COVID-19 Homeless System Response: Establishing a Capitalized Operating Reserve

COVID-19 has highlighted deep disparities in homeless, health care, and housing systems, including access to affordable housing. In response to these disparities, communities across the country are working to rapidly scale up rehousing strategies with Coronavirus Aid, Relief, and Economic Security (CARES) Act funding and other resources. There is a particular focus on increasing the number of people at higher risk of complications from COVID-19, including higher-acuity persons, who can quickly access safe, stable, and affordable housing options with supportive services as needed.

As communities expand their permanent housing options, particularly for vulnerable populations experiencing homelessness during COVID-19, they should consider establishing project-specific capitalized operating reserves to support projects' operating costs and ensure sustainability over time. This brief is designed to help affordable housing developers and state and local financing agencies understand the key characteristics of a capitalized operating reserve and how this financing strategy can be used to support the development of affordable housing in your community.

Capitalized Operating Reserve

A **capitalized operating reserve** refers to funding that is set aside at the beginning of a project to cover potential or projected operating deficits over time. These costs are "capitalized" because the funding to cover them is included up-front as a capital cost within the project's development budget. The purpose of a capitalized operating reserve is to ensure that adequate funds are on hand should operating costs such as utilities, management staff salaries, and maintenance exceed the amount available from a project's income at any time in the project's operations. A capitalized operating reserve is distinct from capital replacement reserves, which are intended to fund the costs associated with replacing project facilities as they wear with age.

Establishing a capitalized operating reserve is a particularly useful tool for supporting the creation of affordable housing, including projects that contain permanent supportive housing (PSH) units, as the amount of rent affordable to persons experiencing homelessness may be insufficient to fully cover a project's operating costs, even in some cases with rental subsidies from Housing Choice or Permanent Housing Vouchers. Such housing projects may also have additional operating costs, such as property management staff costs, that require additional up-front planning to ensure the financial sustainability of the project.

Key Considerations for Establishing a Capitalized Operating Reserve

Funders and developers of affordable housing should consider the following information to inform the design and implementation of a capitalized operating reserve. It is important that the strategy and design for projects which may benefit from a capitalized operating reserve are co-designed with persons with lived experience of homelessness and Black, Indigenous, and people of color (BIPOC) at risk of or experiencing homelessness. This early engagement of key stakeholders with lived experience is essential for establishing equity as the foundation of any new affordable housing project's design and funding strategy.

Definition of operating costs: Operating costs are those costs associated with the day-to-day physical operation of housing projects. A capitalized operating reserve typically covers costs that are over and above what is earned from a project's rents, whether the rents are paid fully by tenants living in the units or are subsidized by vouchers from a housing authority, Continuum of Care (CoC), or other sources. Buildings often have costs that exceed these rent totals on a monthly basis. Operating costs may include:

- *Utilities*, including heating, water, sewer, telephone, and common area utilities (if applicable).
- *Maintenance and repairs*, including supplies, repairs, trash removal, snow removal, pest control, grounds upkeep and landscaping, and painting.
- *Staff and payroll costs*, including administrative, maintenance, and security staff/payrolls.
- *Marketing and leasing*, including advertising, credit investigations, and leasing fees.
- *Taxes and insurance*, including real estate taxes and property insurance.
- *Management fees.*

- *Office supplies and expenses.*
- *Legal services.*
- *Accounting*, such as tax filings, audits, and reporting to investors.

Understanding the operating costs that will or will likely be incurred at a housing site can help determine the amount needed for the project's capitalized operating reserve.

Projecting operating costs: In order to establish a capitalized operating reserve, the financing agency and housing provider need to forecast the anticipated income for the project. This can start with the planned unit/tenant mix, including eligible income level for tenants (i.e., below 30 percent area median income [AMI]), employment history, access to public benefits and rental assistance, and the intensity of service needs anticipated among tenants based on the target population to be served. The target population at the specific housing project should be based on local needs, including COVID-19 risk factors, and should use the data you have to account for racial inequities and disparities experienced by persons experiencing homelessness. Project operating costs include general and administrative expenses, staffing, utilities, maintenance and repair, marketing and leasing, and taxes and insurance. Various resources[1] are available to help developers create an operating budget.

While direct service costs are not included in a project's operating budget, there may be adjustments to operating costs to consider based on direct service provision, such as property management, staffing or marketing, and leasing, as well as COVID-19 risk mitigation. Additionally, it is important for the project to be aware of operating costs such as taxes, utilities, and insurance that may fluctuate over time in order to forecast and build these anticipated increases into annual rent adjustment calculations.

Calculating an anticipated operating deficit: Based on projected operating costs, anticipated income, and program capacity, the housing project can calculate its anticipated operating deficit per unit, if any. An example is provided below:

Calculating an Operating Deficit		
Monthly cost to operate per unit (including staffing costs, utilities, maintenance, repairs, etc.)	$400	
Monthly per unit debt service and deposit to operating reserves	$400	
Monthly Operating Costs		**$800**
Monthly rent affordable to extremely low-income tenants (households with income below 30 percent of AMI), at 30 percent of income for rent	$300	
Monthly rent subsidy	$300	
Monthly Project Income		**$600**
Monthly Operating Deficit (Costs – Income = Deficit)		**$200**

Calculating a capitalized operating reserve: This amount to be set aside in a capitalized operating reserve should be determined based on the expected operating deficit *per unit per year*. Project owners and financing agencies should plan for as long a term as possible when determining the amount needed for their capitalized operating reserve. An example is provided below:

Calculating a Capitalized Operating Reserve	
Operating cost per unit/year	$9,600
Rental income per unit/year	$7,200
Anticipated operating deficit per unit/year	**$2,400**
Anticipated operating deficit for all program units/year (total 6 units)	**$14,400**
Required capitalized operating reserve: 10-year operations period	**$144,000**

[1] "How to Prepare a Supportive Housing Operating Pro Forma," CSH Quality SH Toolkit

Financing Options for a Capitalized Operating Reserve: There are a number of financing options that can be utilized to support the development of a capitalized operating reserve for housing projects, including state and local efforts such as a tax levy placed on development. Two of the most common financing options include:

- National Housing Trust Fund (HTF): HTF entities may set aside up to 33 percent of their HTF allocation to capitalize an operating reserve for HTF-assisted units administered at the project level. Other state or local funding sources could also be designated to fund a capitalized operating reserve.
- Low-Income Housing Tax Credit (LIHTC) Program: Tax credit equity generated through the LIHTC program can be used to capitalize operating reserves for affordable housing projects.

Planning for the administration and disbursement of reserve funds: A capitalized operating reserve supports one particular housing project and may only be used to fund operating deficits within that project. The capitalized reserve may be held or escrowed at the project level or with the funder. The housing project and the funding agency may create a Funding and Disbursement Agreement (FDA) to clearly delineate:

- The uses of the funds within the reserve;
- The conditions under which the reserves may be accessed;
- The procedures and approvals needed for accessing the reserve; and
- How the funds will be invested while they are in the reserve account.

The project and the financing entity may also agree to select a third-party organization to function as the administrative agent to manage the reserve funds for the project. Please see CSH's Capitalized Rental Subsidy Reserves: Concept Summary for more information and examples on management approaches for a capitalized operating reserve.

Overview of Other Sources of Rental Assistance to Reduce the Need for a Capitalized Operating Reserve

A capitalized operating reserve is only one strategy for addressing operating cost deficits and, in most cases, should be the last resource drawn on to cover the costs associated with operating affordable housing units. Affordable housing projects often leverage a number of other resources and strategies to cover the operating costs for units serving extremely low-income households, including:

- *Rental subsidies or operating assistance funds*, such as those provided through the Housing Choice Voucher (HCV) program and local HTFs. These funds cover the difference between the rent (revenue) needed to meet operating expenses and the rent extremely low-income households pay, and are administered on an ongoing basis to fill deficits in operating income needed to meet expenses.
- *Cross-subsidization*, or the blending of extremely low-income (ELI) units with market-rate units affordable to higher-income households. Revenue from higher-income households in mixed-income properties helps offset lower rents collected from ELI households to cover operating costs.
- *Layering funding streams,* including operating subsidies and housing production subsidies such as those provided by the HOME and LIHTC programs to help cover the costs of housing units and reduce reliance on rental income from the tenant for property expenses.

Examples: Capitalizing Operating Reserves as a Housing Financing Strategy

The following examples demonstrate how communities have established methods to capitalize operating reserves as one component of their financing strategies to support the operations and long-term sustainability of housing for low-income households at risk of or experiencing homelessness.

Pennsylvania Housing Finance Agency (PHFA)—LITHC Projects:

PHFA subsidizes operating costs at LIHTC properties that include set-asides of units for ELI households earning less than 30 percent of AMI. PHFA helps support these projects by allowing for a 5 percent increase in the developer fee. This increased developer fee generates a higher tax credit award, and the development agrees that the corresponding increase in equity funds is used to **capitalize an operating reserve for ELI units.[2]**

[2] Final PHFA 2019-2020 Allocation Plan

Multi-Year Affordability through Up-Front Investment (MAUI)

The Chicago Low-Income Housing Trust Fund (CLIHTF) has a MAUI Fund[3] that provides for a **capitalized operating reserve fund.** A request for this type of assistance can be made up-front at the time of the building financing. Developments can receive forgivable no-interest loans to fund an operating reserve for a specific number of subsidized units for households at or below 30 percent AMI for a specified number of years. The designated operating reserve is held by the funder, and owners of a building can draw from the operating reserve on a set schedule, with approval from the oversight agency, based on demonstrated need for the funds.

California No Place Like Home (NPLH) Capitalized Operating Subsidy Reserve

In California, NPLH[4] and other affordable housing funding programs allow the state to provide grants, loans, and other tools to reduce the cost of housing for high-need, low-income populations. The NPLH **Capital Operating Subsidy Reserve** (COSR) supports the development of supportive housing for persons with serious mental illness who are chronically homeless, homeless, or at risk of being chronically homeless by allocating funding to an up-front reserve. The amount for the project-specific reserve is calculated based on underwriting projections for 10-, 15-, or 20-year financial need to supplement rents when other rental subsidies are not available for supportive housing units. Draws from the COSR are based on actual financial performance if a development meets parameters that demonstrate financial strain. The COSR is structured as a 20-year zero-interest deferred payment forgivable loan to the development.

[3] Chicago Low-Income Housing Trust Fund Multi-Year Affordability through Up-Front Investment Program Description
[4] California No Place Like Home Amended Guideline, 2020; page 39