Mixed-Use Development and Federal Housing Regulations

A Report to the Oram Foundation on Literature and Case Studies Findings

January 2013

Study Purpose and Approach

History and institutional rigidities have conspired to create a growing mismatch between federal housing regulations and the market forces to be harnessed to meet federal housing goals. As documented by the Congress for the New Urbanism (CNU) and others, housing demand is being driven by the convergence of the two largest demographic groups in the U.S.—baby boomers and millennials—expressing preference for walkable, urban, mixed-use neighborhoods. Developers, including those creating affordable housing with a mix of government subsidies, are increasingly seeking to respond to this demand by building mixed-use projects with access to transit. Yet agency rules and practices for programs such as Section 220 and Section 221, administered by the Department of Housing & Urban Development (HUD)—as well as requirements of the Federal Housing Administration (FHA)—greatly restrict the amount of non-residential space that can be included and still remain eligible for such programs as federally insured mortgages.

Significant progress has been made recently to reform these rules to meet the dual goals of housing policies and comprehensive mixed-use development. Two actions by the federal government are particularly noteworthy. In 2010, three federal agencies—the departments of Housing and Urban Development and Transportation and the Environmental Protection Agency—formed the Partnership for Sustainable Communities to coordinate place-based investments and programs and break down the bureaucratic silos between federal programs with complementary missions. Since then, the Partnership has supported dozens of the regional and municipal projects to support coordinated housing, transportation and economic development investments, and has facilitated flexible application of agency regulations to meet these objectives. Even more specifically, in September 2012 the FHA significantly relaxed its limitations on the amount of commercial development permitted in

residential condominium buildings while still retaining eligibility for FHA-backed financing.[1] The FHA is also considering relaxation of rules governing multi-family rental housing as well.

As promising as these developments are, the gap between the traditional objectives of most housing programs and the market realities of mixed-use development remains wide. It will take time and effort to reconcile these two worlds, and arguments for change will need to be marshaled on a case-by-case basis.

Unfortunately, hard statistical evidence to measure the impacts of the housing regulations on mixed-use development is scarce. This results in part from the limited number of cases and small amount of data on mixed-use projects that have received federally-backed housing finance. To help fill this gap, RPA reviewed the literature on housing finance as it relates to mixed-use development. This study also surveyed available case study literature, and analyzed the most comprehensive source of development case studies, a database maintained by the Urban Land Institute. The literature review and case study analysis was supplemented with interviews with developers, finance experts and public officials. The results were compared with the findings of CNU and others to provide information that could be useful to the ongoing policy discussions.

The Parallel Universes of Smart Growth and Housing Finance

Since the last decades of the twentieth century, urbanists, environmentalists, and others have advanced a "back to the future" approach to planning that highlights the attractions of traditional towns and cities—easy access to the goods and services needed for everyday life. This philosophy—and associated advocacy movement—rejects both the Euclidean zoning that strictly separates types of uses and the development of an automobile-dependent, low-density landscape, particularly of detached housing.

The movement (generally referred to as "smart growth" or "new urbanism") has given rise to a notable literature on the many advantages of development patterns—featuring a mix of uses (residential, commercial, retail, and even light industrial activities) situated within easy walking distance from each other.[2] Such neighborhoods enable people to live near where they work—reducing commutation time and expenses, allowing greater opportunity for community engagement, discouraging crime through having "eyes on the street," and encouraging healthier lifestyles that emphasize walking and biking.

Well before Smart Growth or New Urbanism entered the planning lexicon, federal housing legislation and administration developed a set of policies, programs and rules designed to address a much different set of problems. Emerging from the Great Depression and continued through the post-World War II housing shortage and urban decay in the 1960s and 1970s, most housing programs were designed with the more singular mission of expanding the supply of affordable housing. Indeed, reducing the cost of housing and

[1] http://www.cnu.org/cnu-news/2012/09/fha-raises-cap-financing-limits-commercial-space
[2] See below, Bibliography and Additional Resources.

expanding home ownership for low- and moderate-income households and for racial and ethnic minorities became the nation's primary anti-poverty tool.

The programmatic structure guiding subsidized housing investments did not emerge overnight. Rather, it evolved over decades with multiple programs layered on top of one another, each with its own distinct history and set of rules. The resulting complexity gave rise to an entire industry of both for-profit and non-profit developers, bankers, regulators and lawyers who could decipher and apply these rules in multiple contexts.

These two realms—making more livable communities with mixed-use development and high-quality design, and reducing poverty and segregation by expanding the supply and locations of affordable housing—can be seen as distinct cultures with interdependent missions. Walkable, well-designed communities with high amenity help attract the density that enables housing to be constructed for a range of incomes. They also provide the context for mixed-income, racially integrated communities that improve enhance social mobility, and that contribute to well-functioning local economies. However, they also increase land costs and can lead to displacement of poorer households. Public financing and loan guarantees are important components for bridging the financing gap and supporting both sets of objectives.

Just as the cultures of mixed-use development and affordable housing can clash, so too can their approaches to managing risk. The regulatory structures for housing finance that have been designed to limit risk are built on the assumption of single-use assets with different risk profiles. They also are intended to shield housing from the riskier commercial investments. This approach is difficult to reconcile with the financing needs of projects that mix asset classes in unique ways depending on the context. Risk can be more difficult to assess for mixed-use projects, even if a case be made for managing risk with a diverse product that can respond to market demand.

Scarce Research on Risks of Single-use Versus Mixed-use Development

One area largely missing from the existing literature is discussion of approaches to and risks of financing mixed-use developments in comparison with single-use developments—whether suburban single-family housing, urban multi-family residential, or commercial or retail projects. Indeed, little data are available, with Dodge Analytics, the arm of McGraw-Hill Construction that tracks construction industry trends, not collecting statistics on what percentage of the market is being invested in mixed-use developments. Dodge Analytics "would have to break down the parts [of a mixed-use project into residential, industrial, etc.] and add up the amounts for each part."[3]

Two studies stand out as the major considerations of financial risk and development challenges for mixed-use projects.

[3] Ralph Gentile of Dodge Analytics, quoted in Angelle Bergeron, "Mixed-Use Developments: New Construction Trend Invades South Central Region," *McGraw-Hill Construction*, August 2007.

A Wharton School working paper by Joseph Gyourko and Witold Rybczynski (Gyourko & Rybczynski – Wharton) found that practitioners in development and finance perceive New Urbanist projects to be riskier than typical real estate projects, thanks to their mixed use nature, considered inherently more difficult to do well.[4] The Congress for a New Urbanism commissioned Gyourko & Rybczynski to assess whether "New Urbanist projects specifically, and mixed-use projects generally, are inherently more risky or costly." Based on a survey of 23 industry practitioners, Gyourko & Rybczynski – Wharton concludes that "the answer is yes on both accounts—risk and cost—with higher risk having by far the more important impact on financing."[5] This working paper evolved into an article for Fannie Mae Foundation's *Housing Policy Debate* (Gyourko & Rybczynski – Fannie Mae).[6]

Nearly a decade after the Gyourko & Rybczynski paper—and more importantly, after the widespread and precipitous decline in the housing market that accompanied the worldwide financial crisis of recent years—Joseph S. Rabianski, Karen M. Gibler, J. Sherwood Clements, III, and O. Alan Tidwell published a two-part article in *Real Estate Issues* (Rabianski, et al.) reviewing the economic, financial, physical, phasing, design, and public policy factors associated with feasibility of mixed-use developments.[7] They found that:

> Some developers believe that a mixed-use project diversifies risk across the multiple uses. Other developers believe that the added financial and physical complexity of a mixed-use development, in addition to longer development timelines, heightens the uncertainty associated with the project and thereby increases the level of risk.[8]

And note further:

> Each use needs to be analyzed with regard to its own demand and supply situation and its relationship to the other on-site uses. Each use on the site must attract sufficient market demand to make it financially feasible. The financial success of one use should not be expected to carry a weak market performance by another use. The contributory value of one use should not subsidize the other uses on the property.[9]

Moreover:

[4] Joseph Gyourko and Witold Rybczynski, "Financing New Urbanism Projects: Obstacles and Solutions," Working Paper #330, Samuel Zell and Robert Lurie Real Estate Center, The Wharton School, University of Pennsylvania, March 2000.

[5] Gyourko & Rybczynski – Wharton, p.1.

[6] Joseph E. Gyourko and Witold Rybczynski, "Financing New Urbanism Projects: Obstacles and Solutions," *Housing Policy Debate*, 2000, 11:3, pp.733-750.

[7] Joseph S. Rabianski, Karen M. Gibler, J. Sherwood Clements, III, and O. Alan Tidwell, "Mixed-Use Development and Financial Feasibility," Part I – Economic and Financial Factors (34:1, pp.11-17) and Part II – Physical, Phasing, Design and Public Policy Factors (34:2, pp.17-21), *Real Estate Issues*, The Counselors of Real Estate, 2009.

[8] Rabianski, et al., Part I – Economic and Financial Factors, p.11. They cite Sule Aygoren, "Ins and Outs of Mixed-Use," *Real Estate Forum*, March 2004, 59:3, pp.6.

[9] Rabianski, et al., Part I – Economic and Financial Factors, p.13.

> Lenders have difficulty determining how well the land uses work synergistically as a single development and estimating the varied sources of the components of income. They tend to evaluate the overall mixed-use project as a weighted average of the individual property types, as collateral that could be sold off separately. Underwriting each land use separately adds to the complexity and cost of the deal. [10]

While investors in other contexts typically seek to diversify their portfolios to decrease risk, these papers indicate that lenders in the world of real-estate development prefer standard products to the novelty and complexity of mixed uses. Indeed, Christopher B. Leinberger and Robert Davis discuss the standardization of real-estate products, especially during the 1990s to satisfy the demands of Wall Street for commoditized investments.[11]

Until the collapse of the housing market in the recent recession, residential development was understood to be less of a financial risk for lenders and investors than commercial or retail development. Considering this context—along with the mandate of the Department of Housing & Urban Development (HUD), its Federal Housing Administration arm (FHA), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) to focus on the residential sector—it is hardly surprising that these agency have imposed caps on non-residential components of subsidy-eligible projects.

Table 1. Restrictions on Commercial Components[12]

	Cap on Gross Income Derived	Cap on Gross Floor Area / Net Rentable Space
FHA - condominiums		25%
HUD 221(d)4	15%	10%
HUD 220	30%	20%
Fannie Mae	20%	35%
Freddie Mac	25%	20%

With limited resources available, HUD and FHA have traditionally funded and insured housing—seeing subsidy of commercial development as inappropriate to their public purpose. Gyourko & Rybczynski (in both their papers) argue that Fannie Mae (and presumable Freddie Mac as well) "is under increasing pressure from Wall Street firms and mortgage servicing firms not to increase its scope of activities and encroach on other players in the residential sector"—and this in 2000, before the financial and housing crash, accompanied by widespread political criticism of the two quasi-governmental mortgage agencies.[13]

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[10] Rabianski, et al., Part I – Economic and Financial Factors, p.15, in part citing Gyourko & Rybczynski – Fannie Mae.
[11]Christopher B. Leinberger and Robert Davis, "Financing New Urbanism," *Thresholds*, 1999, 18, pp.45-46.

[12]CNU web site, except for FHA row of table. On September 13, 2012, FHA issued a mortgagee letter effectively raising the 25% cap to 35% by instituting a ministerial exception process. According to Kenneth R. Harney's account in the September 23, 2012 *Los Angeles Times* ("FHA Eases Burdensome Condo Financing Rules"), the new guidelines "should make it easier for large numbers of homeowner associations to seek certification by the FHA … Without approval of an entire development—regardless of whether it's a small complex in the suburbs or a massive high-rise in the center city—no individual unit can be financed or refinanced with an FHA mortgage."

[13]Gyourko and Rybczynski – Fannie Mae, p.745.

While the HUD programs affect only a limited population of projects, federal regulations largely frame the guidelines private financial institutions use.[14] Already inclined to prefer standard real estate products, lenders can point to the federal caps on commercial components as standard guidelines for financing. In this way, the entire financial system continues to favor single-use projects near-single-use projects (residential with only a very small amount of retail) at the expense of truly integrated mixed-use projects. The federal limitations permeate the system far beyond the projects supported directly.

In addition to these studies assessing risk, the Oram Foundation commissioned a study to specifically address the broader conflict between smart growth and affordable housing, and to suggest strategies to foster neighborhoods that are both walkable and affordable. The report, by Emily Talen, included a survey of 34 affordable housing developers, both for-profit and not-for-profit, by the Institute for Social Science Research at Arizona State University.

The survey and conclusions of the report as a whole confirmed many of the perceptions described previously. The goal of creating neighborhoods that are both walkable and affordable requires reconciling two opposing economic imperatives: "Affordable housing in desirable locations goes against the basic principles of land economics in the U.S. If a neighborhood is walkable and amenity-rich (i.e., well-served by stores, transit and schools), demand for such places will quickly escalate housing costs."[15]

Survey findings support the conclusion that financing mixed-use projects with an affordable housing component is difficult, with 71% saying that they encountered significant barriers in financing mixed-use, mixed-income development. Specific problems included difficulty with commercial lending, high requirements for return on investments that in turn require them to charge high rents, and a general lack of understanding of mixed-use projects in the lending community. Federal housing rules were also referenced, with 68% saying that FHA, VA, Freddie Mae and Freddie Mac reforms might provide an opportunity for providing more affordable housing in walkable neighborhoods.[16] More fundamentally, the limits in federal housing programs were seen as reflecting a basic mindset across the industry: "Single purpose, narrowly focused funding criteria are a deeply entrenched norm across the board—in HUD programs, in LIHTC criteria, in the secondary mortgage market, and in mortgage insurance."[17]

Supporting Evidence from Case Studies

Case study information can supplement available literature and data. While these only suggest patterns that can inform the policy discussion, the growth of mixed-use projects themselves can be evidence of their growing viability. The challenge is developing

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[14]According to its web site, in 2011 HUD insured 189 mortgages through Section 221(d)(3) and Section 221(d)(4) and eight mortgages through Section 220.

[15] Talen, Emily. *Prospects for Affordable, Walkable Neighborhoods*, Report prepared for the Oram Foundation, March 2011, p. 5.

[16] Ibid, pp. 11-13, 44, 48.

[17] Ibid., p. 12

systematic data on characteristics and outcomes from this data to guide policy and investment decisions.

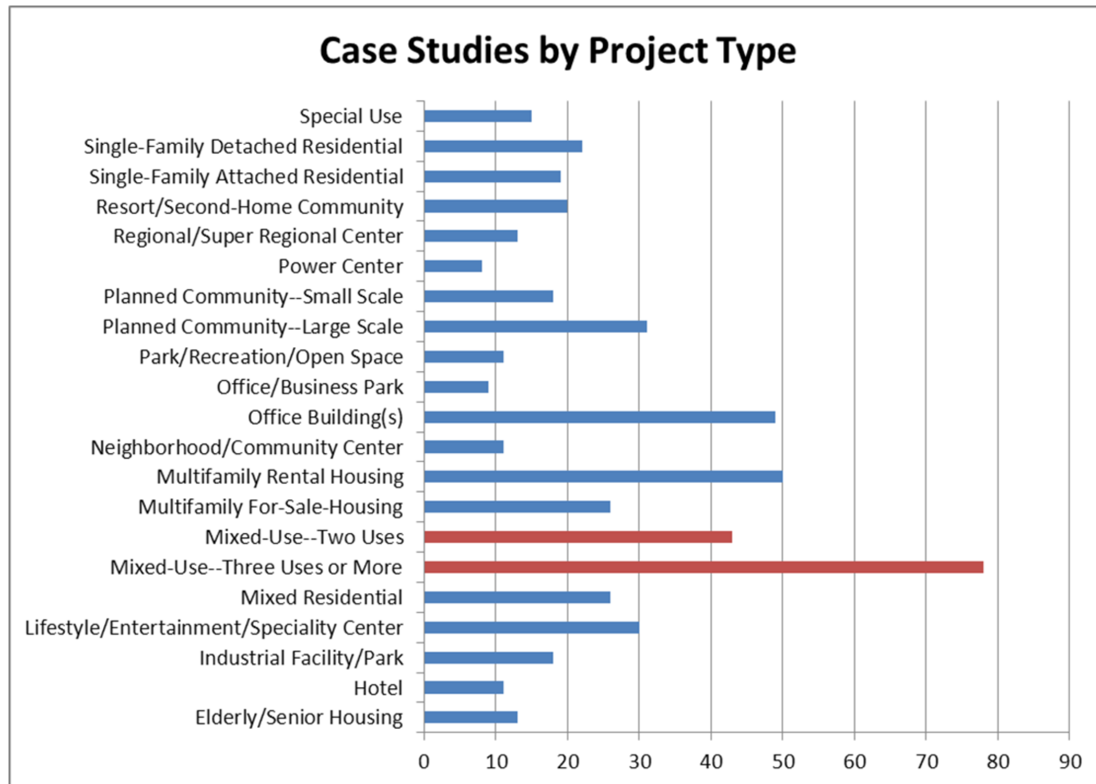
The most comprehensive database that RPA located for this analysis is maintained by the Urban Land Institute (ULI). The ULI Case Studies Database includes 521 cases of which 121 are mixed use projects. The characteristics of these case studies were categorized and analyzed to illustrate several issues that could be associated with risk and success factors, as well as with federal guidelines for allowable commercial development in residential projects. Although finance data and outcomes are not available in enough cases, cases were analyzed along the following parameters:

- Distribution by type and mix of uses;
- Distribution of types of mixed use projects by city size and more and less than 20% commercial;
- The relationship of building project scale for projects more and less than 20% commercial;
- The development cost for projects more and less than 20% commercial;

A 20% threshold for commercial property was used to approximate the amount of commercial square footage allowed in different federal programs.

As shown in Chart 1 below, mixed-use projects represent a significant number of cases:

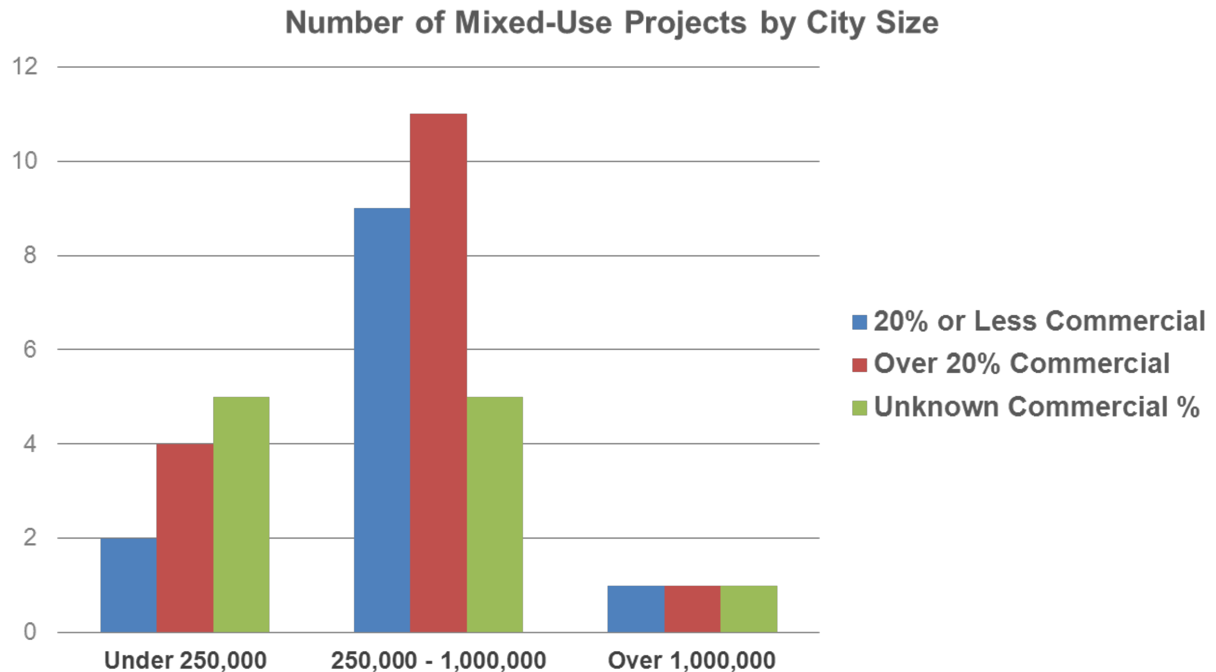
Chart 1



The 121 mixed-use projects represent about a quarter of the cases in this database. Since only projects that were successfully implemented are included, this could suggest that mixed-use projects are a substantial share of successful developments. It could just as easily, however, represent cases that met some criteria of interest to the authors. At a minimum, however, it suggests that successful mixed-use developments represent more than a handful of isolated projects.

Forty projects had complete data and characteristics that were applicable to this study. Breaking down the type of mixed use project with the size of the city in which they are located shows that mixed-use case studies are predominantly in mid-sized cities. One mixed-use developer interviewed for the project indicated that the biggest challenges to mixed-use development is in smaller cities and suburban environments where there is stricter segregation of uses and less government capacity to process and permit complicated projects.

Chart 2



The case studies also show that scale increases with number of uses and share of commercial, with projects over 20% commercial averaging about 650,000 square feet and projects with 20% or less commercial averaging about 280,000 square feet, as seen in Chart 3. This is a logical outcome. Larger scale projects have an easier time supporting multiple uses, such as retail to serve residential users and entertainment, office and retail as a mix of commercial use. .

Chart 3

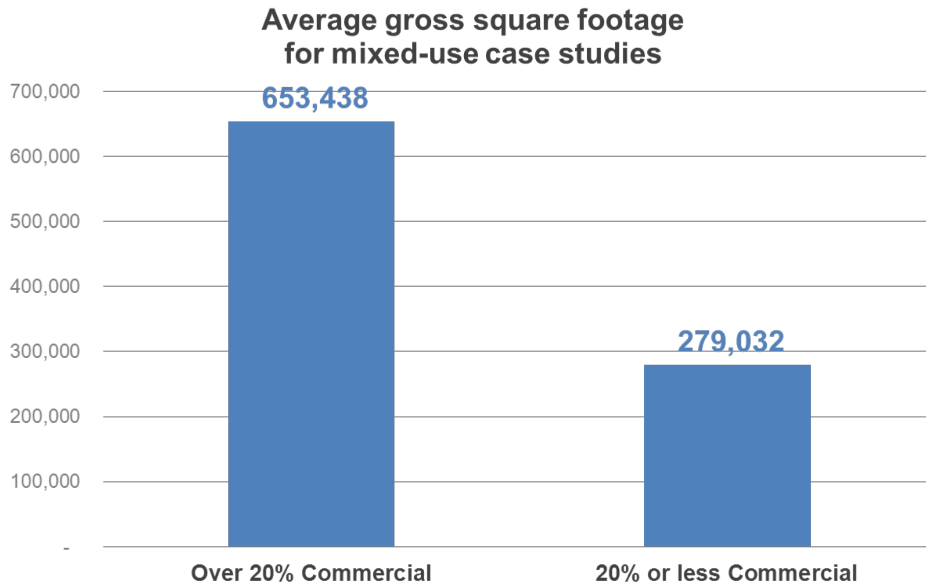
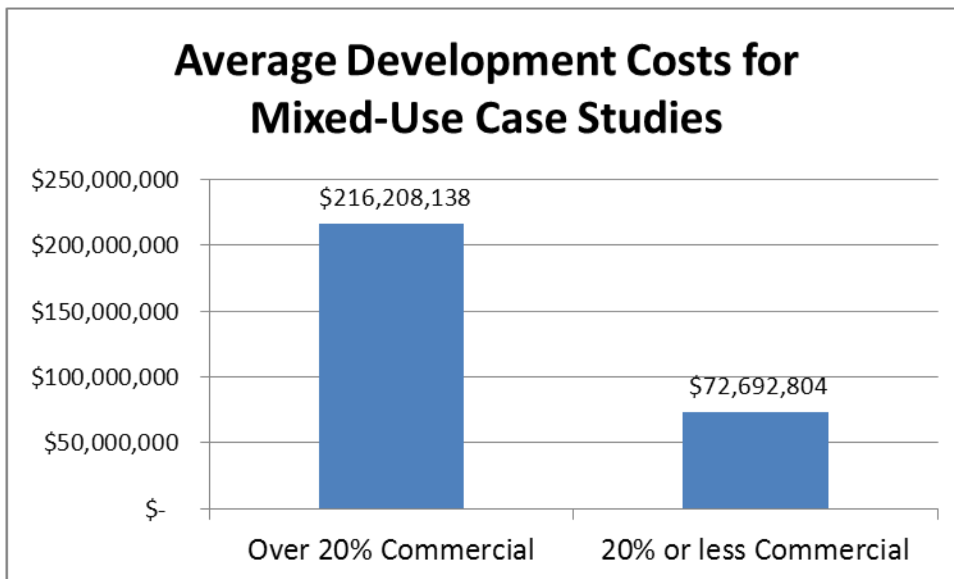


Table 4 indicates an even greater difference in cost between projects with less or more than 20% commercial. Average costs are three times as great while square footage is 2.3 times as large for projects with more than 20% commercial. This is consistent with the expectation that mixed-use projects are more costly to build, but the higher cost could also be indicative of the higher value the projects bring to both owner and community. There was insufficient data to assess the components of cost, but differences in land cost alone could explain the difference.

Chart 4



Conclusion

There is very little hard data to answer the most essential questions of this paper—the impact of mixed-use projects on affordable housing goals, the effects of housing regulations on the success of mixed-use projects, and the level of risk inherent in mixed-use projects. However, economic theory, the observations of industry participants and a growing number of case studies do lead to a number of conclusions and suggestions for policy.

Mixed-use projects are inherently more complicated and costly than single-use projects, and that has contributed to widespread belief that they pose a higher risk to capital of all kinds, particularly government financing with the express purpose of expanding the supply of affordable housing. However, this logic needs to be tempered with the knowledge that the mechanics of mixed-use development, and by implication the types of projects that are likely to have the greatest reward-risk ratios, are poorly understood outside of a relatively small circle of developers, financiers and policy-makers. The lessons of the recent financial crisis, led by a meltdown in the market for residential mortgages, should also cause some recalibration in the relative risks of residential, commercial and mixed-use projects.

It is also fairly clear that federal housing rules make it much more difficult to finance mixed-use, mixed-income developments, not only by placing limits on the use of government subsidy, but also by influencing the willingness and criteria of private capital markets to make these investments. If economically integrated neighborhoods are a legitimate policy goal, then a singular focus on limiting risk by building single-purpose housing creates a different type of risk. As walkable neighborhoods create new demand and become more ubiquitous, low-income housing can be pushed into areas with cheaper land, worse schools and access to fewer jobs and services. This is at the core of the concept of sustainable communities, places that not only have decent affordable homes but that also promote economic and social mobility and a healthy environment.

Policy-makers need always to take prudent actions make insure that taxpayer dollars are used most efficiently for their intended purpose. However, there are multiple ways of mitigating risk while pursuing more complex objects and more effective ways of reducing poverty and expanding economic opportunity. In addition to raising the caps on allowable commercial property, other more nuanced approaches hold some promise:

- Rather than rigid caps on the share of commercial square footage or income, more flexible requirements could be built into underwriting mixed-use projects, with the amount of the down payment, the length of the loan period and the level of interest calibrated to the amount of commercial or level of risk.

- A range of commercial property could be allowed for different sized buildings. In addition to scaling for larger projects, establishing a "floor" for the amount of mixed use allowed could be important for smaller projects that depend on ground-floor retail to be viable or to meet broader goals for creating a vibrant downtown. For

these smaller projects, regulations could allow a certain amount of mixed use, determined by the lot size instead of the overall development size.

- Context sensitive standards could vary allowable commercial property by city size, ratio of developed to undeveloped property, or other criteria. These standards would be more time and staff intensive to administer, and would require more autonomy from administrators to apply their judgment to varying criteria.

Existing regulations exemplify a wide range of well-intentioned but overly prescriptive—and sometimes counterproductive—regulations that influence the nature of development of the built environment. Their laudable purpose is to encourage the development of housing affordable to a range of incomes. Yet decades after their introduction, the American landscape has changed extensively, with more and more people desiring to live in walkable neighborhoods. Many state and local economic development entities recognize the value of transit-orient, mixed-use development and specifically support, fund, and subsidize projects that include a mix of uses—housing, retail, office, hotel, parking, in an integrated package. Just as the country is evolving, its regulations and regulatory apparatus need to evolve and adapt—with limited taxpayer dollars going toward the way its people want to live now and in the future.

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Additional Resources

Congress for a New Urbanism
Entry point to reports, articles, and other resources on the concepts CNU supports—neighborhoods should be diverse in use and population; communities should be designed for the pedestrian and transit as well as the car; cities and towns should be shaped by physically defined and universally accessible public spaces and community institutions; urban places should be framed by architecture and landscape design that celebrate local history, climate, ecology, and building practice. See especially the section on Live/Work/Walk: Removing Obstacles to Investment.

Smart Growth Online
Entry point to reports, articles, and other resources on the concepts and outcomes Smart Growth Network supports—creating more economic opportunities, building great places where people want to live and visit, preserving the qualities people love about their communities, and protecting environmental resources.

Stopping Sprawl
Entry point to Sierra Club reports, articles, and other resources on the environmental, transportation, and health implications of car-dependent development patterns.