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MARKET STUDY IN RESPONSE TO ORDINANCE 01-33, CITY AND COUNTY OF HONOLULU

July 2005

Prepared for:

Land Use Research Foundation of Hawaii

for transmission to

City Council, City and County of Honolulu

Department of Planning and Permitting, City and County of Honolulu

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EXECUTIVE SUMMARY

This report provides market data in order to help policy makers assess whether or not to continue the moratorium on affordable housing controls enacted in Ordinances 99-51 and 01-33 (p. 1). Historically, new residential developments have been subject to conditions in order to provide new homes for specified low- and moderate-income households.[1] In many cases, the City and County required that 30% of all units be priced to be affordable to households with less than 120% of the median income, with one-third of those "affordable" units priced for households making 80% of the median, and two thirds of those units priced for households making up to 120%. In addition to these pricing requirements, further controls – buyer eligibility requirements, shared appreciation over ten years, and buy backs – were designed to make affordable housing available to middle-income households and to keep that housing affordable over a decade or more. These controls were incorporated into unilateral agreements without which new projects could not gain permits.

By 1999, this set of controls was clearly not working. The market was moving through a period of low demand, and there was little difference in price between "affordable" and market homes.[2] New "affordable" homes could not be sold with the deed restrictions for shared appreciation. In response to this situation, Ordinance 99-51 suspended buy back and buyer income restrictions and shortened the term for shared appreciation charges. (Pricing restrictions, owner-occupancy restrictions and some reporting requirements remained in force.) The moratorium created in 1999 was extended in Ordinance 01-33 until August 2005.

The high demand for units priced for the low- and moderate- income levels is a symptom of the larger general problem of a limited supply of new housing units being provided in the market. Currently, demand for new units is fierce, and buyers in the moderate-income group and higher income groups are competing for the same units. These specific conditions arise because the market is cyclic and is constrained by limited new supply of housing units. **Unless the general problem of limited supply is solved, the competition for housing is likely to recur and be worsened by the suite of affordability regulations** (Exhibits 3 and 5; pp. 10, 25-28, 32).

As HUD policy analysts have argued, **regulatory barriers are important in limiting housing supply and therefore access to housing for low- and moderate-income families.** On Oahu, the City and County's lengthy land use entitlement and permitting process has been an important part of the problem. It lengthens the time needed to produce housing, and hence its cost, and it makes it extremely difficult for developers to increase production when market conditions are favorable (pp. 27, 29).

In February 2005, an analysis by the Department of Planning and Permitting indicated that most of the buyers of affordable units from mid-2001 through mid-2004 had incomes

[1] In this report, "low income" is used for households earning 80% or less of the median income, and "moderate income" is used for households earning from 80% to 120%, following City and County rules.

[2] "Affordable" homes may be either homes produced subject to an agreement to provide certain homes at prices targeting low- and moderate-income households, or homes that those income groups can actually afford. The former definition

greater than mandated for their particular units. When income and family size are both taken into account, some 70% of 2001-2004 buyers may be over the target income level for the particular homes they purchased. A reanalysis of the same data by SMS shows that the share of buyers with incomes over the 140% mark (ignoring family size) has increased from only about 10% to about 25% (in Exhibit 1).

Next, SMS adapted the State's approach to pricing to examine the same data.[3] Approximately 60% of buyers of housing designated as affordable in the 2001-2004 period had incomes of 120% of the HUD median or below (Exhibit 2). However, the most striking fact about the data is that **far more homes were produced in some years than others – and it is when supply shrinks that fewer buyers come from low- and moderate-income households** (Exhibit 3).

The key driver for housing prices is the mortgage interest rate. Over the course of the last twenty years, interest rates have fallen and prices have risen. In the short term, when mortgage rates increased slightly, a gap has opened up between median sales prices and prices affordable to moderate-income families. Then, incomes rise and the gap narrows. With current low interest rates, both demand and consumers' ability to pay have grown. However, with limited supply the result is that families from many income groups are all competing for a few units. Now, new homes are often sold at lottery because of strong demand (Exhibit 9).

Affordable housing policy is intended to provide housing for families in the targeted income groups and to ensure that these units will stay affordable in the future. The data studied in this report show that **housing units produced for median income buyers eventually resell at prices that median income buyers can afford** (Exhibits 20 to 22). (Values may increase within the first three years, but then settle down after this brief jump.)

Analysis of resales over twenty years in terms of housing value (rather than price) show that units resell at about the same affordability level in later years: **affordable units stay affordable.** Specifically:

- Units are available and sold for each of the six affordability levels studied, year in and year out;

- Similar to what happened during the mid-1990's, the number of new units produced at the lowest level (0.50 to 0.80 affordability) has declined in recent years; and

- Over time, resales tend to lose value (expressed in terms of affordability), with two major exceptions:

    - The homes which initially sold in the years 1985-1989 gained in value in the first few years. While they have declined in later years, the decline is from the high point reached a few years after the initial sale.

[3] This approach bases prices on the median income for a family of four; Honolulu uses the median for a family of five.

- Homes with initial sales in the 0.50 to 0.80 affordability range have tended to stabilize in value at or above the upper end of that range.

Other market data analyzed for this report indicate some overall trends for the Oahu housing market:

- Housing prices have risen in a cyclic pattern of sudden rise, a plateau (and in the 1990s, a slow fall) in prices, followed by another rise;

- Housing prices increase as mortgage rates go down;

- Construction costs have risen more consistently over twenty years, and have not gone down even when housing prices have fallen;

- New home production does not increase as quickly in boom times as the number of older homes sold; and

- Over time, the new home share of the market has tended to stabilize near 20%, slightly above the rate seen for the US market as a whole.

Policy-makers have a range of options now that Ordinance 01-33 is about to lapse (pp. 33-38):

1. **Continue the moratorium**, either for a short term or permanently. This is the LURF recommendation, at least for the near term.

2. Reinstate all the controls in force before the moratorium

3. Reinstate buyer eligibility rules according to the City's 1994 rules and procedures. This is the DPP recommendation.

.

4. Reintroduce buyer eligibility, but with simpler controls. Two different approaches are considered:

    a. Open new affordable housing to target groups for a limited time, then allow other potential buyers to have the home if no members of the target group can qualify within a set time; or

    b. Set income qualifications to cover the entire income group that affordable housing is designed to benefit, not to identify a smaller target group. In this case, qualification procedures could be revised to track mortgage pre-qualification records, lowering demands on staff time.

5. Use City and County funds to help members of the target groups qualify for mortgages, e.g., by providing mortgage insurance or loaning funds for part of the down payment for these applicants.

6. Change from a regulatory to an incentive-based approach to affordable housing development. This change would take time to craft new policies, so the immediate actions needed to implement it would be to continue the moratorium.

LURF views the last alternative as the best, but it cannot be accomplished quickly. For now, **it is important to continue the moratorium** for several reasons:

- **The best way to implement the City's lead housing objective is to encourage growth in the housing supply.** (In the General Plan, Housing Objective A is "To provide decent housing for all the people of Oahu at prices they can afford.")

- **Reinstatement of buyer qualifications would provide an additional brake on a housing market that is already slowing.** It is very possible that the conditions of the mid- to late-1990s, in which it was extremely difficult for developers and buyers alike to finance new homes, will recur. In that situation, restrictions on buyer eligibility would risk bringing work on large residential developments to a standstill.

- **Reinstatement of shared appreciation requirements would tend to impoverish first-time affordable home buyers.** Buyers with reduced equity in their homes bought under this condition will find it more difficult to reenter the market to upgrade at a later date, even if resale properties are generally affordable.

- **Reinstatement of buyback controls is simply impractical.** Administration of this program involves staff costs for the City and will add appreciably to the cost and time needed to buy a home.

CONTENTS

EXHIBITS

INTRODUCTION

This report has been written in response to Ordinance 01-33 of the City and County of Honolulu. That Ordinance instructed the Department of Planning and Permitting to prepare a report on housing units sold as affordable housing under Unilateral Agreements (UAs).[4] The Ordinance further allowed for an independent analysis of Oahu's need for and ability to support sales of affordable units.[5]

Ordinance 01-33's main purpose was to extend the "moratorium" enacted in Ordinance 99-51.The ordinances deal with housing sold as "affordable" under Unilateral Agreements. They suspend requirements that buyers qualify on the basis of income, they suspend the City's buy back option, and they shorten the period in which the City claims shared appreciation on home values from ten years to three years after the initial sale of the unit. They do not affect the requirement that buyers of affordable units be owner-occupants. They do not apply to rentals, or to 201-G projects. [6]

Unilateral Agreements for large residential developments include pledges by a developer to produce and sell a share of homes in a residential subdivision at prices within the reach of families making moderate incomes. The agreements vary, but in most of the subdivisions now being developed, 30% of all homes are likely to be "affordable," i.e., sold at or below prices calculated by the City and County of Honolulu as affordable to families making up to 120% of the County median income and counted as meeting the terms of the Unilateral Agreement. Of that 30%, 10% typically must be sold at or below

[4] This report deals only with for-sale units. The affordable rental market involves complex issues outside the scope of this report.

[5] The Ordinance states, in part:

> In preparing the report, the department may request proponents of an extension to submit … a marketing study of Oahu's need for and ability to sustain new housing units. The marketing study shall include a statement of assumptions and methodology sufficient to permit independent review of the study by the department and the Council.

[6] "Affordable" housing for sale is subject to a complex set of regulations:

1. Both before and during the moratorium, the City works out the **price** of units "affordable" for families at the 80% and 120% level, using formulae in rules published in 1994;
2. Before the moratorium, people were not eligible to buy units unless they **qualified** on the basis of **income**. The City and County took family size and income into account. To qualify for a 120% unit, a buyer's income had to be at or below the 120% of median threshold for their family size;
3. Buyers must be **owner-occupants**.
4. To control against speculation, resales were regulated. First, the City and County claimed the right to **buy back** affordable units at prices set in relation to their original sales price, not current market prices, for a period of ten years.
5. Even if the City and County did not opt to buy back a home, it would claim part of the difference between the original price and the resale price (based on appraisals of the value of the home and improvements made by the seller). This difference is termed **shared appreciation**. The funds go to a City and County housing development account. Before the moratorium, ten-year shared appreciation periods were normal; under the moratorium, the period is only three years.

a price estimated as affordable for families making 80% of the median income and 20% typically must be sold to families making up to 120% of the median.

Every year, the City and County issues a "Maximum Sale Price for Credit" sheet (Appendix B is the 2005 version.) It includes prices for different income levels and unit sizes. It also shows the annual HUD income levels for different family sizes, with separate amounts for each family size, from one to eight persons. (See http://www.hcdch.state.hi.us/hsgstats.html.) The calculation of maximum sales price for units is based on the HUD income estimates and procedures set out in Department of Housing and Community Development (DHCD) rules adopted in 1994.

The Department of Planning and Permitting (DPP) issued a brief report in February 2005. This report takes the findings and recommendations of the 2005 DPP report into account. However, its aim is to do more than respond to that report. An effort has been made to analyze market trends that need to be understood in order to develop housing policy. Also, interviews with housing agencies and developers have drawn on experience in the other counties of Hawaii. While the housing market in Honolulu is different in size and composition than in the other counties, all are affected by market trends and by Hawaii's status as an international resort destination.

PURPOSE

The immediate task is to understand how the market for affordable housing produced under UAs on Oahu has evolved since the DHCD rules were adopted in 1994. By 1999, developers were finding these "affordable" units impossible to sell. After the moratorium, the units sold, but (as discussed below), some buyers would not have qualified under earlier rules.

The underlying problem that this study attempts to address is: How can the state's residents be assured secure housing, including for-sale housing, at reasonable cost? From the policy-maker's standpoint, the question is more focused: Do affordable housing controls work to actually get residents into new homes? What do Policy makers know about the housing market that must be kept in mind in crafting affordable housing conditions? The study addresses the last question. After a decade in which housing construction declined, stagnated, slowly increased, and now is booming, it is clearly important to understand the economic processes that affordable housing controls are designed to harness.

BACKGROUND

In 1999 (Ordinance 99-51), the City and County of Honolulu simplified controls over the sale of affordable homes under UAs by suspending income qualifications, shortening periods under which shared appreciation rules apply, and suspending the City's right to buy back units. Developers continued to report information on the affordable units sold, and the City continued to mandate that buyers of such units be owner-occupants.

The moratorium on affordable housing controls responded to a situation in which affordable and market units were much the same price, so affordable units, subject to controls not found on market units, were unattractive to buyers and were not selling.

A DPP report in early 2001, based on data from 1999 to 2000, indicates that some 464 affordable units were sold over a period of 16 months.[7] The report found that more than "90 percent of the households earned less than the maximum possible income for a target group household (… based on the HUD standards for a five person Honolulu household with an income equal to 140% of the median income)" (DPP 2001). No comparison was offered between sales before and after the moratorium, since City records from earlier periods lacked sale information.[8] That report recommended continuing the moratorium provisions of Ordinance 99-51.

DPP tracks units built in the City and County of Honolulu and affordable housing exactions. As of the end of June, 2003, DPP estimated that:

- 31,344 units had been built subject to UAs, of which
- 11,743 were affordable units;
- An additional 32,443 units covered by UAs are still to be built, of which
- 5,354 units to be built will be affordable units. [9]

In sum, the long-term trend is for affordable units to form a significant part of housing production, and developers as a whole appear to have been built a larger share of their affordable housing commitments (69%) than of the other housing for which they have permits and UAs (42%).

In 2005, DPP prepared an update of their 2001 report. The 2005 report reviewed sales data for the three-year period from July, 2001 through June. 2004. A total of 2,562 affordable units were counted. This indicates much more affordable housing production – on average, 854 units per year – than reported in the earlier report (464 units over 16 months). (However, the 2001 report did not include some housing produced in Waikele, and hence did not count all affordable housing produced in 1999-2000.)

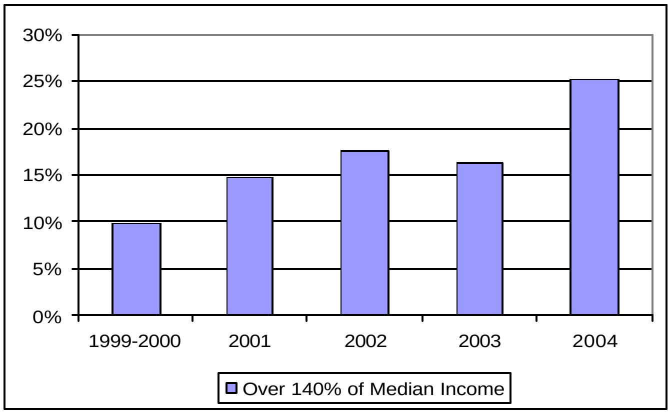
The 2001 report indicated that less than 10% of buyers had had incomes over a 140% standard. SMS conducted this analysis for the years covered in the 2005 DPP report (using the appropriate annual income figures) and found a gradual increase in the higher income buyer group:

[7] In the DPP studies, "affordable" units are units sold at prices under levels set by the City and County which then are counted as meeting the developer's commitment under a UA. Additional units could be within the financial reach of middle-income residents but not be counted. For example, 201-G projects include housing developed at prices set below these "affordable" sales limits. Additional units on the market could also be sold for prices below the levels set by the City and County and hence be "affordable" from the buyer's point of view but not from the City's.

[8] Both the content of the records and the agencies responsible have changed. As the 2001 report notes, "The only information available from Department of Housing and Community Development records was the number of affordable and market units built, as opposed to the number sold." After the Department of Housing and Community Development was dissolved, housing functions were assigned to the Department of Community Services (notably, administration of the Section 8 rental program), the Department of Budget and Fiscal Services (notably, administration of shared appreciation and buy back provisions) and the Department of Planning and Permitting.

[9] The summary, titled "Affordable Housing Construction on Oahu as Required by Unilateral Agreement (as of 6/30/03)," largely deals with units built by private developers since about 1980. However, it includes the State's Villages of Kapolei project.

Exhibit 1: SHARE OF BUYERS WITH INCOMES OVER THE 140% MARK, AFFORDABLE UNITS PRODUCED UNDER UNILATERAL AGREEMENTS



SOURCES: First bar is imputed from text of 2001 DPP report; later bars are based on data from developers shared by DPP (with confidential information removed). "140% of median" follows definition in 2001 DPP report: HUD estimates of income for a five-person family.

Using data provided by developers, DPP ran a fine-grained analysis in 2005 of buyers' incomes. It found that only 30% of buyers qualified for their units in terms of income, family size, and unit. (Information on income and household size was missing in a few cases, largely because of reporting agreements between DPP and the developer.)[10]

DPP did not discuss the fact that the analyses it conducted in 2001 and 2005 were very different. As a result, some readers were under the impression that 90% of buyers had qualified for units in 2000, and only 30% by 2004. Exhibit 1 suggests that, while buyer income characteristics have changed, the change is much smaller. It shows that, with income restrictions relaxed, a wide range of families are seeking homes at affordable prices. We want to understand that finding in relation to the market.

The DPP report concluded with a recommendation that buyer eligibility qualifications be reinstated, even though this step would entail much work for City and County staff, developers, and buyers. We are not convinced that the DPP recommendation is the best response to the DPP findings. Developers remember times, just a few years ago, when it was impossible to build and sell an affordable unit, and are deeply concerned that, by re-imposing income qualifications, the City and County could set the conditions for a return of that situation.

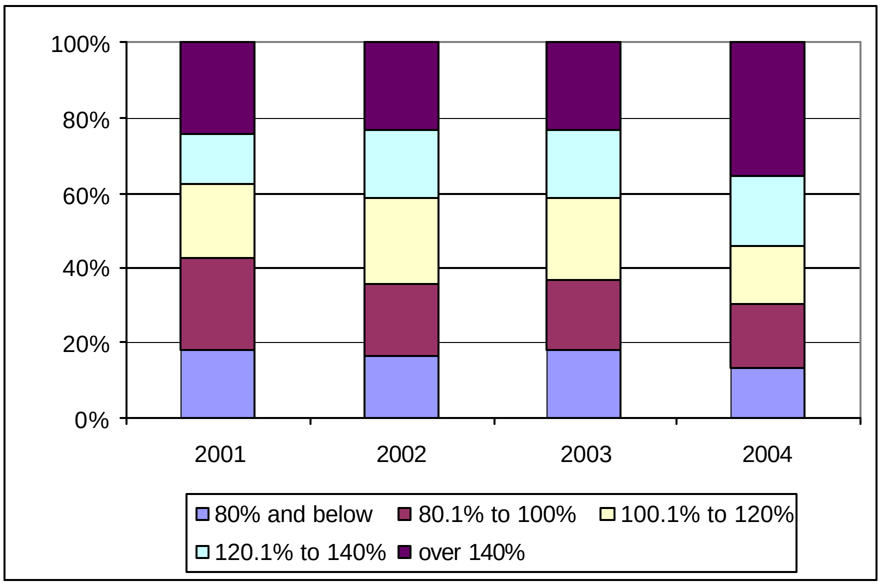
[10] One reason why the new analysis is much more stringent is that affordable housing prices vary greatly by household size. At the 80% of median level, the range in affordable prices can vary by $20,000 according to family size (2005 price thresholds, calculated by DPP):

- One person: $37,950
- Two persons: $43,400
- Three persons: $48,400
- Four persons: $54,250
- Five persons: $58,600

Using this approach, a couple earning $44,000 would be over the 80% income limit, while a family of four earning $54,000 -- $10,000 more – would be below it.

Commenting on a draft of this report, Director of Planning and Permitting Henry Eng felt that the analysis did not show that, "without a condition and monitoring program, the market will reach intended segments of households at or below 120% of the median." We disagree. When the data are re-analyzed in terms of income level (not buyer qualifications based on household size for particular homes), it is clear that households below the 120% level have been finding and buying homes during the moratorium period. Exhibit 2 shows the distribution of buyers in relation to State income group limits. It shows that most buyers were in the 120% or below income groups through 2003.

Exhibit 2: SHARE OF BUYERS OF AFFORDABLE HOMES BY INCOME GROUP, 2001-2004



NOTE: For this and the next exhibit, income ranges were calculated based on the median income for a family of four, rather than the family of five standard used by the City and County for pricing. This approach was preferred to encourage comparison with trends in other counties.

Calculations of *share* of buyers miss the impact of the size of the market from year to year. When attention is paid to the sheer *number* of homes produced, four major points emerge:

1. Under the moratorium, affordable homes are being produced and sold in large numbers;

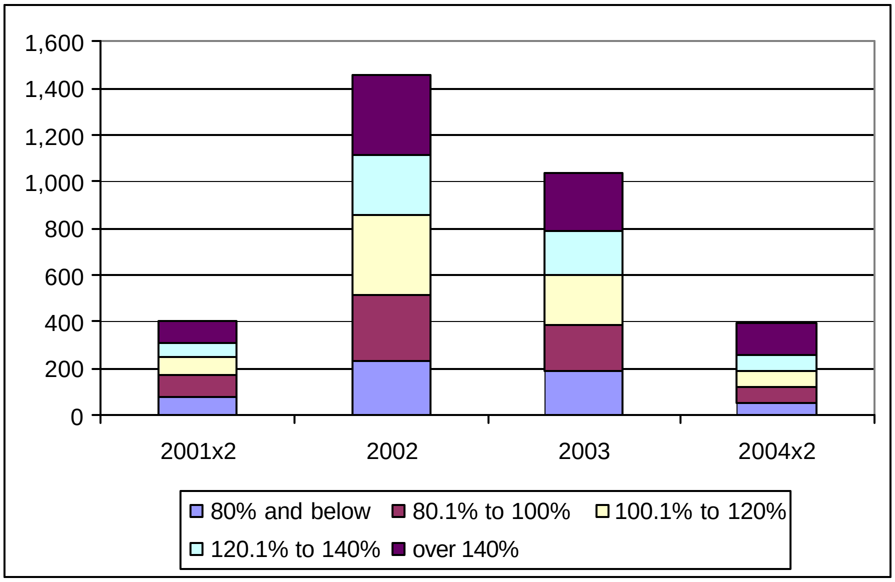
2. Many buyers are in low- or moderate-income ranges;

3. The number of affordable homes varies greatly from year to year; and

4. The share of buyers with incomes over the 120% level increases when supply is smaller (in 2001 and 2004)

The data in Exhibit 3 show that "a rising tide raises all boats" – when more units are available, more families from all income levels can buy homes.

Exhibit 3: INCOME LEVELS OF BUYERS OF AFFORDABLE HOMES, OAHU, 2001-2004



NOTE: The data in the DPP report cover half of 2001, all of 2002 and 2003, and half of 2004. To show changes from year to year, SMS has simply doubled the number of cases for 2001 and 2004 in this exhibit.

ORGANIZATION OF THIS REPORT

To address the issues raised by Ordinance 01-33 and the DPP report, SMS undertook a comprehensive market study to learn whether housing that Oahu residents can afford is available, and whether changes in affordable housing policy have measurably affected the supply of housing for residents. The report presents the results in four sections:

INTRODUCTION: This section introduces the background and scope of work for this market study raised in Ordinance 01-33 and DPP reports;

THE HOUSING MARKET ON OAHU: This section describes fee simple sales and resales over a twenty-year period.

DISCUSSION: This section presents findings form the study. First, major trends are noted. Then, specific questions arising in Ordinance 01-33 or raised by DPP are answered on the basis of the data.

ALTERNATIVES: This section presents possible courses of action for consideration by the City Council, and includes LURF's recommendations for action in 2005.

AUTHORSHIP

The report has been developed by SMS Research & Marketing Services, Inc., a Honolulu-based research and consulting firm, for the Land Use Research Foundation of Hawaii (LURF). SMS is responsible for the market analysis. LURF staff and board members have supported the project by sharing information and experience. The recommendations of this report emerge from the analysis, but have been developed in collaboration with LURF, and should be viewed as recommendations from that source.

The Land Use Research Foundation of Hawaii is the voice of landowners and developers in Hawaii. LURF was established in 1979 to promote and advance the interests of the development community, particularly in the areas of land use laws and regulations.

Over the years, LURF has been a strong voice of reason, working to represent the interests of its membership and at the same time find common ground for the concerns of government, business, and the community. LURF accomplishes this through a three-pronged program of Research, Information, and Advocacy.

THE HOUSING MARKET ON OAHU

In Hawaii, the housing market in general has been segmented based on income levels and in turn affordability. Affordable units are priced based on two variables, income (HUD Median income levels based on family size) and interest rates. Different agencies use different approaches to decide what prices are "affordable."

Both state and local governments have imposed requirements on developers to build a certain number or percentage of their units to be priced as affordable. Affordable housing controls respond to a situation in which it seems that no housing is being produced for ordinary families. In addition, the City and County of Honolulu instituted buyer qualifications for affordable units. Also, buy backs and shared appreciation rules are based on the assumption that affordable housing appreciates in value so quickly that it is simply no longer affordable when it is resold. With these assumptions in mind, it seemed useful to gain a long-term understanding of the housing market that could trace how prices appreciate for homes from sale to resale.

SOURCES

The analysis presented here draws on a data set created for this report. Using the Hawaii Information Service, Inc. compilation of real property tax data, SMS identified residential fee simple market sales of land and housing over the period from 1985 through 2004. The database is somewhat smaller than the sales figures reported elsewhere, but is, we believe, a solid basis for understanding property sales and appreciation in Hawaii.[11]

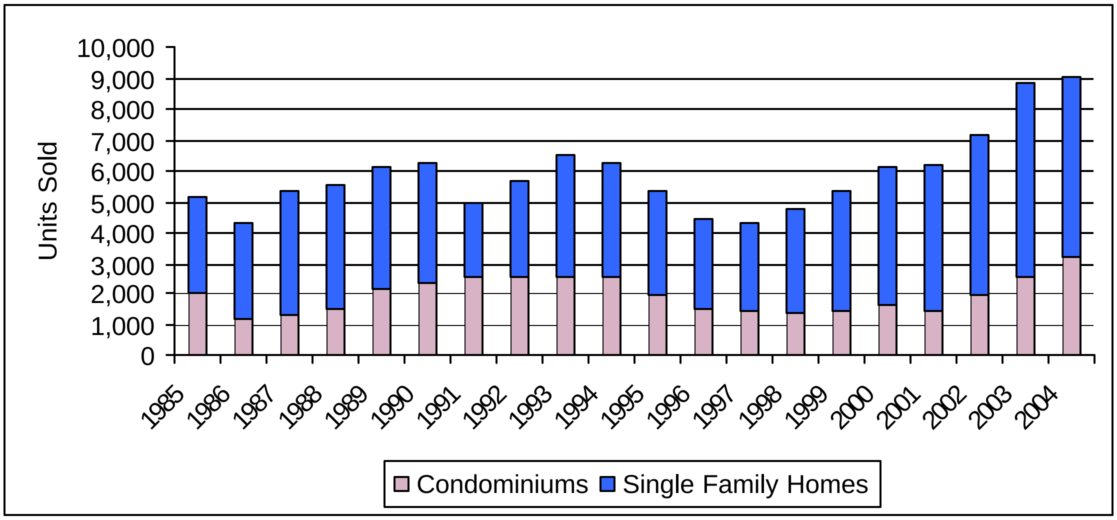
CHARACTERISTICS OF THE OAHU HOUSING MARKET

Volume

In Oahu sales data, single family units consistently make up most of the housing market. In years when sales decline, the decline affects both single family units and condominiums. Similarly, sales growth is visible in both categories. Still, single family sales make up an increasing share of the market, as shown in Exhibit 4:

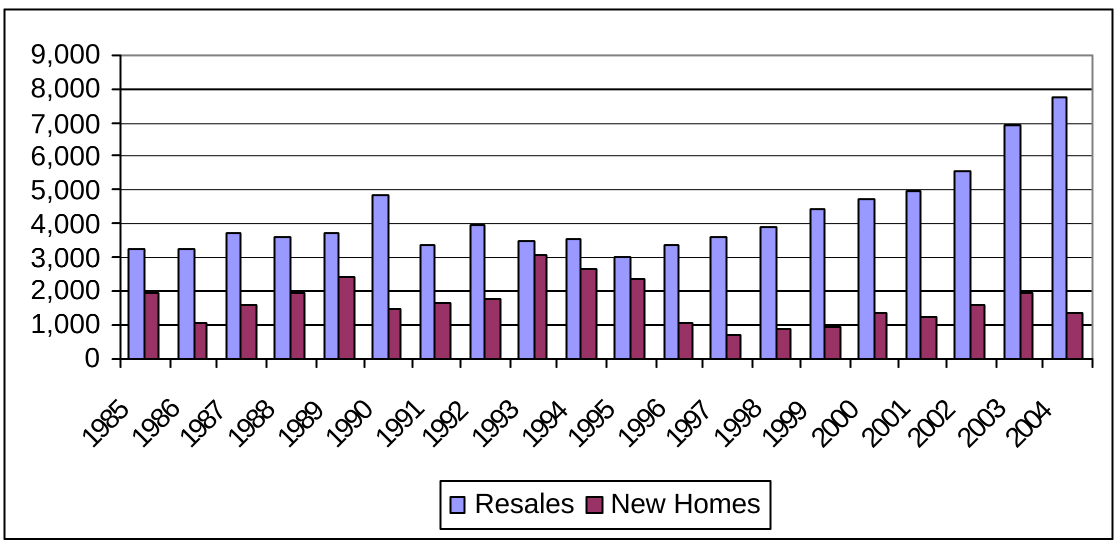
[11] The data set was delimited to exclude sales of partial interest in properties, multiparcel sales, and transfers of interest for a consideration not based on market price. See Appendix A for details.

Exhibit 4: FEE SIMPLE SALES, RESIDENTIAL PROPERTY, OAHU, 1985-2004



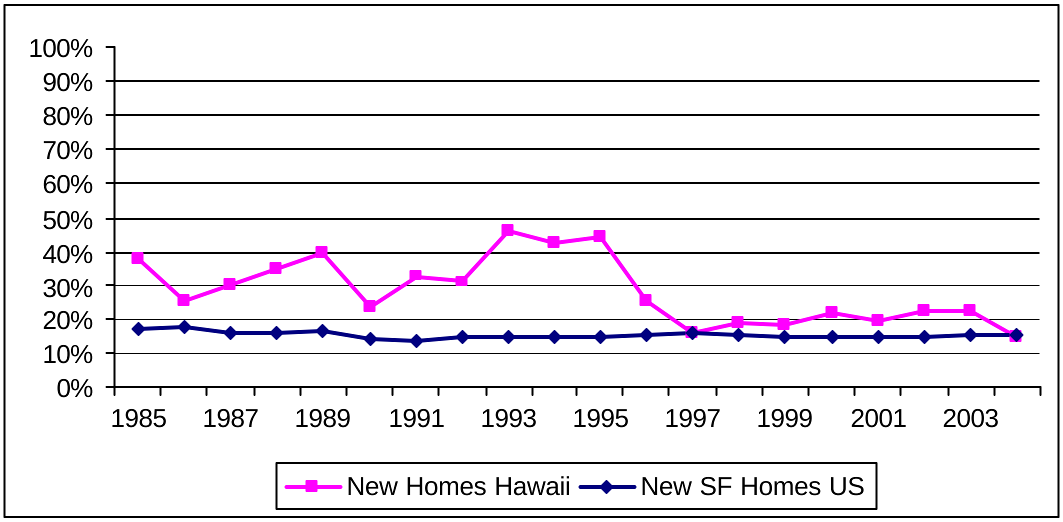
While the volume of single family and condominium sales tend to covary from year to year, the relationship between new home production and resales is more complex. After the mid-1990s, when the new home market became very slow, developers have scheduled production in small increments. They keep unsold inventory to a minimum. The resale market has increased much more quickly, as shown in Exhibit 5.

Exhibit 5: NEW HOME PRODUCTION AND RESALES, OAHU, 1985-2004



The relative size of the resale and new home markets has varied greatly from year to year in Hawaii, much more than in the United States as a whole. Exhibit 6 shows the new housing share of the market to be approaching the national standard, but this may be somewhat misleading. The national market is booming, and resales and new home production are increasing at the same pace. On Oahu, the land use entitlement and permitting process are quite cumbersome and developers cannot increase new home production in a few months if market conditions are favorable.

Exhibit 6: NEW HOME SHARE OF MARKET: OAHU VS. US SINGLE FAMILY



SOURCE: US Department of Housing and Urban Development, 2005.

Sales Prices

The story of Hawaii residential real estate prices is well known. For many years, local real estate was seen as a safe investment, sure to appreciate in value. During the 1990s, prices declined and would-be sellers waited for the return of buyers with ready cash. In the last few years, demand and prices have increased. The current boom has been fueled by:

a. Low interest rates;
b. The relative price of Hawaii vs. US Mainland real estate, especially in the urban California markets;
c. The lack of supply of new homes (see Exhibit 5);
d. An influx of second home buyers for reinvestment purposes; and,
e. The lack of highly desirable investments after the stock markets corrected valuations at the beginning of the decade. Baby-boom demographics contribute to the renewed interest of West Coast buyers in Hawaii property, since these buyers, nearing retirement, tend to have considerable assets. One striking new development is that non-resident ownership, long part of the real estate market on other islands, is increasingly found on Oahu as well. Offshore buyers tend to purchase more expensive products than residents, creating a distinctive demand for high-end units visible even in Hawaii Kai (SMS, 2004).

Exhibit 7 shows the historical trends for median prices of fee simple residential property on Oahu, while Exhibit 8 shows the trends for average prices. Usually, the average prices are well above the median, due to the impact of a few high-price properties.

Exhibit 7: MEDIAN SALES PRICES, OAHU, 1985-2004

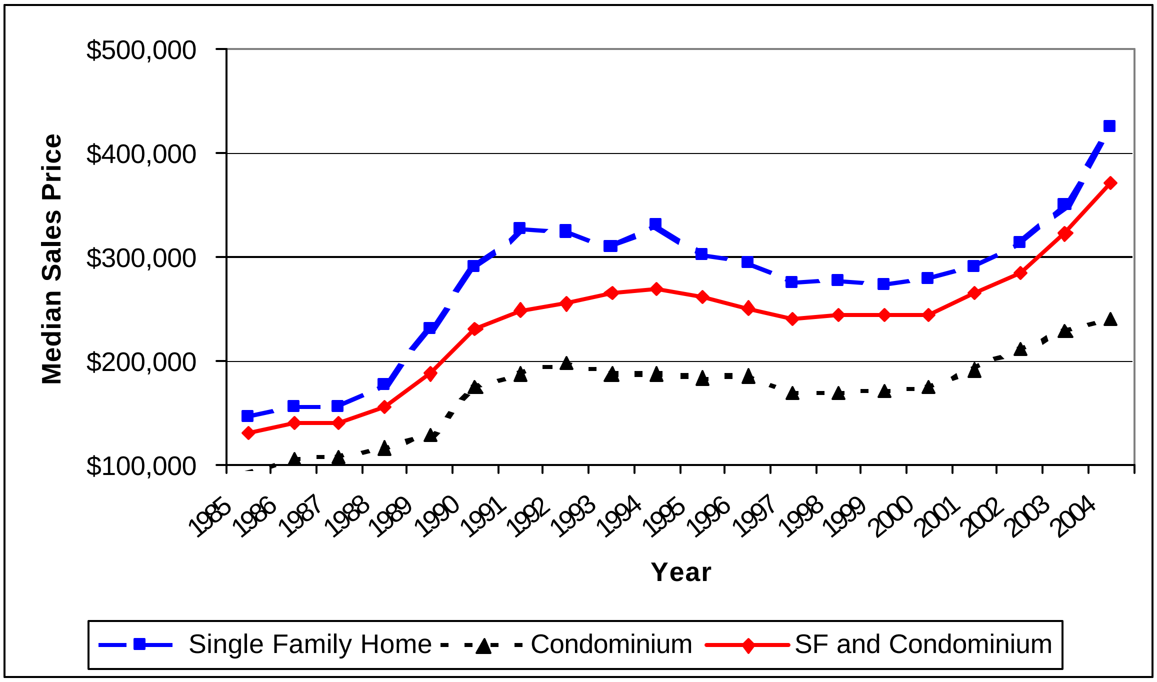
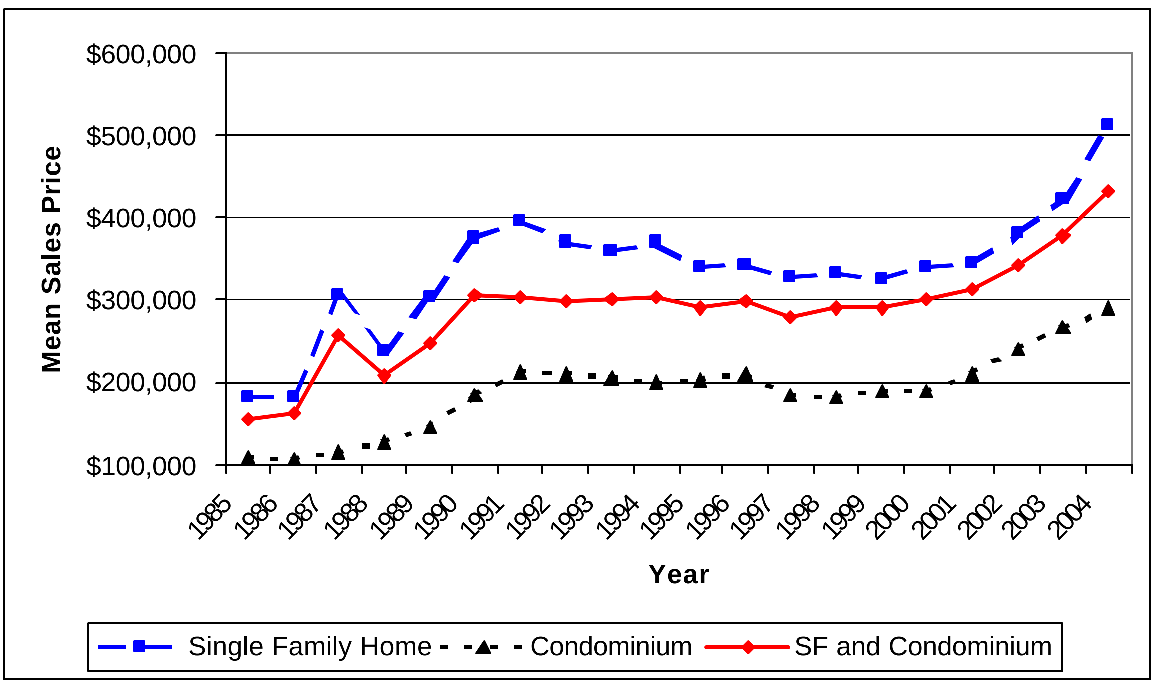


Exhibit 8: AVERAGE SALES PRICES, OAHU, 1985-2004

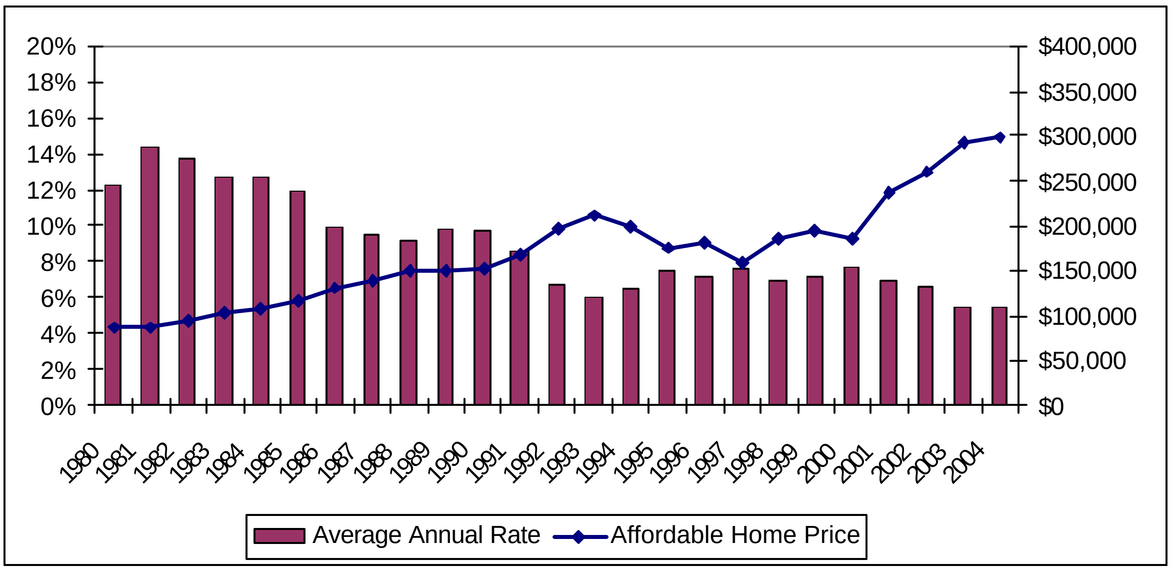


Drivers of Sales Prices

Interest rates have played an important role in allowing price increases over the last twenty years. These correlate closely, with prices increasing as rates fall. Exhibit 9 shows this and underlines the point that interest rate rises create declines in purchasing power. (The correlation coefficient between average mortgage rates and affordable housing prices is -.90. The correlation between mortgage rates and median housing prices is nearly as strong, at -.89 between 1985 and 2004.)

The close link between prices and interest rates creates a concern for developers that affects the resale market to a lesser extent. When rates increase, the amount buyers can afford for new home declines. At the same time, construction costs can be expected to rise, making it harder and harder to deliver new homes at the same price as before, much less the reduced amount buyers can afford. Exhibit 10 shows how the prices affordable to moderate-income families and construction costs have covaried.[12]

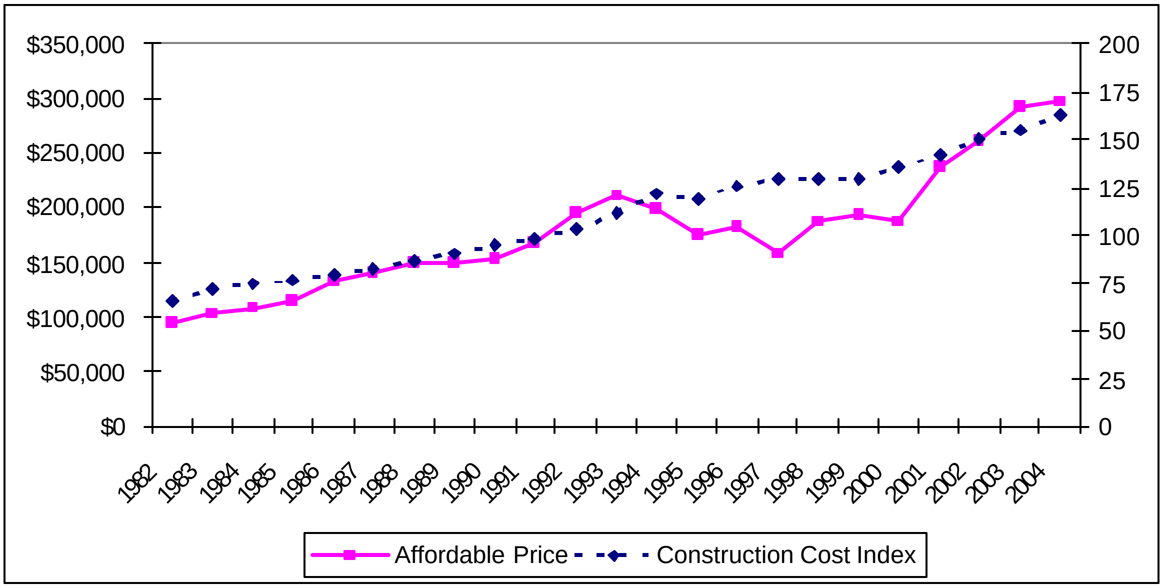
Exhibit 9: AVERAGE ANNUAL MORTGAGE INTEREST RATE AND AFFORDABLE HOME PRICE, 1980-2004



SOURCE: Adapted from SMS, 2003.

[12] Here and subsequently, "affordability" is a matter of calculation, not limited to homes produced under a UA.

Exhibit 10: AFFORDABLE HOUSING PRICES AND CONSTRUCTION COST INDEX, 1982-2004



SOURCE: Construction cost index for single-family homes, Honolulu. DBEDT, 2005.

Appreciation and Affordability

A major concern of policy makers is to assure a continuing supply of housing for families at all income levels. This is obviously a concern with regard to rentals. Several older buildings, built with federal loans that restricted their use for rentals over 20 or more years, are now being renovated and sold as condominiums. In the for-sale market, the first question is what buyers can afford, and hence sellers can realize, in terms of the value of their real estate.

A standard approach to the question is to calculate appreciation over time in dollar value. A house bought in 1985 for $115,000 and sold in 2004 for $298,000 has appreciated in value at an average rate of 4.9% over 20 years. This suggests that a mid-price Hawaii home is a solid but modest investment. However, that approach begs the crucial question for most sellers: What can you buy with the money from the sale? The answer turns out to be: exactly the sort of house that families with moderate incomes can afford in 2004. The sales figure in this example is what a family with the median income can afford in the current economy, both in 1985 and in 2004. (See the "Affordable Price" line in Exhibits 9 and 10.)

This approach can be used for the range of actual sale prices, not just for a simple example. A sales price can be translated into a multiple of the affordable price for the year in which the sale occurs, and then compared in terms of affordability with sales in earlier years. Exhibit 11 shows the average annual home interest rate and affordable price used for each county over the twenty-year period. The county prices vary because the median income is estimated separately every year for each county in the State. Exhibit 12 shows the number of households in each income segment studied in this section.

Exhibit 11: AFFORDABLE HOME PRICES, 1980-2004

Year	Interest rate	"Affordable" Home Price *Hawaii County*	*Honolulu County*	*Kauai County*	*Maui County*
1980	12.30%	$67,131	$86,967	$72,191	$78,406
1981	14.42%	$67,084	$86,905	$72,139	$78,349
1982	13.74%	$73,379	$95,062	$78,910	$85,702
1983	12.70%	$79,541	$103,046	$85,536	$92,899
1984	12.73%	$82,855	$107,336	$89,096	$96,767
1985	11.96%	$89,208	$115,567	$95,928	$104,189
1986	9.92%	$102,007	$132,150	$109,696	$119,138
1987	9.54%	$108,276	$140,271	$116,436	$126,459
1988	9.17%	$115,483	$149,604	$124,183	$134,873
1989	9.83%	$115,776	$149,984	$124,498	$135,217
1990	9.78%	$118,685	$152,807	$129,441	$139,826
1991	8.60%	$130,971	$167,477	$145,047	$155,589
1992	6.74%	$147,915	$196,195	$164,916	$182,276
1993	6.05%	$153,958	$211,802	$172,843	$196,785
1994	6.53%	$135,059	$199,681	$170,059	$144,896
1995	7.51%	$163,029	$175,099	$126,134	$131,077
1996	7.17%	$138,466	$182,079	$156,883	$169,574
1997	7.58%	$190,501	$157,853	$149,669	$190,836
1998	6.96%	$183,206	$186,643	$185,341	$188,185
1999	7.21%	$174,649	$194,430	$173,887	$201,156
2000	7.74%	$167,814	$186,895	$167,031	$193,226
2001	7.01%	$179,303	$237,081	$203,911	$222,980
2002	6.64%	$199,016	$260,679	$218,818	$205,144
2003	5.53%	$219,957	$291,546	$243,285	$227,856
2004	5.50%	$221,867	$297,585	$246,861	$230,977

SOURCE: SMS, 2003, updated for this report. Based on median income for a family of four. Affordable price calculated based on prevailing interest rates, a 28% qualifying ratio, and 5% down payment.

Exhibit 12: NUMBER OF HOUSEHOLDS PER INCOME SEGMENT, OAHU, 2003

Percent of Median Income			Household Count	Percent of Households
0%	to	80%	48,896	47.9%
80%	to	100%	12,743	12.5%
100%	to	120%	15,573	15.2%
120%	to	140%	7,613	7.5%
140%	to	180%	7,807	7.6%
>180%			9,554	9.4%
Total Demand			102,187	100.0%

SOURCE: SMS, 2003.

Using this approach, we can ask what sort of house a moderate-income family can afford. Exhibit 13 shows selected homes – new units in Mililani, and older homes in Kailua – that sold for the price estimated as affordable to a median-income family of four.

In the terminology used in later tables, these houses were sold at about Affordability Level 1.00.

Exhibit 13: SAMPLE HOUSING UNITS SOLD AT PRICES AFFORDABLE TO FAMILIES WITH THE MEDIAN INCOME

Year Sold	New Unit, Mililani	Older Unit, Kailua
1985		
Rooms	4 bed 2 bath	4 bed 2 bath
Size	2,446 sq. ft.	1,442 sq. ft.
Land area	4,830 sq. ft.	7,433 sq. ft.
Year Built	1985	1951
Price	$130,500	$112,000
2005 Assessed Value	$471,100	$545,000
1990		
Rooms	2 bed 2 bath	5 bed 4 bath
Size	760 sq. ft.	1,564 sq. ft.
Land Area	4,439 sq. ft.	7,500 sq. ft.
Year Built	1989	1962
Price	$157,400	$150,000
2005 Assessed Value	$368,980	$488,100
1995		
Rooms	*NO NEW*	3 bed 3 bath
Size	*CASES WITH*	1,092 sq. ft.
Land Area	*AFFORDABILITY*	3,825 sq. ft.
Year Built	*FROM 0.95 TO 1.05*	1988
Price		$185,000
2005 Assessed Value		$399,500
2000		
Rooms	2 bed 2 bath	4 bed 4 bath
Size	1,121 sq. ft.	968 sq. ft.
Land Area	Condo	6,100 sq. ft.
Year Built	2000	1957
Price	$189,900	$194,000
2005 Assessed Value	$279,100	$433,000

NOTE: Examples were taken from a larger data set, with the only selection criterion being affordability at time of sale. No attempt was made to pick typical cases within the selection range. Cases were selected from single-family homes where these were available, then from condos for the 2000 Mililani unit. Current assessed values should not be treated as if they were present-day appraisals of the properties that sold earlier, since they reflect maintenance and improvements.

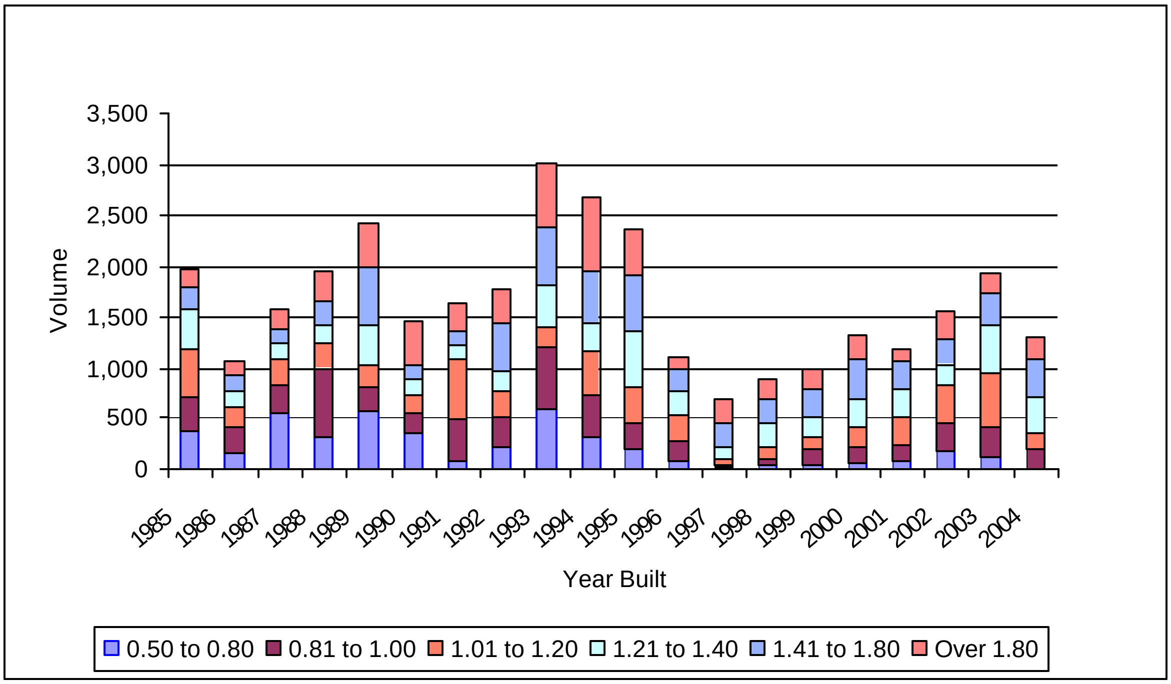
The homes shown in Exhibit 13 sold for different prices but about the same value, i.e., the amount affordable to families with the median income in the year of sale. Current (2005) assessed values also are in much the same range, although the homes in Kailua have higher values than the Mililani ones. In short, homes affordable to median income buyers in earlier years are now assessed at or just above the range of homes now selling to median income buyers.

The analysis used here distinguishes **price**, in dollars, from housing **value**. Housing value is used here to refer to the capital needed to acquire housing of the sort which buyers of a given income level can purchase.

Affordability of New Homes

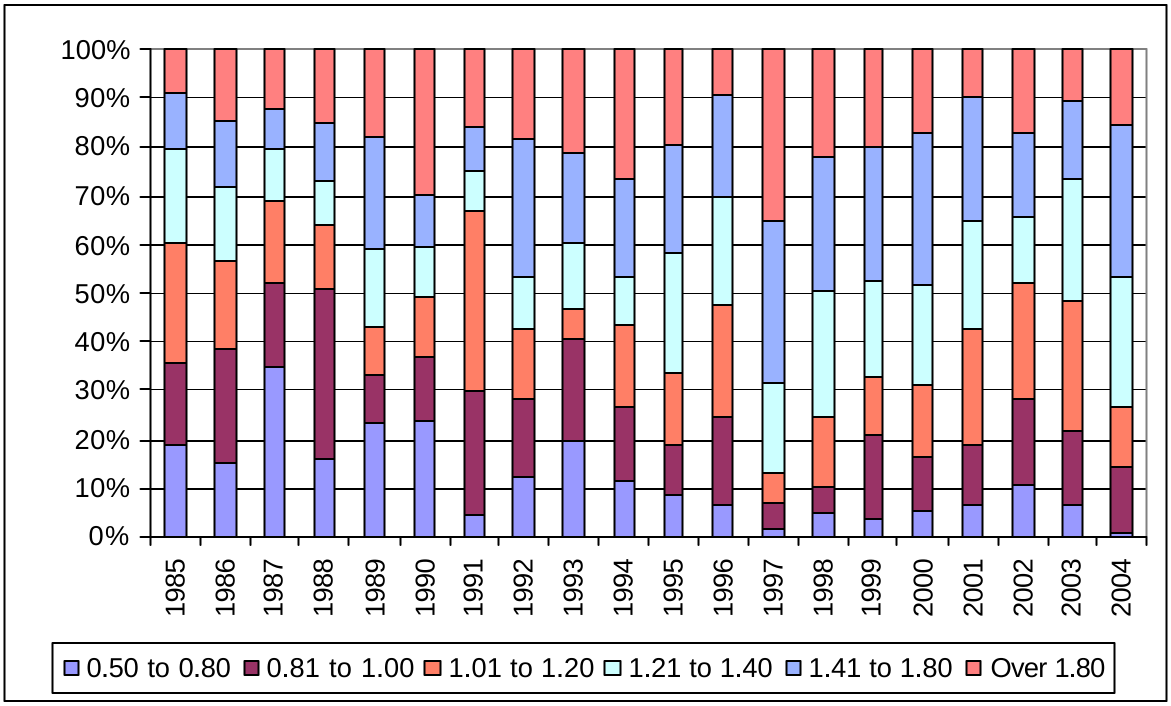
It is possible to see what share of the housing market is within the reach of different income groups. New units have been produced in different quantities for each segment, depending not only on the volume of production but also on developers' and policy makers' choices. Exhibit 14 depicts the distribution by number of units, while Exhibit 15 shows the share of production by segment from year to year.[13]

Exhibit 14: ANNUAL DISTRIBUTION OF NEW PRODUCTION BY AFFORDABILITY LEVEL, 1985-2004



[13] Affordability levels below 0.50 were excluded because many sales listed in the TMK database below this level are not market transactions. For example, many are transfers within a family or between owners and a trust set up in their names.

Exhibit 15: ANNUAL SHARE OF NEW PRODUCTION BY AFFORDABILITY LEVEL, 1985-2004



It turns out that production for the lowest segment shown – 0.5 to 0.8 – has been declining over twenty years. At the other end of the spectrum, the share of new production priced for households earning over 180% of the median income has varied from 10% to 30% of production. That segment was largest in the early 1990s, when the State government was pressing developers to increase the number of units affordable to families with 80% to 140% of median income.[14] Presumably, the need to underwrite sales of homes at controlled affordable prices pushed market sales prices higher.

Affordability of Older Homes Sold on the Market

Exhibit 16 shows the range of fee simple home sale prices restated in terms of affordability levels from 1985 to 2004. Exhibit 17 shows the share of annual sales included in each of the six levels used in this study. They show that each category represents at least 10% of sales each year. The number of sales in the 1.20 and below ranges has exceeded 3,000 homes in the last few years, and total sales have climbed to the highest numbers in the twenty-year period.

[14] The segments shown here are *based* on those used for affordable housing exactions. However, they are not identical with the cutoff points determined by government agencies. The counties use different formulae to calculate affordable housing prices, and may change assumptions used for those formulae from year to year. As a result, a unit that counts as a "120% of median" sale for county purposes could be in the 1.01 to 1.20 range or the 1.21 to 1.40 range. Moreover, the City and County of Honolulu is currently using declared household size as one of the criteria used to calculate whether a home is an "affordable" sale. That factor is not available in the TMK records used for this study.

Exhibit 16: ANNUAL DISTRIBUTION OF FEE SIMPLE HOME SALES BY AFFORDABILITY LEVEL, 1985-2004

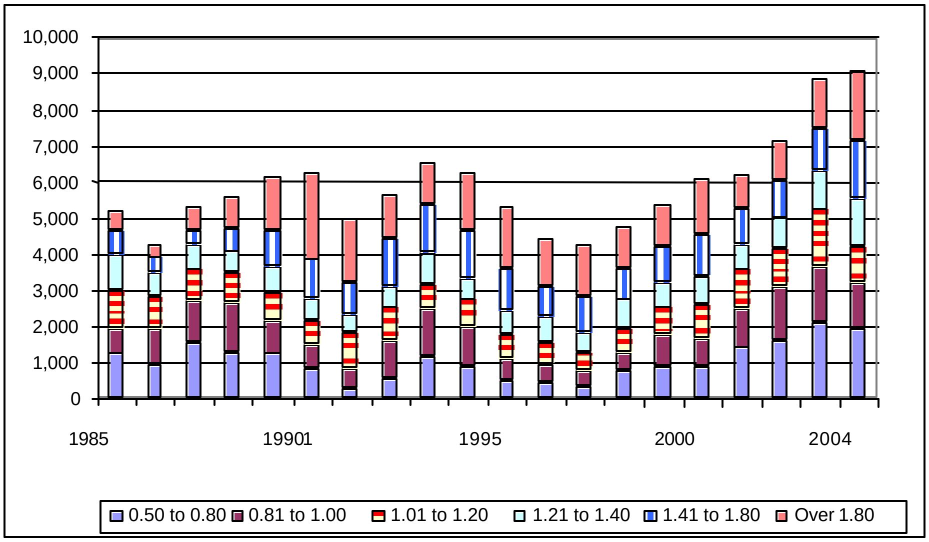
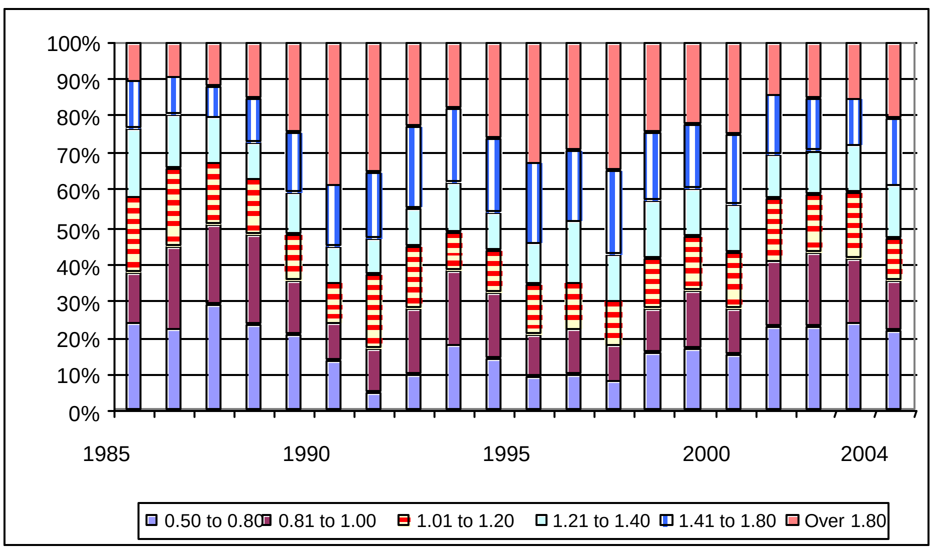
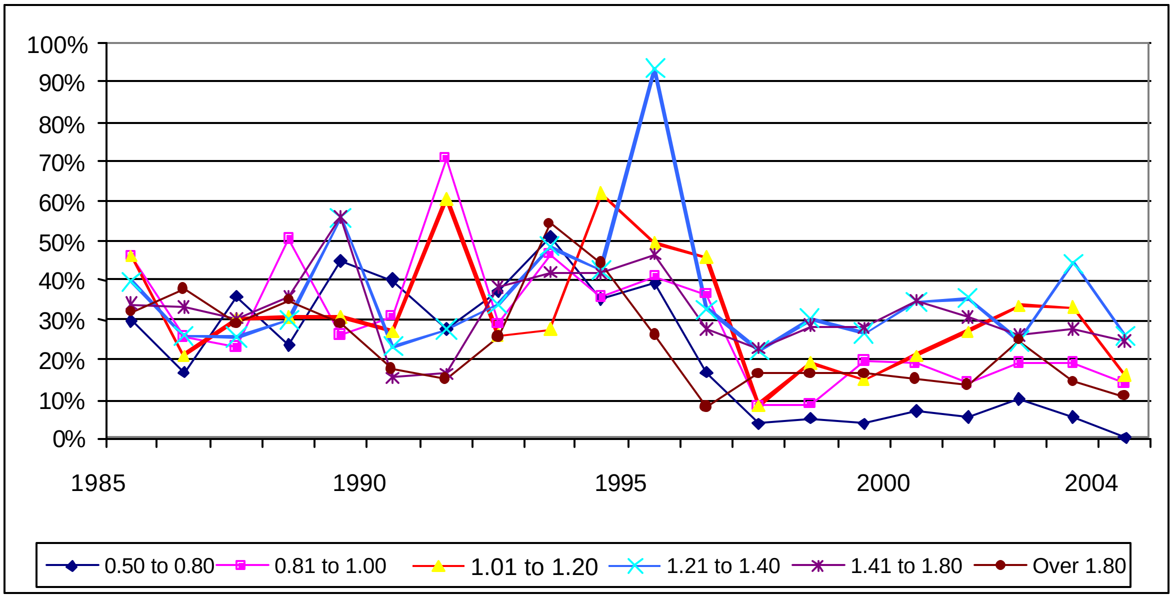


Exhibit 17: ANNUAL SHARE OF FEE SIMPLE HOME SALES BY AFFORDABILITY LEVEL, 1985-2004



As noted earlier (in Exhibit 14), new home production at levels below 0.8 has declined in recent years. Exhibit 18 shows the share of total sales represented by new homes for each affordability level. For each particular level, the share can change greatly from year to year, depending on market conditions.

Exhibit 18: NEW UNITS AS SHARE OF TOTAL SOLD ANNUALLY, BY AFFORDABILITY LEVEL



Resales of Units Initially Sold at Affordable Prices

A key concern has to do with whether units sold at affordable prices will ever be affordable again. SMS investigated this by tracing initial and subsequent sale prices for particular fee simple units. Units were grouped by the amount for which they sold and the time at which they first sold. "Initial sales" are the first sale within the study period, 1985-2004, for which sales prices could be converted to affordability levels.

It turns out that units in the least expensive segment – the one that developers are no longer producing for sale – appreciate in housing value as well as in price, as Exhibit 19 suggests. In the first year or two, resales for all of these units show increased value as well as price. For units built before 1995, the resale value climbs above 0.8, i.e., outside the initial sales range. Next, units that sold from 1985 to 1989 turn out to have much higher resale value than units that entered the database later. This trend recurs for all segments. One factor may help to explain it: many of Oahu's most prestigious neighborhoods are in older areas of the island, so the earlier sales are likely to include more units from those neighborhoods.

The next three graphs (Exhibits 20 to 22) cover the "affordable for sale" target income ranges. They show very similar characteristics to those seen in the last exhibit. Again, the oldest units in the database have much higher resale prices than more recent ones, and a small increase in value is visible in the first year or two. Afterwards, the value of these homes trends downward.

Exhibit 19: RESALE AFFORDABILITY, UNITS INITIALLY SELLING FROM 0.50 TO 0.80

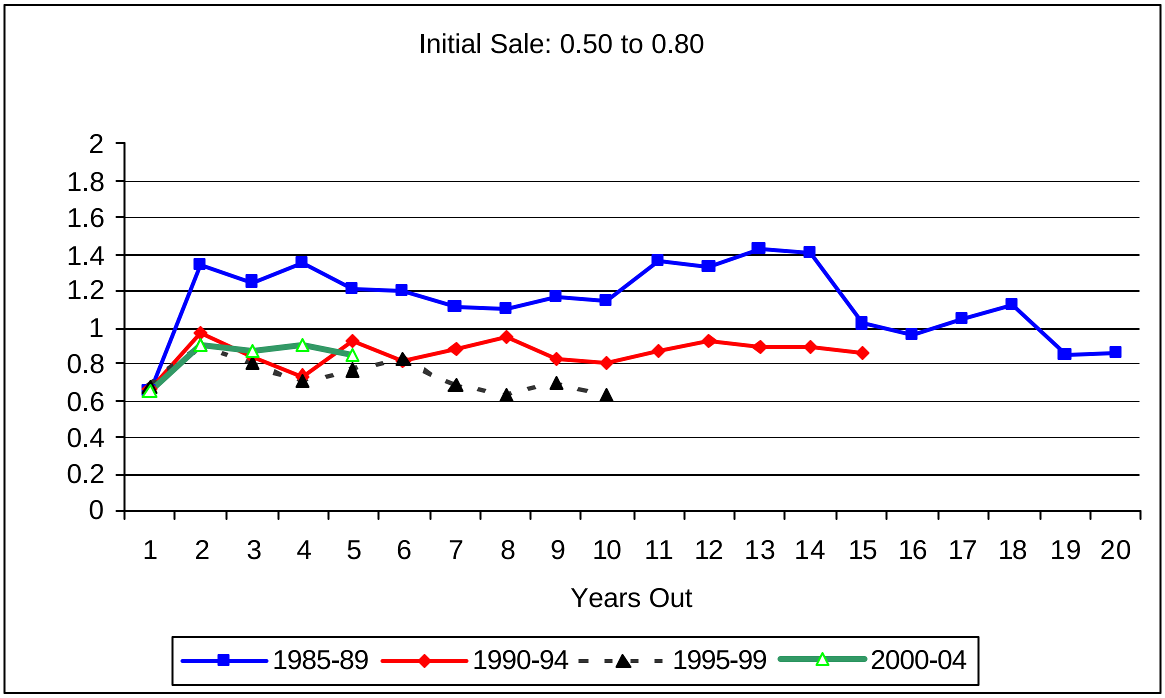


Exhibit 20: RESALE AFFORDABILITY, UNITS INITIALLY SELLING FROM 0.81 TO 1.00

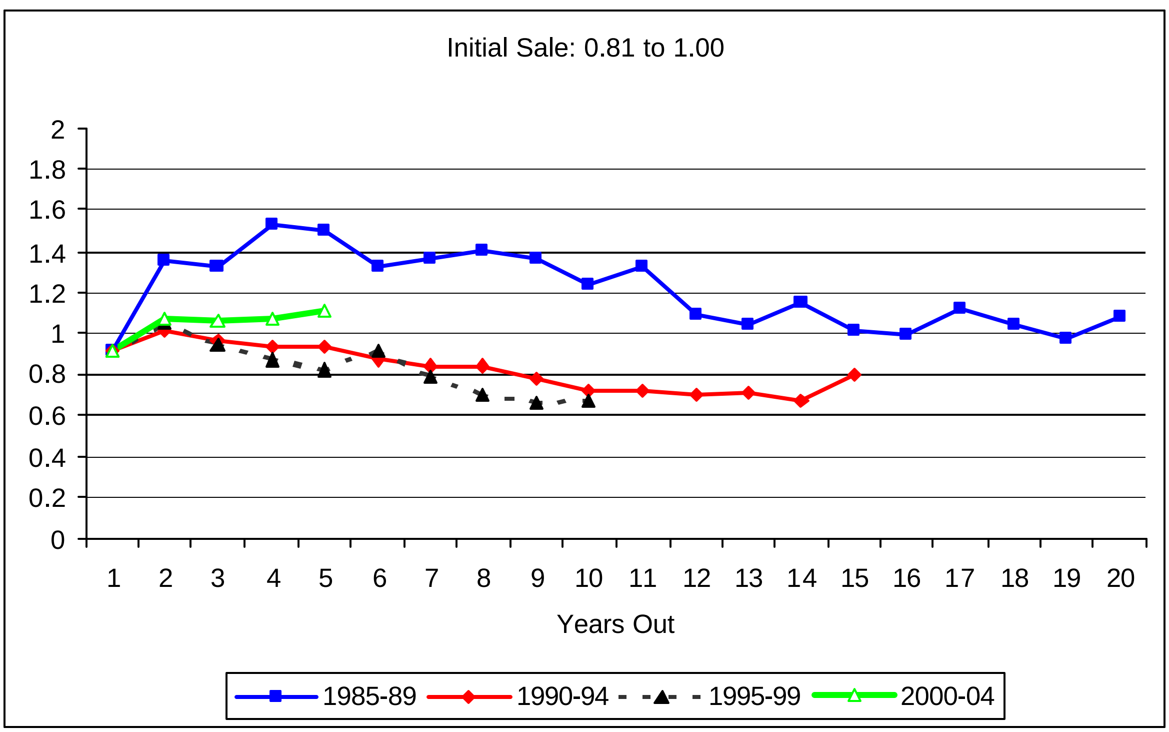


Exhibit 21: RESALE AFFORDABILITY, UNITS INITIALLY SELLING FROM 1.01 TO 1.20

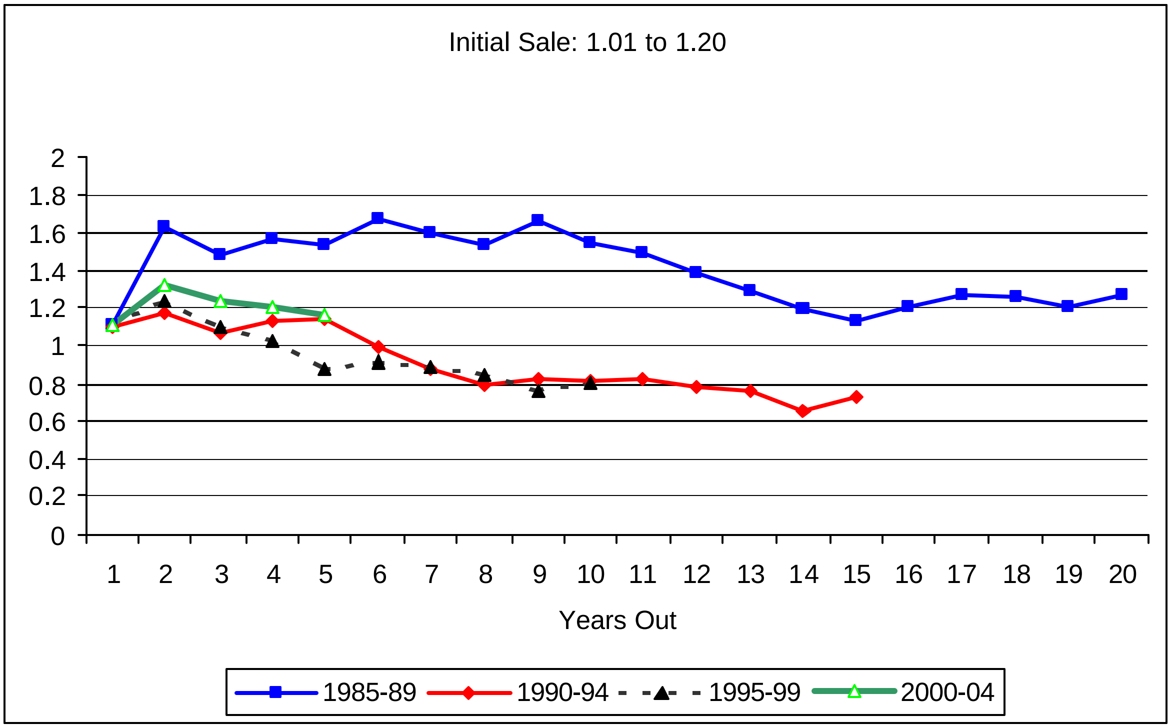
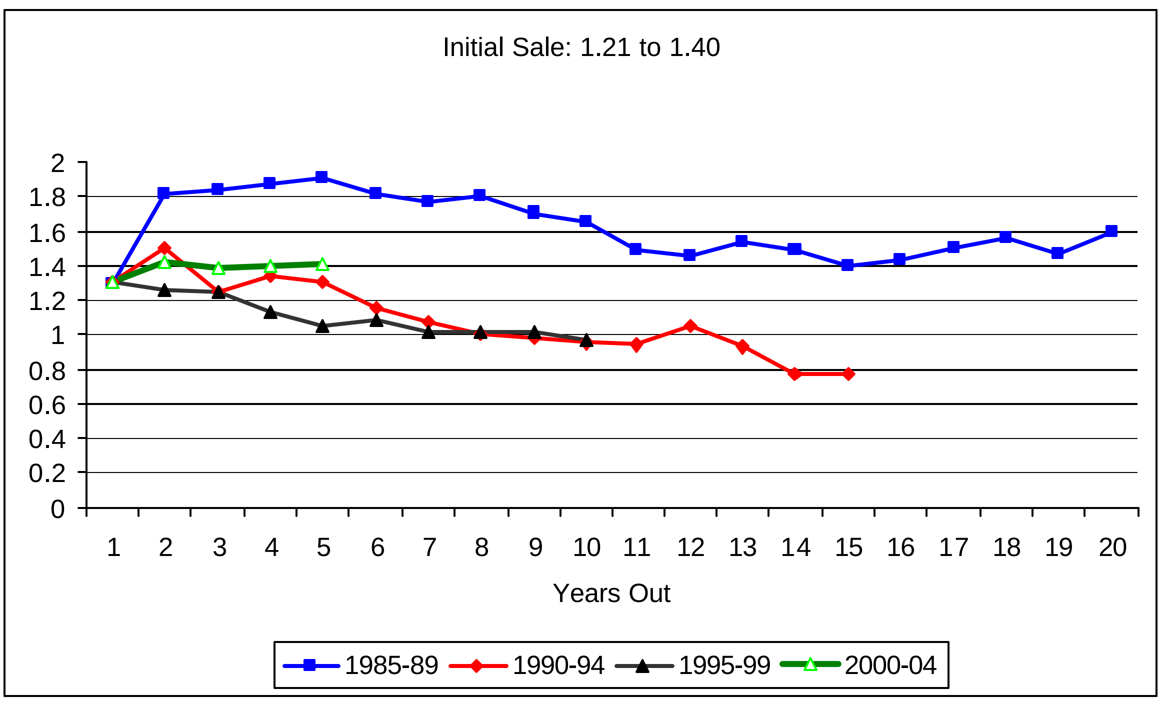


Exhibit 22: RESALE AFFORDABILITY, UNITS INITIALLY SELLING FROM 1.21 TO 1.40



The brief increase in value (in the first year or two after the initial sale) suggests that home buyers can make a profit on their homes by reselling quickly. For affordable units under UAs, this should be delimited by owner-occupancy rules.

The data for the next segment show similar trends (in Exhibit 23). The top-of-market segment, however, is a bit different, as shown in Exhibit 24). At the top of the market, resales decline in value more slowly, and may even increase in value many years after the initial sale.

Exhibit 23: RESALE AFFORDABILITY, UNITS INITIALLY SELLING FROM 1.41 TO 1.80

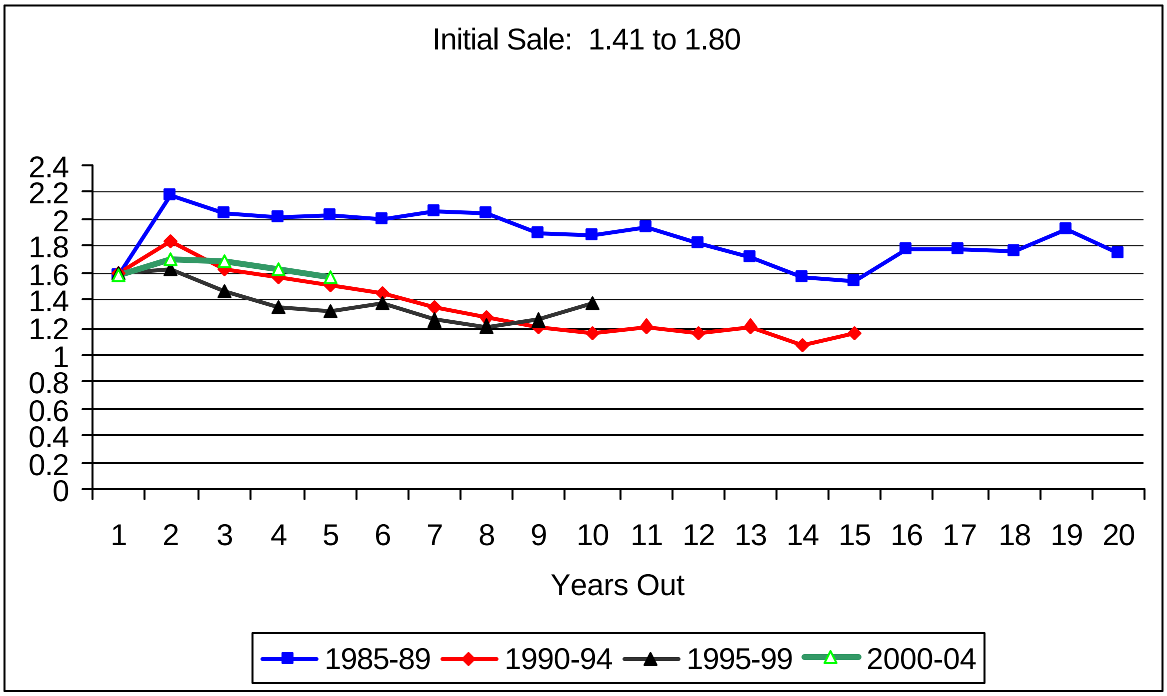
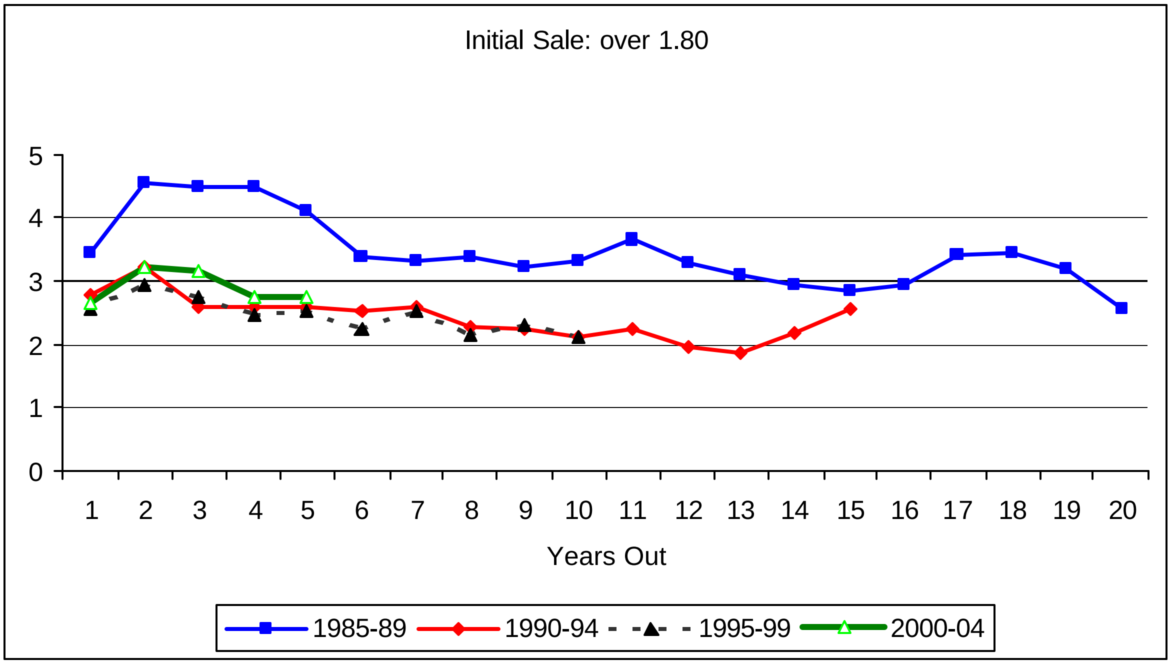
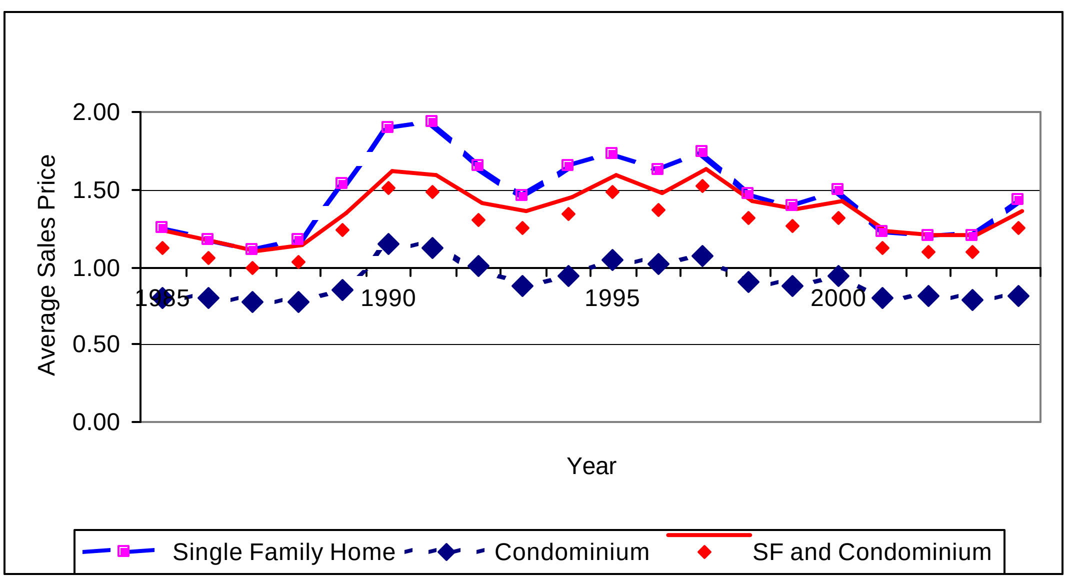


Exhibit 24: RESALE AFFORDABILITY, UNITS INITIALLY SELLING OVER 1.80



The resale analysis shows that the Oahu housing market is not characterized by the disappearance of affordable units. Another way to see this is to translate the median prices of units sold year by year into affordability levels. Exhibit 25 shows the results.

Exhibit 25: AFFORDABILITY OF MEDIAN PRICED UNITS, 1985-2004



DISCUSSION

This section begins by summarizing major historical trends and indications of the outlook for the next few years in the Oahu housing market. Next, the issues raised by Ordinance 01-33 and the DPP are addressed.

MAJOR TRENDS

The last section showed some overall trends for the Oahu housing market:

- Housing prices have risen in a cyclic pattern of sudden rise, a plateau (and in the 1990s, a fall) in prices, followed by another rise;
- The volume of housing sold annually has followed much the same pattern, with the number sold increasing as prices go up;
- Housing prices increase as mortgage rates go down;
- Construction costs have risen more consistently over twenty years, and have not gone down even when housing prices have fallen;
- New home production does not increase as quickly in boom times as the number of older homes sold; and
- Over time, the new home share of the market has tended to stabilize near 20%, slightly above the rate seen for the US market as a whole.

The analysis of home production and sales in terms of affordability levels showed some clear trends:

- Units are available and sold for each of the six affordability levels studied, year in and year out;
- Much as in the mid-1990's, the number of new units produced at the lowest level (0.5 to 0.8 affordability) has declined; and
- Over time, resales tend to lose value (expressed in terms of affordability), with two major exceptions:
    - The homes which initially sold in the years 1985-1989 gained in value in the first few years. While they have declined in later years, the decline is from the high point reached a few years after the initial sale.
    - Homes with initial sales in the 0.50 to 0.80 affordability range have tended to stabilize in value at or above the upper end of that range.

The major finding of the affordability analysis is that **affordable units for sale stay affordable.** Homes do not increase in *value* so that they are no longer available to moderate-income buyers when it comes time for them to be resold. On reflection, these results are not surprising. Housing is sold on the market to local buyers, and prices are constrained by what buyers can pay. As the share of housing on Oahu sold to non-residents increases, this may be less true over time. For the moment, much of the market clearly is priced to serve Oahu's moderate-income families.

MARKET SIZE

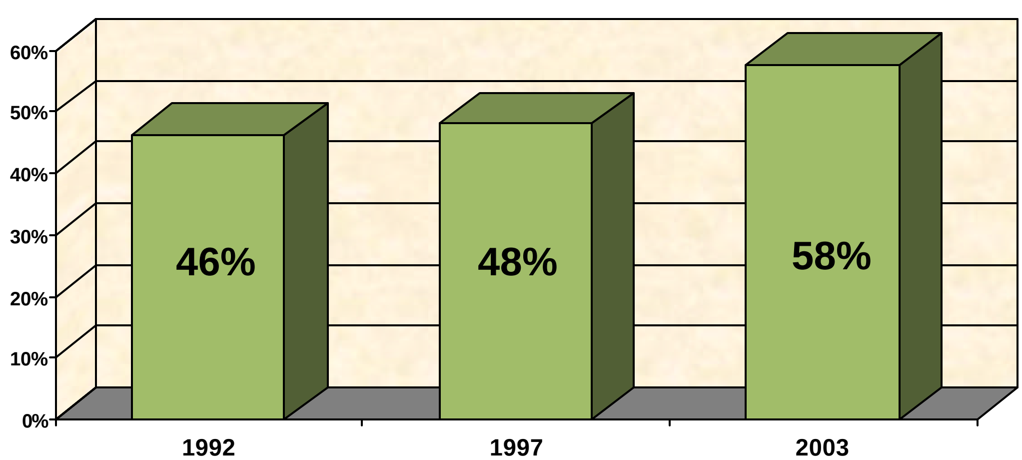
Currently, demand for new homes is extremely strong. Developers are holding lotteries for new homes as these become available, or are taking deposits months in advance. Is this based on the structure of Hawaii's market, and not likely to change, or is it likely to be a short-term phenomenon?

Historically, Hawaii's housing crisis is far from new. Policy-makers remember similar crises in past decades. The crises have ebbed when the economy changed, and then returned.

Hawaii's pattern of housing price booms and plateaus has been found throughout the United States (personal communication, Dr. Michael Sklarz, Fidelity National Information Services, March 2005). It has recently brought much discussion of whether a "housing bubble" exists nationally or in a few areas. The pattern reflects a situation in which demand far outstrips supply.

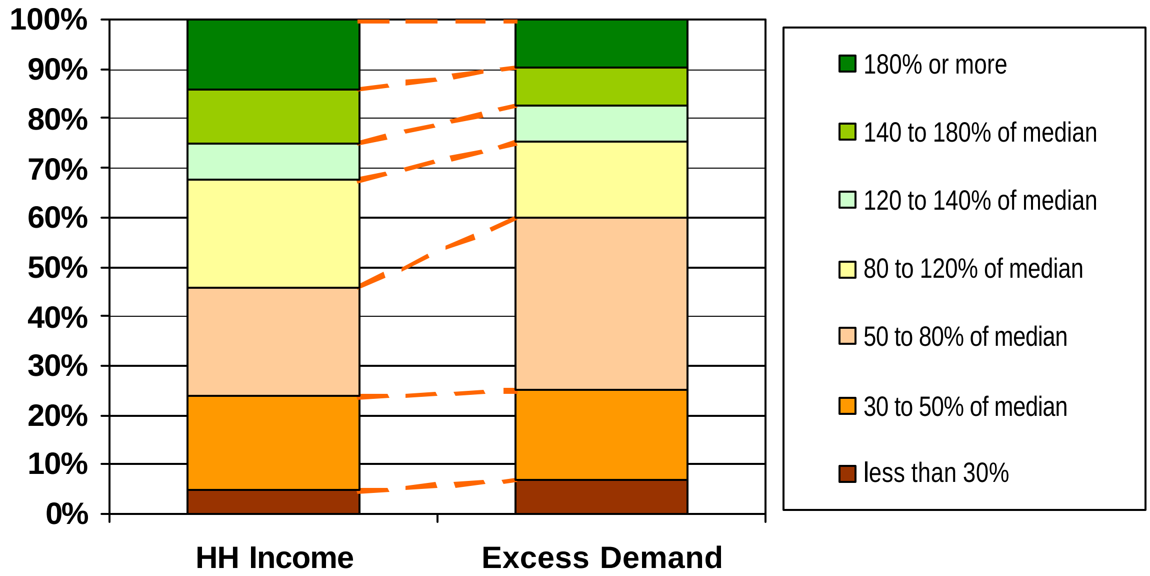
The SMS *Housing Policy Study* (2003) suggests that total demand has, over time, been declining, as many residents come to live in what they see as their desired family home, as shown in Exhibit 26. It also suggests that, with rising prices, demand from low-income and moderate-income families has not been met as well as from other income groups (Exhibit 27). These indicators include both renters and homeowners, and the lion's share of unmet demand is in market segments that typically rent.

Exhibit 26: SHARE OF HOUSEHOLDS NOT EXPECTING TO MOVE AGAIN, IN HOUSING POLICY STUDY DEMAND SURVEY



SOURCE: SMS, 2003

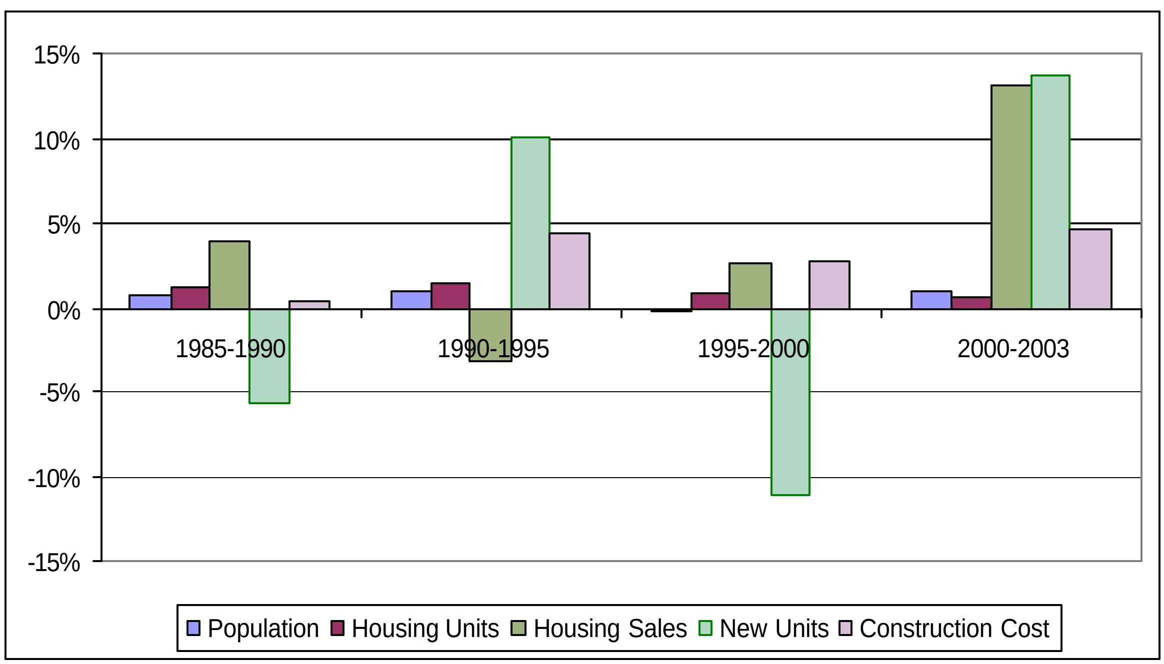
Exhibit 27: HOUSEHOLDS EXPECTING TO MOVE, BY MARKET SEGMENT, 2003



NOTE: Market segments shown are defined by HUD income levels for families of various sizes.
SOURCE: SMS, 2003

Another way to approach the question is to ask whether growth in housing units has kept pace with population growth. For most of the period studied, the rate of growth of housing units outpaced population growth.

Exhibit 28: CHANGE IN FIVE-YEAR INTERVALS: POPULATION, HOUSING, SALES, NEW UNITS AND CONSTRUCTION COSTS



Recently, both housing sales and production have been rising at much faster rates than population increase.

These trends make supply much less of a problem at the highest income levels, but, as Exhibit 27 indicated, not for low- and moderate-income levels. The net difference between supply and demand for homes for residents on Oahu has been estimated as greater than 20,000 units (SMS, 2003, for the years 2003-2004). Even if housing production keeps increasing, it will be many years before supply is not highly constrained for most buyers (and renters).

What Next?

The market study cannot predict the exact timing of future trends. Nonetheless, it is appropriate to note broad, if tentative, findings that may be relevant to any new policy initiative:

Interest rates are low and are likely to stay low for a year or longer. With low rates, residents can qualify for large mortgages.

However, rates are expected to increase, lowering what home buyers can pay while the cost of home building is increasing rapidly. With construction of all kinds booming, housing developers are concerned that they may soon find it impossible to deliver affordable homes for sale at prices that families making 80% of the median can afford.

It is disturbing to note that the curves for affordability and construction costs in Exhibit 10 show much the same pattern in 1990-1994 and in 2000-2004. The first period was soon followed by the time when the market for new homes shrank greatly. **This situation, in which developers cannot find financing and would-be buyers cannot qualify for mortgages in the "affordable" for-sale price ranges, could recur in the next few years.**

Developers are unable to rapidly increase new production. In part this is due to both the lack of qualified additional construction workers, and the lenders' reluctance to finance more rapid production and inventory. They (and their lenders) are unwilling to build and hold unsold inventory. The construction workforce in Hawaii, which contracted during the 1990s, is now in demand for many different new projects. To accelerate production, homebuilders would need to bring new workers in from outside Hawaii.

Now and in the past, the pace of much home construction has been set by the length of time needed to gain entitlements. Major developments need land use permits from the State and the City, subdivision permits, and then grading and building permits. During the process, regulations and other conditions are likely to change, forcing developers to change plans and resubmit applications. The process is long; it demands continuing effort for an eventual return; it ties up capital; and it makes it very difficult to accelerate the pace of new construction when buyers are able to enter the market.

The trends noted in the affordability analysis are based on market relationships and are likely to continue. Even if new housing construction dries up, the resale market will continue, and will adjust to buyers' ability to pay. Prices may rise or fall, depending on the larger economy, but home values, expressed in terms of what residents can afford, are likely to change much less.

Non-residents are increasingly part of the Oahu housing market. Their role may lessen, now that Hawaii prices have caught up to California prices. Still, affluent members of the baby boom generation can be expected to be in the market for second homes or retirement homes for at least the next decade.

INFORMATION REQUESTED IN ORDINANCE 01-33

Ordinance 01-33 allows for a study "of Oahu's need for and ability to sustain new housing units." The preceding analysis and discussion show that:

- Homes have sold and continue to sell at all affordability levels;
- Both home sales and new housing production have been growing more quickly than population; and
- Demand is growing for income levels that typically rent, rather than buy.

The historical analysis hence indicates that new housing and resales are likely to serve a wide range of buyers. The only caveat to this analysis is that, due to rising interest rates, higher construction costs may make it very difficult in a few years for builders to deliver homes for sale at the 80% of median level. Even then, resales are likely to be available for this market segment. In short, the conditions found before 1999, which led to instituting the moratorium, could well return as part of the Oahu housing market. In other words, the issue raised in the Ordinance, whether Oahu can "sustain" new housing units – keep producing them for sale for all income levels year in and year out – is uncertain. It is very likely that production of homes for sale at the 80% of median level will, with increasing construction costs, not be economically feasible at times. In the past, rising incomes have helped moderate-income families buy new homes again, and developers have been able to produce units for the 80% of median market again.

IMPACT OF THE MORATORIUM

What has happened to supply and demand for affordable and market units for sale?

The market study shows clearly that more affordable units have been available on the market since 1999 than in any earlier time in the study period, as shown in Exhibit 17. Moreover, the resale analysis shows that units offered at prices in reach of moderate-income buyers tend to resell at about the same affordability range, and hence are affordable for the next generation of buyers.

Did the 1999 moratorium have measurable effects on the market?

The immediate effect expected with the moratorium did occur: the number of new units for moderate-income families increased. However, new units only amount to 15% to 35% of total sales in the key affordability ranges. The bulk of sales consists of resales, and their prices are a function of the overall market, not the rules governing affordable sales of new units.

Does the DPP finding, that many buyers have higher incomes, by strict income standards, than the target group for a particular home, mean that less affluent buyers are being shut out of the market?

No, since there are many more units available as resales than as new units. However, SMS is concerned that first-time home buyers with moderate incomes (notably in the 80% of median range) have difficulty qualifying for any mortgage unless they have family support to increase their down payment.

On Maui, for 201-G projects, rentals are typically offered for families up to 100% of the median income, and homes are offered for sale to families at the 110% and 120% levels. This approach recognizes the pressures of a tight housing market. Maui officials see the only solution to the high median prices on Maui Island to be to greatly increase the housing supply (personal communication, Ed Okubo, Department of Housing and Human Concerns, Maui County, May 2005). With a wider range of housing on the market, the median price will fall.

Hawaii policy-makers have recognized that regulatory barriers and delays are important constraints on housing. The Affordable Housing Task Force has urged the State and Counties to shorten processing time and to work out subdivision standards for affordable housing projects (HCDCH, 2005). This is part of a national trend, documented by HUD in an extensive database of literature on regulatory barriers (available at http://www.huduser.org/rbc/index.html). Current research deals with administrative processes and streamlining; zoning, subdivision, building and housing codes; growth restrictions; and related topics.

ADDITIONAL QUESTIONS RAISED BY DPP

In a memo dated December 15, 2004, DPP Branch Chief Robert Stanfield listed questions that he found relevant to the market study:

1. *What has happened to the supply and demand for for-sale affordable and market units since the adoption of Ordinance 99-51?*

   As Exhibit 16 shows, the number of homes sold at the 1.2 affordability level and below has increased since 1998. Exhibit 17 shows that the share of the market for these segments has increased as well. Production of new units for these segments has also increased (Exhibit 14). Evidence of continuing or increasing demand is widespread, as new product sells very quickly in all price ranges.

2. *What has happened to the prices of market units and affordable units during that period?*

   Prices have risen recently but, as the affordability analysis shows, both new product and resales are available. When the median price is expressed in terms of affordability, it turns out that the 2004 median was still well below the affordability levels seen through most of the 1990s (as shown in Exhibit 25).

3. *Do time-on-market statistics from 1998-1999 bear out reports that the prices of market and affordable units were so close that many buyers were unwilling to take on the buy back / shared appreciation requirements of "affordable" units,*

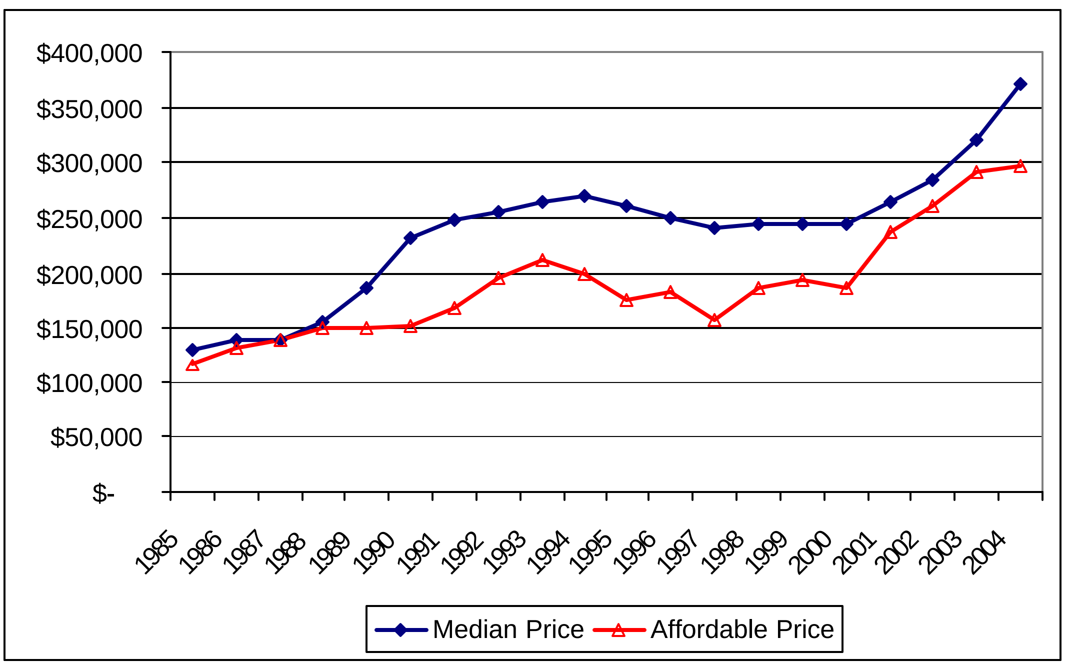
preferring to pay the additional cost to have a market unit, so that developers had difficulty selling their inventory of affordable units.

Time-on-market data are in the Multiple Listings Service database, not the TMK (Real Property) database, and were not available to SMS. Moreover, the MLS database does not include many new subdivisions and condominium buildings, since units in them are typically listed only by a single agent. Accordingly, the MLS data would likely not bear on the question.

4. *What was the difference between market unit and affordable unit prices in 1999?*
5. *What has happened to the difference between market unit and affordable unit prices since 1999? Can that be validated or quantified?*

With the transfer of duties from the Department of Housing and Community Development to other departments, records of past prices are not available from the City and County. Using the affordable price and median price data from this report, Exhibit 29 shows the gap between affordable and market prices increased in 1998. This was largely due to changing interest rates (shown in Exhibit 9). In the last few years, lower interest rates and increased incomes brought the two closer together, but the gap between them has grown since 2003.

Exhibit 29: AVERAGE ANNUAL AFFORDABLE AND MEDIAN PRICES



6. *What is the history/operational effectiveness of the City's Affordable Housing buy back and shared appreciation programs?*
10. *Have either of these programs actually been used by the City?*
11. *Are the buy back and shared appreciation programs effective at accomplishing their aims/purposes? …*

SMS did not have access to City records of buy backs and shared appreciation. We know of no buy back activity. Shared appreciation continues in force under the moratorium (and for 201-G projects). Shared appreciation is registered in individual deeds, and no database of units subject to these constraints has been compiled. The City Department of Budget and Fiscal Services imposes shared appreciation when title companies inform it of pending sales subject to these conditions. (personal communication, Beryle Matsumura, Department of Budget and Fiscal Services, March 2005).

According to records shared by City personnel, the City has received about $300,000 in shared appreciation on properties under UAs in FY 2003 and 2004. It appears as if no shared appreciation was gained under UAs between 1995 and 2002. Nearly 90% of shared appreciation revenues were on units in 201G projects, not ones covered by UAs.

The question of operational effectiveness depends on the objectives of the City. SMS has not conducted a historical study of legislative intent, and does not know the City's original objectives. However, if the aim was to keep affordable housing for sale as affordable, this aim has been met by market conditions, rather than by specific regulations.

7. *Why were these elements [shared appreciation and buy backs] made part of UA Housing Program requirements? Are they required by Ordinance or are they just standard requirements Council included in UA Conditions?*
8. *Specifically, was buy back included to insure that "affordable" housing units were retained in the market?*
9. *Was shared appreciation included to minimize speculation and/or to generate funds for affordable housing programs?*

SMS has not conducted a historical study of legislative intent, and does not know the City's original objectives. However, if the aim was to keep affordable housing for sale as affordable, this aim has been met by market conditions, rather than by specific regulations.

12. *How effective have these programs been in: (a) preventing speculation? (b) providing/retaining affordable housing units in the local housing market? (c) Helping young families / gap-group households become home owners and build household wealth? (d) Providing funds for City Affordable Housing programs?*

The City and developers did not share records of specific units sold as "affordable" under UAs, out of concern for confidentiality. Hence SMS was not able to investigate these questions with regard to actual buyers and sellers.

13. *Should the moratorium on buy-back and shared appreciation continue? Instead of just a moratorium, should these two programs be deleted from the City's affordable housing requirements on private developers? Address specifically what to do with (1) buyer eligibility requirements; (2) shared appreciation; and (3) buy backs. Explain why or why not.*

In the next section, SMS considers a range of alternatives, noting findings that bear on implementation. LURF then provides its recommendations.

The analysis of resales raises an important point with regard to shared appreciation. Shared appreciation limits the equity a buyer of an affordable home can gain over time. The idea is that the initial price is below market, and the initial buyer is hence gaining a windfall. When that buyer sells, the City retains the windfall. However, the windfall is a matter of price, not housing value. After about two years, homes that were initially bought at a price that moderate-income buyers could afford resell at about the same value, i.e. a price in later years that moderate-income buyers can afford. (See Exhibits 20 to 22.) In terms of the affordability levels, a home that sold at 1.00 is likely to resell for about .90 to 1.00 three to ten years later. If the sellers only receives 70% or 80% of the sale price, they have equity to re-enter the market at the .70 to .80 level. They are worse off than when they initially bought an affordable home.

The term, “shared appreciation,” is a misnomer. It is not shared: the City takes any gains due to price appreciation. Considered in terms of housing value, the City usually takes far more than any appreciation in value over time – which is very unlikely to occur if resales happen in the third year after initial purchase or later. The program penalizes short-term sales of affordable homes, and it is better described as a fine or penalty.

SMS notes that the availability of housing on the market, rather than specific controls, appears to be the major force guaranteeing affordability. Hence, any action that encourages more homes to be produced and sold, and speeds the sale process, is likely to help affordability. Controls that limit buyer pools and slow sales could have the opposite effect. This issue applies especially to buyer eligibility requirements, since these demand that buyers qualify both for mortgages and for City approval of their purchase. Implementation of these requirements calls for additional staff time not currently budgeted by the City and County.

ALTERNATIVES

Finding that the majority of buyers of affordable housing mandated under UAs have incomes higher than the desired level (for a given unit, and for the reported size of the purchasing family), the Department of Planning and Permitting recommends that buyer eligibility requirements be reinstated. SMS and LURF accept the DPP finding, but do not see it as leading clearly to the DPP recommendation. This section explores the alternatives that the City Council may wish to consider.

A range of alternatives is presented here, with comments on the feasibility and potential impact of each.

1. CONTINUE THE MORATORIUM

While DPP has identified trends that may be of concern, it is not clear that they call for a legislative solution, so long as the UAs work to encourage development and sale of housing for Oahu's moderate-income residents.

This choice is simple as a matter of legislation, and can be implemented either for the long term or a short term. If the moratorium is extended for a year or two, the Council will have time to explore alternative ways to encourage affordable housing development. Also, further research can be done on the factors that limit would-be buyers from qualifying, and hence on barriers to homeownership that could be addressed by City programs.

It is worth emphasizing that housing has been produced, and older housing has been sold, to all levels of the housing market. The current system may be far from perfect, but it does make housing available for sale to buyers at all levels. Moreover, it is not clear that reinstatement of the buyer eligibility controls or other controls would improve matters.

2. REINSTATE THE VARIOUS CONTROLS IN UNILATERAL AGREEMENTS THAT WERE RELAXED OR REMOVED WITH THE MORATORIUM

We mention this alternative in order to highlight the problems that could arise if the Council does not take any action. If the current moratorium simply lapsed, the City, buyers of affordable homes and developers would face a confusing and very difficult situation:

- The City would need to re-introduce forms and procedures for income qualification, and would need staff to administer this program. Without new staff, buyers of affordable units could have to wait for months to learn whether they could in fact have their new homes. In the meantime, the homes would stand vacant.

- The City would need to develop new procedures for dealing with shared appreciation. If a unit sold in 2003 is subject to a three-year shared appreciation period (under Ordinance 01-33), would that period now be extended? Or would it expire in 2006, while a new unit in the same development, built in late 2005, would be subject to a ten-year shared appreciation provision? Would the City institute procedures and sequester funds for buy backs?

The analysis of affordability in the last section indicates that shared appreciation provisions, at least as written in Honolulu UAs, are deeply unfair to homebuyers. Their purpose is to insure that housing on the market stays affordable. The market already assures that. However, shared appreciation provisions deny owner-occupants a "windfall" due to price increases, but give this to the City and County. The result is that when an affordable home is resold, the sellers receive far less than they would need to purchase similar housing. They may get back the dollar amount they put into the house (plus equity gained through mortgage payments), but they are likely not to be able to buy a similar home at current prices.

Shared appreciation provisions are a powerful disincentive for homeowners to sell their units. As a result, these units are slow to return to the housing market, and these provisions contribute to the low volume found in Hawaii's housing market.

3. THE DPP PROPOSAL: REINSTATE BUYER ELIGIBILITY PROCEDURES

Under the current moratorium, affordable units must be sold to owner-occupants who do not already have residential property. If the buyers resell within three years, shared appreciation clauses in the deeds call for a complex process of appraisal of the value of the home and improvements, estimating a share of the value which is given to the City and County of Honolulu. The City proposes reinstating the procedures whereby would-be buyers would not be able to get their homes until they were qualified as meeting affordability targets.

This proposal has an obvious appeal: if the aim of affordable housing exaction was to provide housing for families at particular income ranges, then that aim is not being very met in many cases. However, the aim is more general. It is not to provide homes for sale to families at the 80% and 120% break points, but to house a wide range of moderate-income families.

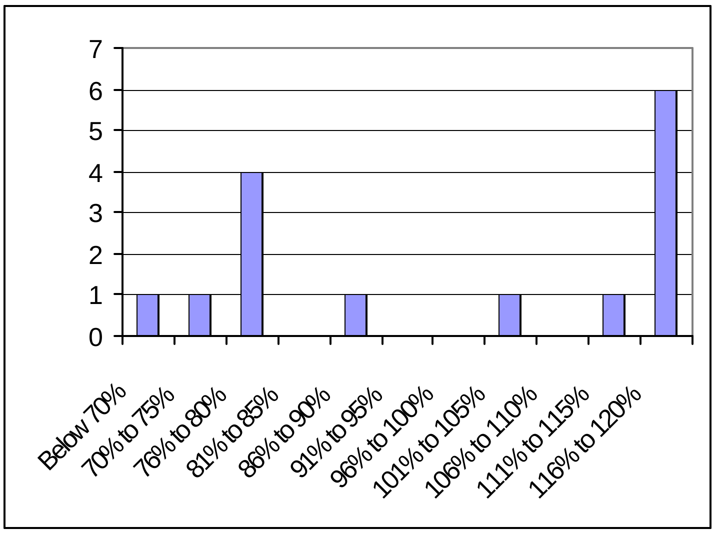
SMS suggests that reinstating the qualification procedures would slow the buying process. (We can only suggest, because detailed income records are not available for the period in which eligibility requirements were in force on Oahu.) Both developers and officials from other counties expect that it may take time to find buyers qualified by income range. In Hawaii County, units are typically offered for sale to families making 100% of the median income, then, if would-be buyers do not qualify for mortgages, to ones at 110%, 120%, 130% and 140% of the median income. The process is slow and typically results in sales to buyers at income levels well above the target level (Personal communication, Edwin Taira, Director, Office of Housing and Community Development, County of Hawaii, May 2005).

This objection is important, since anything that slows development increases costs and reduces the volume of housing production.

Next, it is not clear whether DPP proposes that DPP or DBFS take on the job of requesting additional documentation from would-be buyers, reviewing the documents, making audit checks, and qualifying applicants as meeting income limits. Nor is it clear whether DPP wants to reinstate the entire set of documents – commonly described as "two inches thick" for every buyer's submission – or create a new paper trail. What is clear is that the DPP recommendation would demand additional City staffing. Offices that once had three or more staff members to handle these documents now have one experienced staff member and may have the help of an intern.

Even if target buyers could qualify for units easily, it is not obvious that reinstating buyer qualifications is good policy. A hypothetical example should make the point. [15] UAs demand production of housing for the 80% and 80% to 120% of median income levels. Affordable housing prices are set with the 80% and 120% targets in mind. If a project increment has 5 units for families earning less than 80% of median and 10 units for families earning less than 120%, buyers are likely to have incomes as shown in Exhibit 30. We expect that most of the buyers would just barely qualify for their affordable housing level. As a result, few buyers with incomes up to 79% and between 81% and 119% of median would qualify. We do not see this as a particularly efficient way to help the entire range of low- and moderate-income households.

Exhibit 30: DISTRIBUTION OF BUYER INCOMES FOR A HYPOTHETICAL PROJECT WITH STRICT ENFORCEMENT OF INCOME ELIGIBILITY RULES



4. REINSTATE BUYER ELIGIBILITY CONTROLS, BUT SIMPLIFY THEM

Under the City's affordable housing rules (adopted October 20, 1994), the City sets both the maximum price for homes for sale at target levels and, using a different formula, buyer eligibility qualifications. As discussed above, mortgage lenders add another, conservative, test of income qualifications. The result is that very few families in the target group qualify to buy homes, even in a market with strong demand and low interest rates.

4a. Strict Buyer Eligibility for a Limited Period. Under some UAs, affordable homes are offered to members of the target income group for a set period. If none qualify, the buyer pool is expanded. One way to reinstate buyer eligibility, then, would

[15] A hypothetical example was used because data from the period before the moratorium were not available.

be to mandate strict eligibility controls for a set period of thirty days, and then, if the home has not sold, to remove the controls.

This approach would demand most of the staff time discussed above (under 1). Its advantage is that it avoids leaving new houses standing vacant for months at a time. Also, it begins to address the risk that, in a declining market, houses with affordable conditions will no longer be attractive to buyers.

4b. **Redefine Eligibility Calculation.** The problem could be approached differently by uncoupling buyer eligibility controls from the strict target definitions that DPP used in its report. Houses would then be priced according to affordability formulae used by the City for units at the 80%, 100% or 120% of median levels, but income qualification would be set to a single standard, e.g., the State's 140% of median level (either adjusted by family size or by using a single income standard, based on families of four or five persons). Presumably, income qualification procedures could be simplified, e.g., by demanding that buyers find mortgages from registered lenders, and that the income shown in the mortgage application be at or below the 140% level.

This approach would guarantee that buyers were in the moderate-income range without tying them to strict target levels. If it had been in force recently, it would have permitted sales to most buyers, but ruled out the most affluent group (shown in Exhibit 1). It might simplify the qualification process. And, as our study has shown, the market forces would keep units affordable at different income levels for buyers.

This approach should have most of the advantages noted for 4a, above, and would clearly delimit the group of buyers who qualify for affordable units.

5. HELP TARGET BUYERS QUALIFY FOR HOMES

Much of the problem experienced before the moratorium was installed arose because few first-time home buyers at the target income levels – especially the 80% of median level – qualified for mortgages. The City could address this problem by using the funds gained from shared appreciation sales to provide candidates with mortgage insurance or even down payment funds (as a long-term loan secondary to the mortgage) from the Housing Development Special Fund.

This proposal would further increase the demands on City staff time, and would take funds from the Housing Development Special Fund that might otherwise be spent to develop new housing.

Rules and procedures for this alternative would need to be specified carefully.

6. MOVE TO AN INCENTIVE-BASED SYSTEM RATHER THAN A SET OF CONTROLS

If supply increases, prices should drop – unless basic economics simply does not apply to Hawaii. Exhibit 3 already suggests that when supply increases, buyers at all income levels benefit. Therefore, the most straightforward and effective way to promote affordable housing in all economic climates is to increase supply. If the City and County of Honolulu intends to increase the housing supply for resident families, it would do well to make that objective clear and to invite developers to do just that.

Many incentives and moves to streamline permitting have been suggested, notably in the Governor's Affordable Housing Task Force discussions. (Discussions and reports are available at http://www.hcdch.state.hi.us/scr135.htm.) The City and County of Honolulu may wish to see which of these is most promising, and reorganize its affordable housing policy accordingly. LURF expects that the volume of homes produced for moderate-income and gap group residents can increase greatly in the Neighbor Island counties, due to collaborations between county administrations and developers, and innovative policies in developing 201-G projects.[16]

Steps to implement this change would likely include (a) continuing the moratorium for two or three years; (b) encouraging developers to propose alternative ways to meet affordable housing requirements; (c) reviewing the results of developer proposals and either studying the impact of the Task Force proposals, or urging legislators to fund an independent study of the impact and utility of the proposals, looking at their impact in Hawaii on an island-by-island basis and compiling information on the impact of similar proposals elsewhere in the United States; and (d) developing a policy that stresses the most effective actions to expand the housing supply.

PREFERRED ALTERNATIVE

The research has shown that the housing market in Hawaii is cyclical. Personal income, interest rates, and construction cost are all independent variables that, at a minimum, have a tremendous impact on the housing market. Past attempts at imposing government control over certain segments of the housing market have had minimal success. Furthermore, because government controls are not tied to market forces, when one or more of the variables change (i.e. interest rates), government controls tend to have a negative impact on the housing market. For example, the moratorium that is being discussed right now was to reduce some of the government restrictions imposed on the affordable housing segment of the market.

Prior attempts at providing affordable housing through government involvement have been in the form of: a) direct funding (i.e. government funded infrastructure or land acquisition); or, b) exactions (i.e. % of development for affordable housing as a condition of entitlements). Most of the alternatives listed in previous section have been tried in the past and, if resurrected, would require additional government funding, staff and/or resources. The City's Housing Department, which was responsible for overseeing this program in the past, has been dismantled. Oversight of the buyer qualification, shared appreciation and buy back programs would have to be absorbed by existing City agencies.

[16] The 201-G process streamlines permitting greatly. Over half the units in 201-G residential projects must be affordable. The developer and County representatives work out details of a housing mix that meets local needs. The developer may propose that the project be exempt from some of the rules and fees imposed on other subdivisions. A full discussion of these projects is beyond the scope of this study. However, it is worth stressing that this process provides a collaborative alternative to the UA process, allowing developers and government agencies to work together to produce decent housing for residents.

Alternative No. 6 suggests a different approach to the problem, which is based on incentives. It focuses on an outcome and leaves it to the development community to decide how it will achieve the desired results. It also focuses on increase in the supply of product to provide consumers with choices and relieve some of the demand in different segments of the market.

APPENDIX A: METHODOLOGY

The research for this study was done with publicly available materials and the Real Property Tax database as kept by the City and County of Honolulu and copied by Hawaii Information Service, Inc. SMS downloaded all fee simple residential property transactions for the period from 1985 through 2004. Leasehold transactions were excluded as not comparable with fee simple ones without information about lease values at the time of sale, and as affected by the changing legal and market status of leasehold real estate. In the event that lessees acquired the fee in their property, any subsequent sale of the property was treated as an "initial" sale and no earlier sales were counted for the purposes of this study.

Technical information on the steps taken to create a dataset of market transactions, and to exclude non-market transactions is available on request from SMS.
Readers should note that the only effective way to limit the presence of friendly resales in the data set (e.g., between John Doe and John and Jane Doe, or the Jane Doe Trust) was to limit the number of sales counted in a single year to a single sale. The dataset could thus fail to include some market transactions. No claim is made here that the dataset includes all such transactions, only that it includes the large majority of them.

Some terms have been used in ways commonly used by housing agencies:

- "Median Income": the mid-range household income in a county in a given year, according to estimates by the federal Department of Housing and Urban Development (based on surveys). Annual income estimates are published by the Housing and Community Development Corporation of Hawaii on its website (http://www.hcdch.state.hi.us/hsgstats.html). "Income Limits" for each county include estimates of income levels for households of different sizes. The "Affordable Sales Price Guidelines" uses the distribution of incomes for households of four persons. The median for a family of four is used in this study as "the median income" unless alternate means of calculation are described.

- "Low- and moderate-income levels": HUD and associated agencies typically refer to families with 50% of the median income or less as "very low-income families," families with 50% to 80% of the median income as "low-income," and families with 80% to 100% of the median income as "moderate-income."

The "affordability levels" used in this study make it possible to study what families with a given income level can afford over time. They are based on the Affordable Sales Price Guidelines. Readers may note that the counties use the HUD income data in somewhat different ways. For example, since 1994, the City and County of Honolulu has used data for families of five to price affordable units. However, City and County buyer qualification procedures have taken the size of buyer families into account. The income levels identified by HUD as 50% and 80% of median sometimes are not arithmetically 50% and 80%. When that is the case, Maui County recalculates these levels arithmetically to avoid confusion (personal communication, Ed Okubo, Department of Housing and Human Concerns, Maui County, June 2005).

APPENDIX B:

CITY AND COUNTY OF HONOLULU HANDOUT

City and County of Honolulu
Maximum Sale Price for Credit

Unit Size	Studio	1 Bedroom	2 Bedroom	3 Bedroom	4 Bedroom
80%	$172,621	$212,388	$251,404	$282,311	$315,420
100%	$227,231	$277,907	$327,161	$366,161	$408,630
120%	$281,841	$343,426	$402,917	$451,210	$501,840
140%	$336,451	$408,945	$478,673	$535,660	$595,049

These sales prices are based upon a 5.61% interest rate and 10% down-payment. Should these variables change, new sales prices need to be calculated. All units will be evaluated electronically and a site survey conducted prior to final approval.

2005 HUD Median Income Limits
Effective Date: February 15, 2005

Income Percent Median	1	2	3	4	5
80%	$37,950	$43,400	$48,800	$54,250	$58,600
100%	$47,438	$54,250	$61,000	$67,813	$73,250
120%	$56,925	$65,100	$73,200	$81,375	$87,900
140%	$664,143	$75,950	$85,400	$94,938	$102,550

Income Percent Median	6	7	8		
80%	$62,900	$67,250	$71,600		
100%	$78,625	$84,063	$89,500		
120%	$94,350	$100,875	$107,400		
140%	$110,075	$117,688	$125,300		

Based on data provided by the U.S. Department of Housing and Urban Development on their Web Site: www.huduser.org/datasets

UA/AH/906 Effective Date: February 15, 2005

NOTE: Copied and reformatted by SMS.

APPENDIX C: DIRECTOR’S REPLY TO DRAFT REPORT

From: Eng, Henry [mailto:heng@honolulu.gov]
Sent: Thursday, June 23, 2005 3:55 PM
To: Dean Uchida (E-mail)
Subject: Comments on Draft Report

Dean,

Thank you for the opportunity to review your draft report, "Market Study in Response to Ordinance 01-33." Our comments and observations are presented below. While we appreciate the detailed description of the sales housing market, the report doesn't seem to make a conclusion about near-term housing market activity. Ordinance 01-33 stipulates a "marketing study of Oahu's need for and ability to sustain new housing units." However, page 25 of the report says the study "can hardly predict future trends." The intent of this stipulation was to give City Council an idea of how the market would act in the next few years, to help determine whether the current moratorium should be extended to the next few years.

In the absence of a market description for the next few years, it may be better to focus on the question of continuing the moratorium on eligibility, documentation and resale of affordable sales units, rather than describing the overall sales housing market. We sense that the argument is being made that the city should not impose a condition on "middle class housing," because it is being delivered regardless of the condition. Also, as you are probably aware, the UA condition is not just intended for middle-class housing, but includes provisions for low-income families, including rentals.

The report does not convincingly assert that without a condition and monitoring program, the market will reach intended segments of households at or below 120% of the median. Nor does not dispute our findings, wherein the majority of recently delivered units that should have gone to this population, did not.

We appreciate the "Preferred Alternative No. 6," but do not feel that a broad rethinking of the city and state's approach to affordable housing can be completed well before the current end-date of August, 2005 for Ordinance 01-33.

We don't have formal comments by our sister city agencies on the issue of buy-back and shared appreciation, so must reserve comments on these aspects of Ordinance 01-33.

I hope these comments are helpful in finalizing your report.

Henry Eng, FAICP
Director
Department of Planning and Permitting
523-4432

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