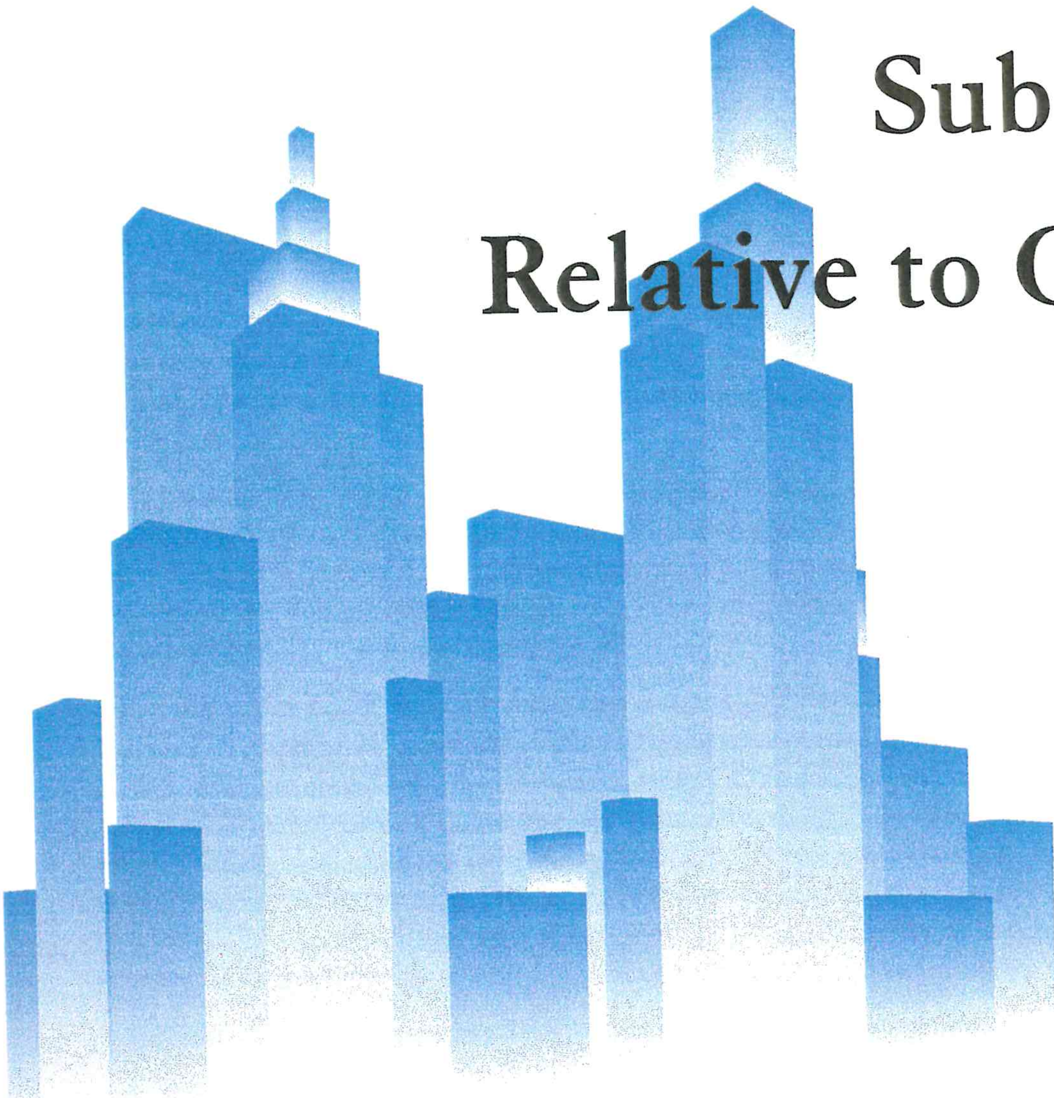
Rent Guidelines Board Submission Relative to Order 28



Rent Stabilization Association

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Summary

The housing industry remains in poor condition, both by historical standards in New York, and those of the industry nationwide. Operating ratios have improved, but they are still significantly higher than the base levels when stabilization began. Operating ratios are also approximately 50% higher than the national levels, creating a disincentive for housing investment in New York. Moreover, the available data mask even higher operating ratios because smaller buildings with higher ratios are excluded and because the operating ratios are adjusted downward to account for dated and unrepresentative audit findings.

Even at its highest level since 1991, the 6% Price Index underestimates some operating costs and excludes other costs. This year, for example, electrical costs within the spiraling utility component are underestimated while items such as vacancy and collection losses have never been included in the Price Index. In addition, by measuring a constant quantity of goods and services, the methodology fails to recognize that aging buildings require ever higher maintenance costs.

Approximately one-third of regulated apartments continue to rent for less than the reasonable costs of operation, vacancy and collection losses remain at an abnormally high level of 12%, more than 10% of stabilized buildings continue to have operating costs in excess of income, and real estate tax delinquencies remain at record levels. These facts reflect the continued malaise affecting the City's housing market.

On the other hand, with rent-to-income ratios of 28%, New York tenants are well below the national median of 31% and below the 30% Federal rent-to-income standard. Because property assessments are based on rental income, this is a tax free bonus for tenants which neither the troubled housing industry nor the economically struggling City can afford. Over the long term, rent regulations have held New York renters harmless from the ever increasing housing costs experienced nationally. Given the low average rent-to-income ratio, and the fact that more than half the tenants of low rent apartments pay less than 30% of income for rent, New York tenants have the capacity to pay for the rent increases now required by rising operating costs.

In light of these factors, the RSA recommends the following rent guideline increases:

- 7% for a one-year lease and 11% for a two-year lease
- An additional $20 for all apartments renting for less than $500 per month.
- In addition, to provide capital funds for the repair and improvement of an aging infrastructure and to maintain the competitive position of the housing industry by reducing extraordinarily high operating costs:
    - Upon a vacancy, the highest rent for a comparable apartment, a minimum rent of $500 per month or an increase of 25%, whichever is greater.

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Condition of the Housing Industry

Each year, the Rent Stabilization Association provides the Rent Guidelines Board with its view of the housing market and the data before the Board and a set of recommended guideline increases.

This year, the housing market remains in poor condition. Property tax delinquencies are at record levels, there is very little improvement in the number of buildings in economic distress, vacancy and collection losses remain at abnormally high levels, and the core inflation rate promises continued increases in operating costs in the future.

After two years of record low rent increases, the industry is ill-prepared to accommodate unusually high operating cost increases of 6%, as measured by the Price Index, or higher when qualitative factors not measured by the Price Index are included. Clearly, there must be significantly higher rent increases this year.

Operating Ratios Are Still Too High

Operating ratios, as determined by income and expense statements filed by property owners with the City's Department of Finance, have become a standard, since 1989, for measuring the health of the housing industry. [This measure replaced the operating ratio historically determined by what became known as "Table 14".]

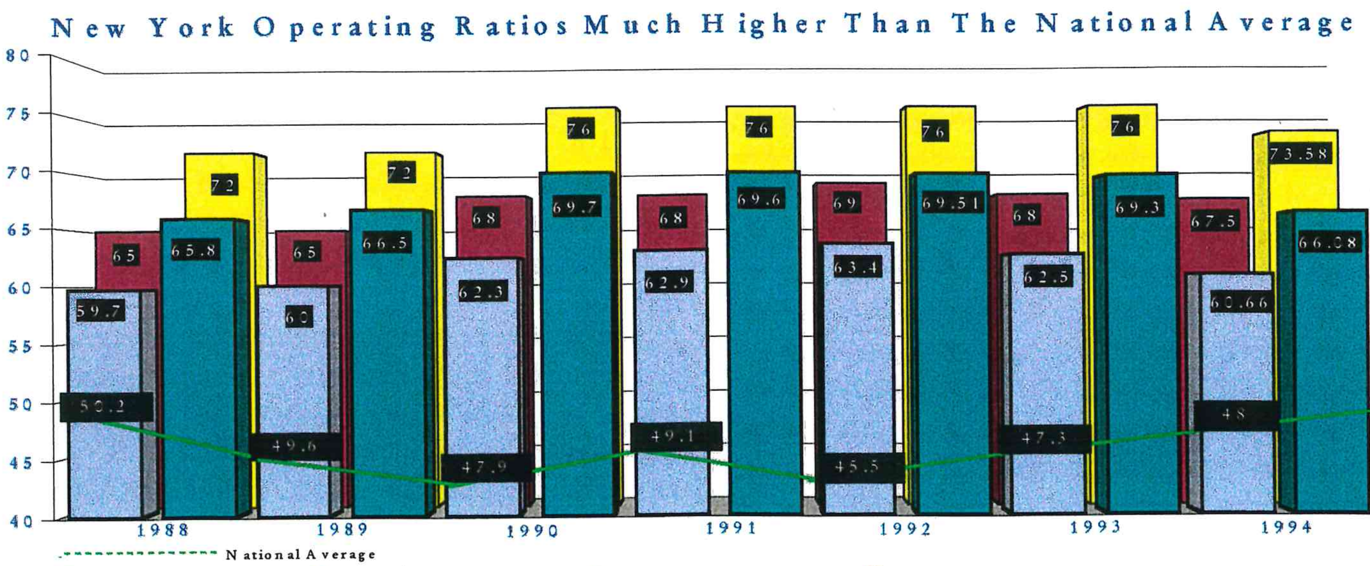
But there are several problems with the current measure of operating ratio and the way it is used:

(1) Often, an inappropriate ratio, the income to cost ratio is used rather than the appropriate rent to cost ratio. The income ratio includes rental income plus income from other sources such as stores, garages and laundry rooms. Only a small percentage, approximately 12%, of buildings have commercial income, but commercial income can have an enormous affect on average operating ratios. For instance, the income ratio is 66% but the rent ratio is significantly higher at 73.5% (unadjusted). The use of the income to cost ratio conveys the notion that the housing industry is in much better condition than it is in reality.

(2) Operating ratios do not represent the entire housing stock. Smaller properties (those with less than 11 units or assessed at less than $40,000) are not required to file income and expense statements and are therefore excluded from the operating ratio calculation. Since smaller buildings tend to have higher ratios, and about 10% of the stabilized stock exists in buildings of less than 10 units, this measure underestimates the true operating ratio.

(3) Both the income and rent ratio numbers are adjusted downward to account for the results of a 1992 audit which is dated and unrepresentative. The audit

Chart 1



Source: IREM Income & Expense Analysis For Elevator Building
RGB, Income & Expense Reports

found over-reporting of expenses ranging from 2% for larger owners to 15% for smaller owners. The RGB has since been adjusting everyone's expenses downward by 8%. Yet, when the audit was conducted, income and expense filings were a new requirement with which owners had little experience. Moreover, owners had little motivation to spend time and money accounting for their expenses when the audit had no direct financial consequence. It is very likely that a current audit, properly documented, would find far less over-reporting of expenses.

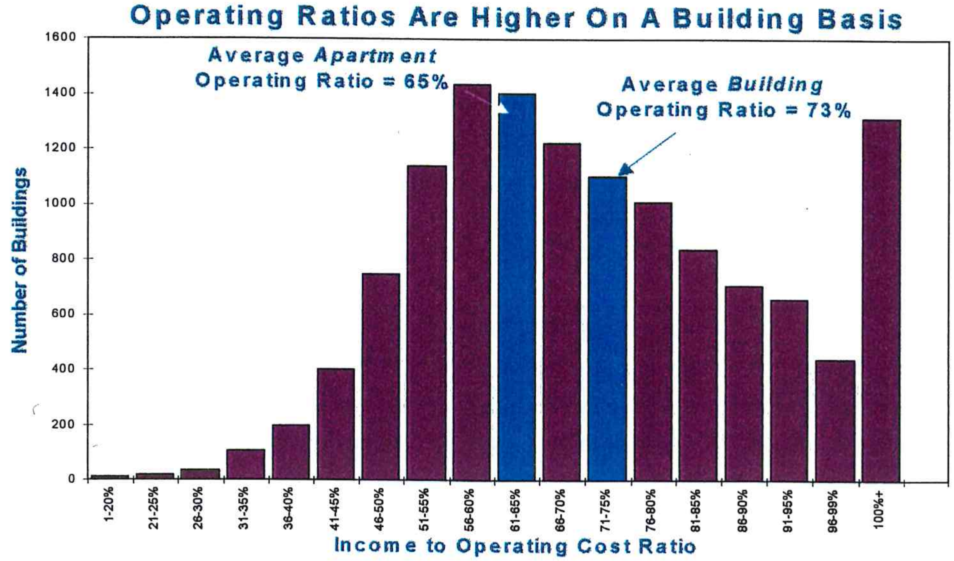


Chart 2

(4) Operating ratios are now viewed only within the five year period for which income and expense filings are available. From this narrow perspective it appears that operating ratios have declined almost to the level of 1989. But according to the RGB "1989 was a particularly bad year for owners ..." (Income and Expense Report, 1996, page 7). A return to the operating ratios of 1989 does not reflect a healthy industry. Nor does it restore the industry to the position it what was in when stabilization began, when it maintained the benchmark of a 55% rent to operating cost ratio.

(5) Operating ratios have almost exclusively been viewed in terms of a percentage increase from one year to another rather than in absolute terms. But if rent-to-cost ratios, for example, fell from 70% in 1992 to 67.5% in 1994, that ratio would still be unacceptably high, either in comparison to the 55% historical New York benchmark, or in comparison to the national average of 50%.

(6) Operating ratios are usually expressed on a per unit rather than per building basis, distorting the perception of the condition of the industry. Chart 2 shows a distribution of income-to-operating cost ratios for buildings indicating a per building operating ratio of 73% versus a per apartment operating ratio of 65% (unadjusted). It is also clear that the distribution of buildings is not a normal, bell-shaped curve, but is skewed heavily toward higher operating ratios. Even more dramatic is a decile distribution which shows that the top 10% of buildings have an average ratio of 67%. Since it is buildings, not units, which are either maintained or abandoned, we believe it is appropriate for the RGB to focus on building rather than apartment operating ratios.

Price Index Is Underestimated

This year's Price Index measuring cost increases of 6% reflects real increases in fuel costs, real estate taxes and water and sewer charges. But even the substantial 6% increase in costs does not adequately reflect all cost increases.

For example, the costs of electricity are measured on a point-to-point basis rather than on a "cost-weighted" basis as are oil and other utility components, resulting in an underestimation of the increase in electric costs. Water and sewer rates clearly increased by a uniform 5%, yet the Price Index measured a smaller increase of 4.7%.

The Price Index, of course, seeks to measure a constant quantity and quality of goods and services. But an aging housing stock requires ever more repairs and equipment replacement. The Price Index does not account for the increased maintenance requirement of a housing stock in which 70% of the buildings are more than 50 years old and 55% are nearly 70 years old.

Qualitative Factors: Costs Not In the Price Index

Government places ever growing and more costly burdens on property owners, which are not included in the Price Index.

For example, the lead paint abatement bill now being debated in the City Council, which affects the vast majority of residential buildings in the City, is almost certain to make ordinary paint and plaster jobs more expensive, just as the expense of larger lead remediation projects has already added a new category of expenses to building operations.

Similarly, it is likely that the recent suspension of two-thirds of the City's elevator inspectors will result in owners assuming the cost burden of additional elevator inspections. These kinds of continual cost increases incurred by aging properties or foisted on owners by government are never accounted for or measured by the Price Index, but have often been taken into consideration as qualitative factors requiring guideline increases above and beyond the commensurate rent index.

Maintenance Deficiency Indicators and Contract Rent (All Stabilized Units, 1993 HVS)

Rent In dollars	Mean Number of Maintenance Deficiency Indicators
Less than 400	2.02
400-499	1.89
500-699	1.53
700 or more	1.12

Chart 3

Housing Conditions Related to Rent Levels

We also ask the Board to consider that housing conditions are directly related to rent levels (see Chart 3). Lower rent apartments tend to have more maintenance deficiencies than higher rent apartments. Since the Price Index measures a constant quantity and quality of goods and services, by definition it does not account for the fact that maintenance costs increase as buildings age and deteriorate. The guideline increases should provide additional revenue to ensure that an increasingly aging housing stock is adequately maintained and that reserves are made available for those improvements which are not compensated via rent increases for major capital improvements.

Guideline Recommendations

As it has for several years, the staff has provided the RGB with a variety of methods to calculate the "commensurate rent adjustment"—the base level of rent increase needed to compensate owners for increases in costs measured by the Price Index. The commensurate rent increase has generally been considered as a base level of rent increase because it is often adjusted upwards to account for so-called "qualitative" factors which are not measured by the Price Index.

This year, the Board has been presented with commensurate rent adjustment resulting in one year guidelines increases ranging from 4% to 7%. This year, however, the staff has made it clear that the "traditional" method of calculating the commensurate rent increase, which results in the lowest possible level of rent increase, 4%, is problematic and ineffective.

The traditional commensurate formula assumes that all renewals come up each year, ignoring the mix of one and two year leases. It also assumes that net operating income (the amount left over after operating costs to cover mortgage payments, profits and costs not including in the Price Index, such as vacancy and collection losses) should be held constant in nominal dollars, that is, it should not be adjusted for inflation. So, for example, if an owner had net operating of 30 cents for every dollar in 1991, he would still earn 30 cents on the dollar in 1996.

The second model, the "net revenue" model, which results in a one year rent increase of 5%, takes into account the correct distribution of lease terms, but still does not adjust net operating income (NOI) for the effects of inflation.

The "NOI Adjusted Net Revenue" computation corrects both problems contained in the traditional commensurate formula and yields a one year rent increase of 7%.

The RSA has argued for years that it is essential that net operating income be adjusted for inflation. It is precisely the failure to adjust NOI which has resulted in spiralling operating ratios and the decline in the competitive position of the housing industry. Therefore, we urge the Board to adopt a one year guideline of 7%.

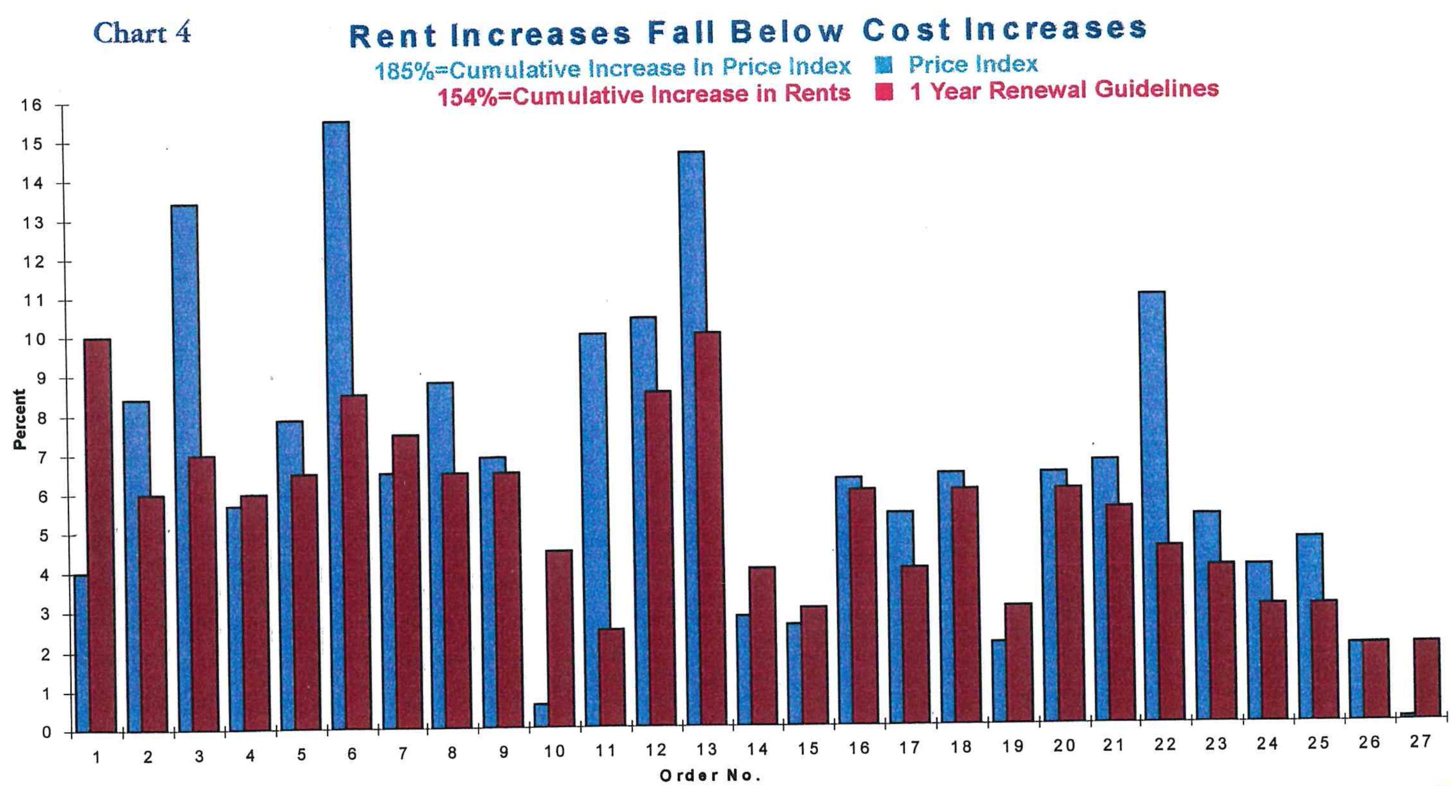
The commensurate rent adjustments suggested by staff provide for a small additional increment for a two year lease, based on a relatively low projected price index for next year. For example, in the case of the NOI adjusted model, it was suggested that a two year lease be 8% versus the 7% for a one year lease. These suggestions are just illustrative, and other variations, for example 6% for a one year lease and 9% for a two year lease, would yield the same revenue as 7% and 8%.

But projecting future price increases is notoriously unreliable. Take this year as an example, when the Price Index was twice as high as last year's projections. This places owners in an untenable position of being locked into two year leases based on projected costs which are more often wrong than right. Before the State Legislature eliminated three year leases in 1993, the situation was even worse, with long-term tenants benefiting handsomely from a succession of three year leases which inevitably failed to meet rising costs.

The RSA has always urged that, since tenants enjoy security of tenure, only one year leases should be offered, thereby eliminating the uncertainty of cost projections. In the interim, we suggest that the two year increase be substantially higher than the one year increase. This will discourage tenants from taking two year lease renewals, and to the extent a tenant opts for a two year lease, it will split the gamble on the direction of future cost increases between the owner and tenant.

Therefore, we urge the Board to adopt a two year guideline of 11%.

Chart 4



The Problem Of Low Rent Apartments

Last year, the Board adopted a supplemental adjustment of $20 for rents below $400, recognizing that apartment rents must at least cover their maintenance and operating cost, and recognizing also that percentage increases translate into a smaller dollar amount for low rent apartments than for higher rent apartments. The Board's action was strongly supported by the Administration which recognized the underlying economic reality, and sought to keep rental properties in private hands, paying real estate taxes, rather than have these properties fall into City ownership and incur huge taxpayer funded expenditures.

This year, we ask the Board to maintain and expand the low rent adjustment by making it applicable to those apartment which rent for $500 a month or less.

New York Rents Are Low

It is important to note that the rent stabilized stock is characterized by low rent levels. The median rent for all stabilized apartments in 1993 was just $525 per month, meaning that half of all apartments rented for less than $525, with nearly a quarter (23%) renting for less than $400 per month. In contrast, less than one out of ten (9%) of stabilized apartments rent for more than $1,000 per month. Data from 1994 income and expense filings reveal a more dramatic picture: 30% of stabilized buildings have average rents below $400 per month and 60% of stabilized buildings have average rents below $500 per month (see Chart 5).

Moreover, the RGB should recognize that the stabilized stock is saddled with 100,000 units of rent controlled housing with a median rent of just $366 per month. When we combine stabilized and controlled units, we find that 33% of all apartments rent for less than $400 per month and 40% rent for less than $500 per month.

Clearly, this rental market does not contain a large number of high rent apartments to balance the income from the low rent apartments. It is a rental market characterized by a majority of apartments which are distributed over a narrow range of moderate rent levels.

Minimum Rent Required

What is an adequate rent level in the New York housing market? The RGB appears to have chosen $400 per month as a minimum rent level based on the finding that operating costs for the stabilized stock average just over $400 per month. But the operating costs measured by the Board do not include the costs of financing, nor do they include an allowance for vacancy and collection losses, nor do they include any provision for profit. A building which simply meets its operating costs, narrowly defined, will still not be economically viable if it cannot sustain a mortgage and provide a return on investment.

A realistic minimum rent would include a reasonable allowance for net operating income to cover financing costs and profit. Assuming an operating ratio of 75%, which is very high by national standards, apartment rent should average $550 to meet average operating costs. More reasonable operating ratios would require even higher rent levels.

A minimum rent of $400, in light of these considerations, is clearly inadequate. But these considerations also demonstrate that a majority of current rents are below the level needed to make New York housing an attractive investment option.

Majority of Buildings Have Low Average Rent

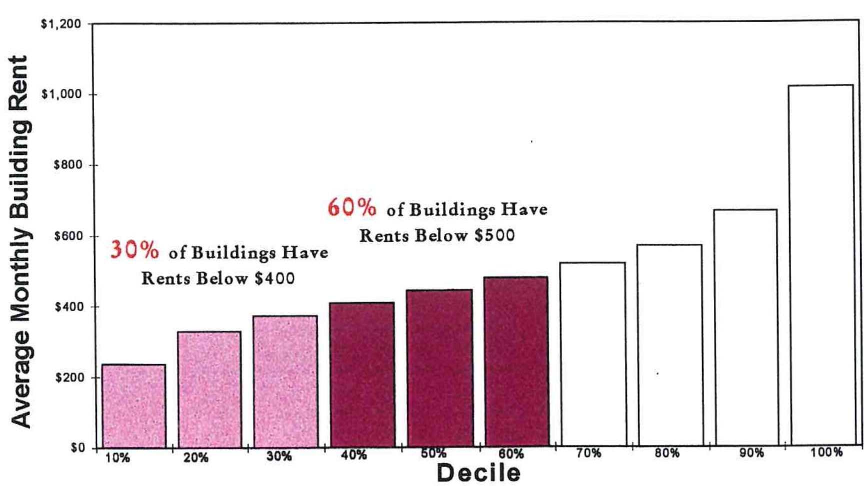


Chart 5

Relief Needed

By providing additional relief only to those apartments renting for less than $400, the RGB fails to acknowledge the precariously narrow distribution of rents in New York City. If a rent level below $400 is inadequate, what about the rents between $400 and $499 per month, which comprise 12% of the stock and, at best, can be seen as dangerously low rent levels? And what about the rents between $400 and $800 per month, which comprise more than 50% of the housing stock?

We ask the Board to recognize that rents just above $400 per month are just as inadequate as those below $400. An additional dollar amount for low rent apartments is needed and justified now as it has been in the past, but the dollar level to which it applies needs to be adjusted upwards.

At the very least, if a $400 dollar rent was insufficient last year, and costs have risen by 6%, then the $400 level needs to be adjusted upwards by at least the same amount. But since the $400 level was inadequate last year, we suggest that the rent level for the supplemental adjustment be raised to $500 per month, which is still barely adequate to meet the costs of operation and finance.

Low Rents and Low Incomes

Board members may justifiably be concerned that some low income tenants will be adversely affected by the low rent adjustment. But simply because a tenant pays a low rent does not guarantee that the tenant has a low income. In fact, more than half of all tenants occupying low rent apartments can afford to pay higher rents based on the accepted standard of 30% of income going for rent (see Chart 6).

It is equally true that nearly half of tenants in low rent apartments appear to be paying as much or more rent than they can afford. But these tenants are generally protected by market limitations on rents which prevent the property owner from collecting a higher rent from an alternative tenant. The Board is well aware of the phenomena by which collectible rents are held below their legal regulated maximum because of market conditions. This mechanism prevents owners from collecting authorized increases in some low rent apartments and provides the Board with some level of assurance that much of the potential negative impact on low income tenants will be averted.

Low Rents Have Room To Rise
(All stabilized households - 1993 HVS)

Percent Households with Rent/Income Ratio Below:	Units with Contract Rent Less Than $300	$400	$500
15%	18.9%	21.2%	20.7%
20%	33.6%	33.6%	32.9%
25%	46.1%	44.9%	44.8%
30%	55.1%	52.9%	52.6%

Source: 1993 NYC Housing and Vacancy Survey
Chart 6

The Vacancy Allowance

New York's system of rent regulations is increasingly anachronistic and nowhere is this more clearly reflected than in the treatment of the vacancy allowance. Most regulatory regimes, such as those which prevailed in California, allowed for rents on vacancy to rise to market and to be subject to regulation for the next tenancy (called decontrol-recontrol).

Even these moderate regulatory regimes are now being phased out, leaving New York in the unique position of sponsoring the most restrictive regulatory structure in the nation, even with regard to the treatment of vacancies.

The RSA continues to believe that there is no reason to restrict a rent upon vacancy. The purpose of rent regulations is to protect existing tenants from excessive levels of rent increase, not to protect a prospective tenant who enters into a lease arrangement with open eyes and the freedom to negotiate.

We were, therefore, extremely disappointed that last year's proposed vacancy guideline was misunderstood and opposed by the Administration and was subsequently abandoned in the final guideline vote.

Even last year's vacancy proposal (the highest comparable rent up to $1,000, a minimum rent of $400 or a 15% vacancy increase, whichever is greater) was inadequate. But it was a step in the right direction. We renew our call for a vacancy allowance which is as expansive and unrestricted as possible.

And we believe the RGB acted appropriately last year in enacting a vacancy allowance independent of the one and two year lease renewal guideline. The vacancy allowance does not apply in a uniform manner across the rent stabilized housing stock, but in a totally serendipitous manner depending on such factors as location, the duration of occupancy, and the relationship of the regulated rent to market rent levels.

For these reasons it is inappropriate to consider the vacancy allowance as part of the basic package of one and two year guideline increases needed to compensate owners for increased operating costs. We urge the Board to continue its practice of last year.

There are many reasons for allowing a generous vacancy allowance. Primarily, the vacancy allowance allows owners to recoup the cost of repairs and collection losses associated with apartment turnover.

The vacancy allowance also allows some of the cost burdens of rental housing to be placed on prospective tenants rather than on existing tenants. For instance, this year, when the rent increase required by the Price Index is already 7%, the vacancy allowance can provide funds to cover unusual maintenance costs or to restore a building to profitability.

The vacancy allowance has always been viewed as a means of providing needed cash flow to the housing industry, without affecting sitting tenants. It has also, legitimately, been viewed as a means of restoring the competitive position of the housing industry.

The vacancy allowance has also been characterized, in an RGB staff study (Rent Skewing in Rent Stabilized Buildings, 1994), as a means of correcting rent skewing in the stabilized housing stock. The report acknowledged that long-term occupancies caused rents for similar apartments to be vastly different. Vacancy allowances can serve as a mechanism to eliminate these inequities in the regulated market.

Given the need and justification for a substantial vacancy allowance, it is difficult to understand how the Administration could have mischaracterized last year's proposed vacancy allowance as akin to vacancy decontrol. The Board does not have the power to decontrol rents, even if it wanted to, and the proposal before the Board by definition could not have been a vacancy decontrol proposal. The Administration somehow perceived the proposed vacancy allowance as affected existing tenants, whereas, again by definition, no vacancy allowance affects existing tenants.

There is a strong need for a vacancy allowance which will provide cash flow and correct inequities in the stabilized stock without affecting tenants in place. The RSA renews its call for a vacancy allowance which would allow the greater of: the highest comparable rent, a minimum rent of $500 per month or 25%.

The Red Herring of Housing Affordability

For years, the RGB has considered housing affordability as a counter-balance to the need for rent increases to maintain the housing stock.

Initially, it was the "poor" who became the rallying cry for the advocates of housing affordability. But it became increasingly clear that the "poor" were not the beneficiaries of rent regulation because "most could not afford apartments with the lowest rents even if there were enough to house them." (RGB Income and Affordability Study, 1996 pg.9) No, for the poor, it is not a question of low rent, but a question of low income. The poor will never be able to afford housing, regulated or non-regulated, without subsidies.

The housing affordability advocates then argued that rents should be regulated, not just for the poor, but for everyone; that apartment rents should be kept low as a matter of public policy.

But in 1993, the State Legislature and then the City Council said, "Not so!". Certain high income households and certain high rent apartments would not, as a matter of public policy, be regulated.

Next, the advocates of housing affordability argued, if not for the poor and not for the rich, then rents should be regulated for the benefit of the broad middle class! Now, however, we learn that the broad middle class, the average renter, is not under any particular economic stress. In fact, New York renters are doing quite well in relation to comparably situated renters throughout the country.

This year's RGB Income and Affordability Report found New York renters have median rent to income ratios of 28%, below the U.S. median of 31%, below the Federal housing standard of 30% and well below the rent-to-income ratios in the majority of cities surveyed. These results are so striking that the RGB data is reproduced here as Chart 7.

Also reproduced here is a very similar chart which was provided by the Adminstration in support of a water and sewer rate hike of 6.5%. The chart shows that New York water and sewer rates are well below those of other cities, just as rent to income ratios are well below those of other cities.

The argument for rent regulatory protections for the middle class falls even flatter when one considers the evidence that, on average, regulated renters outside the Manhattan core receive no subsidies from rent regulation because their regulated rents are roughly equal to quality adjusted market rents (see, Henry

New York City's Rent Burdens Are Lower Than Cities

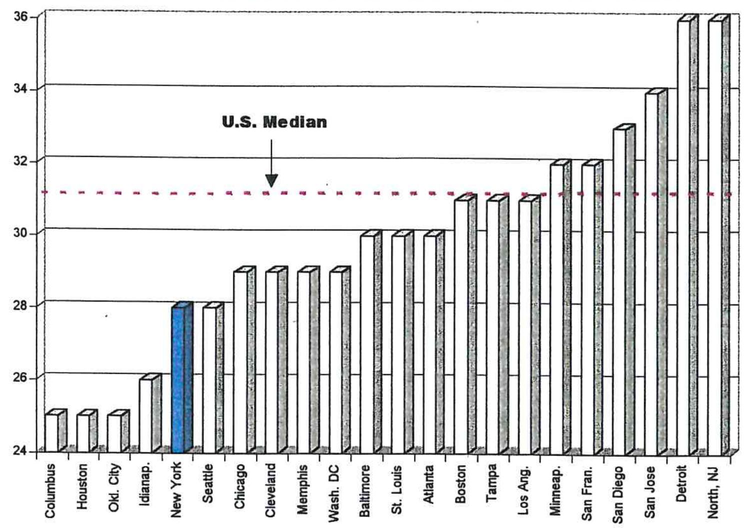
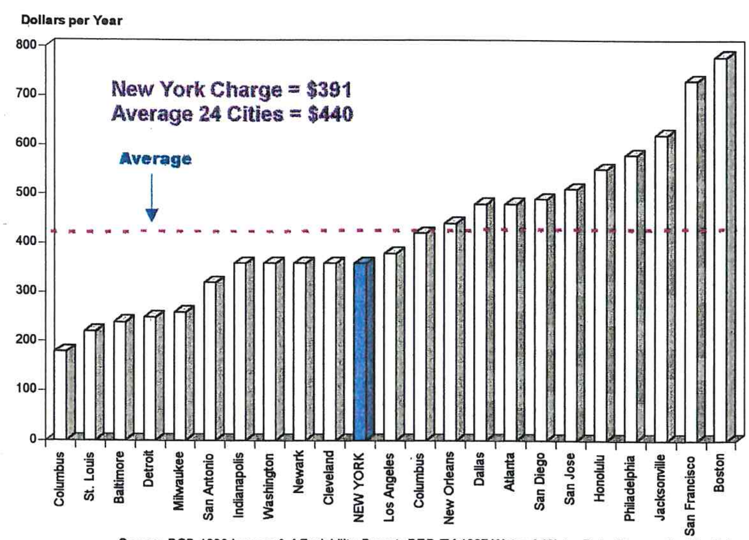


Chart 7

Water & Sewer Charges Are Lower Than In Other Cities



Source: RGB 1996 Income & Affordability Report; DEP FY 1997 Water & Water Rate Charges Residential

Chart 8

Polakowski, The Effects of Partial Rent Deregulation in New York City, Jan. 1992).

In short, rent regulations do very little to protect those most in need of rent protections, provide the greatest benefit to the relatively well-off who need the benefits least, and do nothing for the majority of regulated renters.

We do not believe that issues of housing affordability should be considered relative to the rent guidelines. The legislative mandate of the RGB does not mention housing affordability. Rather, the Board is charged with maintaining the competitive position of the housing industry.

The protection afforded to tenants is the very existence of a rate-setting board and the presumption that the Board will set rates, and only those rates, necessary to maintain the economic viability of housing in New York. In other words, tenants are not protected by the difference between a rent increase of 6% and 4% but the difference between 6% and no limit on rent increases whatsoever. In fact, a point difference in the rent guidelines is of very little consequence to an individual tenant, but of much greater significance to a property owner who multiplies that one point by a number of apartments.

We ask that the Board take cognizance of its responsibilities and provide owners with the rent increases they need to continue providing decent housing in New York.