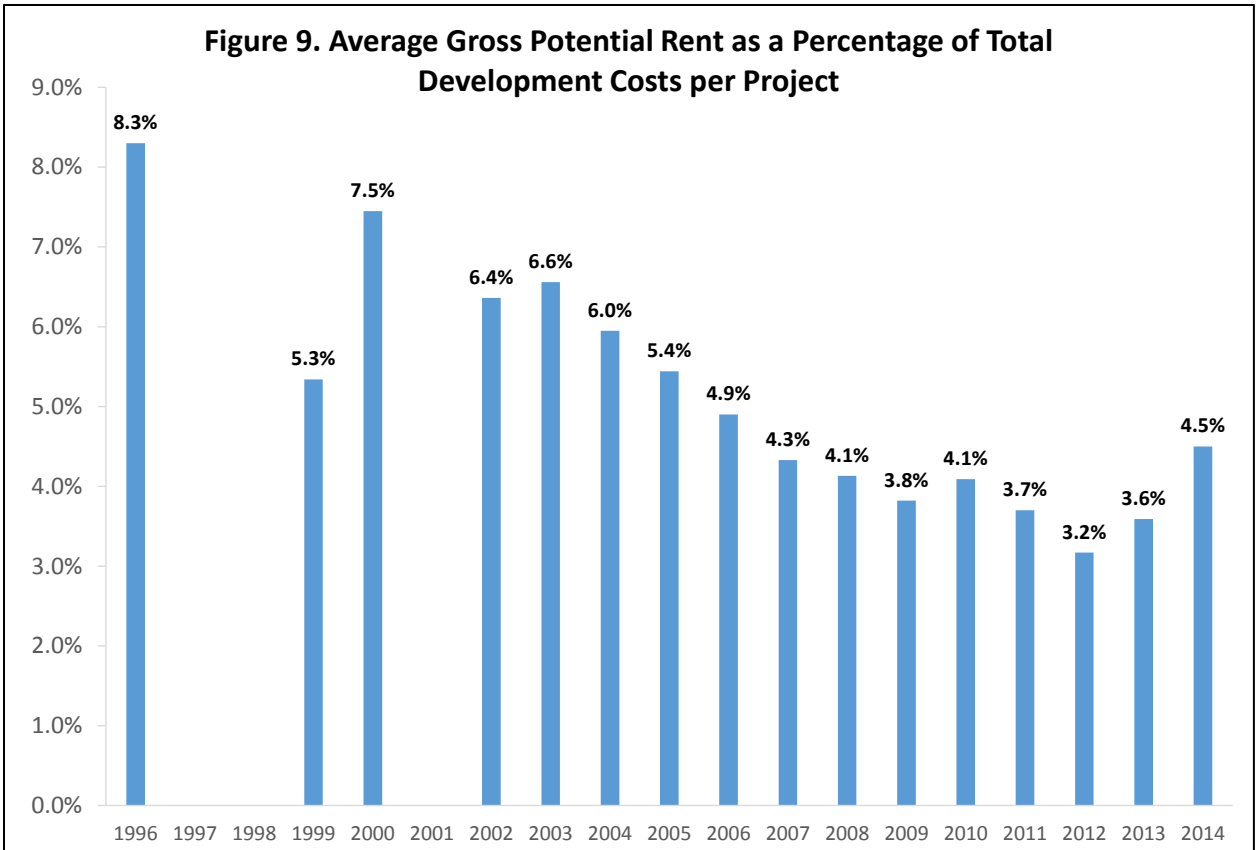
Over the entire 2002 to 2014 period, the change in average real rents for smaller units was much smaller than that of larger units. One bedroom units recorded a 2 percent decrease in average real rents over the period while two bedroom units registered a 1 percent increase. Despite some oscillation in the 2011 to 2014 period, especially in the average real rent of four bedroom units, three bedroom units recorded a 6 percent increase and four bedroom units experienced a 23 percent decline.

Average gross potential rent as a share of total development costs, a measure of a project's potential capitalizations rate, have declined over much of the period. Over the years of 1996, 1999, and 2000 this "cap" rate started, but the cap rates in both 1999 and 2000 were lower than its rate in 1996. Following a brief increase between 2002 and 2003, the average cap rate on new construction projects fell to 3.2 percent in 2012, the year that the average development cost on a new construction project peaked.



In the two years that followed, cap rates rose to 4.5 percent, a level last seen just prior to the recession. The increase in the cap rate likely reflected the decline in the average development cost. At the same real rents rose on one-, two-, and three-bedroom units over this same period while the decline in real rents on four-bedroom units coincided with its shrinking portion of new construction projects.

The rate measured for the 538 program presumes that each apartment will be occupied. Even if there were no vacancies, the rate under the 538 program is less than that obtained from market rate apartment buildings. By comparison, the Rental Housing Finance Survey (RHFS) a survey administered by the U.S. Census Bureau and the U.S. Department of Housing and Urban Development that is designed to collect data on rental properties nationwide, indicates that the average, expressed as median, cap rate for all properties in its survey is 6.0 percent indicating that the return on market rate apartments exceeds that of the projects constructed under the 538 program[8].

[1] Although these two numbers illustrate the difference between rental prices for subsidized and unsubsidized apartments, they may not be geographically comparable.
[2] U.S. Department of Housing and Urban Development "Selected Property Characteristics by Mortgage Status, All Properties". (link). This data was calculated in 2012.
[3] Office of Management and Budget. "Fiscal Year 2015 Federal Credit Supplement". (link)
[4] Office of Management and Budget. "Fiscal Year 2016 Federal Credit Supplement". (link)
[5] United States Department of Agriculture. "Agency Financial Report: Fiscal Year 2014". (link)
[6] A related, and much older program, is USDA's Multifamily Direct Loan Program.
[7] Up to the release of this dataset, no loans were guaranteed for new construction in the first half of 2016.
[8] U.S. Department of Housing and Urban Development "Selected Property Characteristics by Mortgage Status, All Properties". (link). This data was calculated in 2012.