

SUBMISSION TO THE RENT GUIDELINES BOARD FOR ORDER NO. 30

MAY 1998

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SUMMARY

The primary legislative mandate of the Rent Guidelines Board is to maintain and preserve rental housing by providing adequate rent increases.

The Rent Stabilization Law specifically sets forth the considerations (highlighted on this page) which the Rent Guidelines Board (RGB) must take into account in setting rent guidelines. These considerations almost exclusively relate to the economic condition of the housing industry.

This year, the most recent income and expense data shows that the economic condition of stabilized housing has deteriorated. Two years of the lowest guidelines in his-

tory, combined with unexpected increases in operating costs, drove operating ratios up and reduced net operating income, making housing a less attractive investment.

THE RENT GUIDELINES BOARD

"...in determining whether rents for housing accommodations subject to the emergency tenant protection act of nineteen seventy-four or this law shall be adjusted shall consider, among other things (1) the economic condition of the residential real estate industry in the affected area including such factors as the prevailing and projected (i) real estate taxes and sewer and water rates, (ii) gross operating maintenance costs (including insurance rates, governmental fees, cost of fuel and labor costs), (iii) costs and availability of financing (including effective rates of interest), (iv) over-all supply of housing accommodations and over-all vacancy rates, (2) relevant data from the current and projected cost of living indices for the affected area, (3) such other data as may be made available to it."

Despite this year's aberrantly low price index, the core rate of inflation for operating costs remains between 2-3%, driven by continuing increases in real estate taxes and water and sewer costs. In light of the costs which are omitted or understated by the Price Index, an increase significantly higher than last year's record low increases is necessary this year to maintain the City's aging housing stock and to restore the competitive position of stabilized housing.

While the annual deliberations of the RGB have become a balancing act between the housing affordability needs of tenants versus the rent increases needed to maintain housing as a competitive investment, there are good reasons why the legislative mandate of the RGB does not call for consideration of tenant incomes or housing affordability.

First, under the Rent Stabilization Law, the RGB's responsibility to tenants is achieved by en-

acting *any* guideline, not a *particular* guideline. Tenants are not protected by the difference between a 3% versus a 5% guideline. They are protected by a 5% guideline versus no guideline at all.

Second, even if it were so mandated, the RGB could not ensure housing affordability, however defined. Furthermore, there is no evidence that the rental burden of New York stabilized renters is excessive in relation to income, or that it is any greater or has grown more quickly than for renters in the rest of the country. In fact, during the past ten years stabilized rents, adjusted for inflation, have increased by just over 1% per year.

There is, however, clear evidence that past RGB rent increases have failed to keep pace with operating costs. There is also clear and explicit evidence that the economic and physical conditions of New York's rental housing are deteriorating. It is the mandate of the RGB to preserve this rental housing through adequate rent guideline increases.

Excerpted From: Rent Stabilization Law, Section 26-510b



RGB Rent Increases Have Failed to Keep Pace With Increased Operating Costs.

As the chart on this page clearly indicates, the rent increases authorized by the RGB have failed to match the increase in operating costs as measured by the Price Index of Operating Costs (PIOC). Comparing the one-year guidelines authorized since the inception of the rent stabilization system with the increases in operating costs measured by the Price Index, we see that operating costs have increased by 194.5% while rents have increased by only 162.5% based on one-year renewal leases. The comparison becomes even more unfavorable when we compare the longer

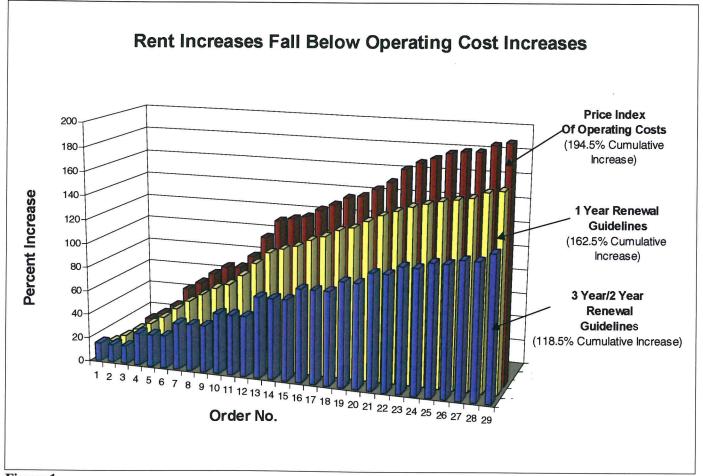


Figure 1 Source: RGB Explanatory Statement-Order No. 29

term leases which are favored by the majority of stabilized renters. Assuming a tenant selected the longest lease option available, rents would have increased by only 118.5% versus the 194.5% increase in operating costs.

This inadequate level of rent increase has resulted from an inappropriate computational method which assumed that only the portion of an owners' income dedicated to operating costs needed to be adjusted for inflation. No inflation adjustment was made for costs not covered in the price index—financing costs, vacancy losses, reserves or return on profit.



Only in recent years has the RGB staff provided explicit models which allow the Board to consider the rent increases necessary to adjust other components of building operation and financing costs for the effects of inflation. While these calculations show that increases are necessary in the current year to keep owners whole, they still do not take into account the "rent gap" which has developed over the years as a result of the past failure to adjust net operating income for inflation.

The "Average" Operating Cost Increase Measured By The Price Index Masks Significant Hidden Costs.

The annual Price Index of Operating Costs (PIOC), as well as the Owner Income and Expense Survey, tend to have results expressed as broad averages covering all stabilized rental housing. But there is no average for New York City's one million widely dispersed and varied stabilized apartments. This housing stock is not only geographically dispersed, with corresponding differences in potential rental income; the stock is also composed of various housing types ranging from six-family row houses, to garden apartment complexes, to high-rise luxury buildings, all of which can have vastly different operating cost experiences.

One example of the difference between statistical abstraction and economic reality is provided by income and expense surveys of low income tax credit projects in New York City conducted by the New York Equity Fund. Reviewing water and sewer costs for a three-year period from 1993-96, the survey found that such costs for its sample increased by 18.6%. For the same period, the RGB Price Index study found that costs increased by only 4.7%, since water and sewer rates had been frozen for two of the three years. The authors of the Equity Fund survey attribute their finding of a significantly higher increase in water and sewer costs not only to rate increases, "but also various projects in the portfolio correcting prior billing anomalies, and incurring significant charges from prior periods as a result." Such discrepancies between actual bills and measured increases can also be understood in light of problems with the water and sewer billing system and the inability of the RGB price index to include metered water costs in its survey.

Another example of the anomalies which can result from statistical abstraction is noted in this year's PIOC report in its discussion of the real estate tax component. The staff notes that the increase in real estate taxes measured by the PIOC is 1.2%, but real estate taxes for the "typical" building increased by 2.7%, more than twice as much as the PIOC increase. This year's Price Index clearly does not reflect the real rate of property tax increases.

These are just two examples of how economic reality for significant groups of buildings can vary from the statistically derived "average" generated by such studies as the PIOC and the Income and Expense Survey. In previous years, RSA's submission to the Board has documented how real estate taxes for properties located in the City's poorest neighborhoods increased at a rate significantly faster than the Citywide rate of increase. For example, from 1988 to 1993 real estate taxes City-wide

 [&]quot;Building a Future: A Report on the Performance of Low Income Housing Tax Credit Projects in New York City" New York City Equity Fund, 1997



increased by 81%, but in Bronx Community Boards 2 and 3, real estate taxes increased by an even more astounding 225%.² Even this year we note a wide range of real estate tax increase in different neighborhoods. Real Estate taxes in Brooklyn Community Boards 4, 5 and 16 increased by 7, 6 and 9% compared to the 1.2% of increase City-wide.

Income and Expense Data Shows Deterioration In the Economic Condition of Stabilized Housing.

The income and expense data provided each year by property owners to the Department of Taxation and Finance (DOF) and analyzed by the RGB provides a means of gauging the health of the City's housing industry. This year's data shows that the economic condition of the market declined in the most recent reporting period. Perhaps more significantly, this data shows that, despite three prior years of improvement, the housing market has still not achieved the relative health exhibited 10 years ago, before the City and its real estate market were plunged into recession.

Inflation Adjusted Net Operating Income

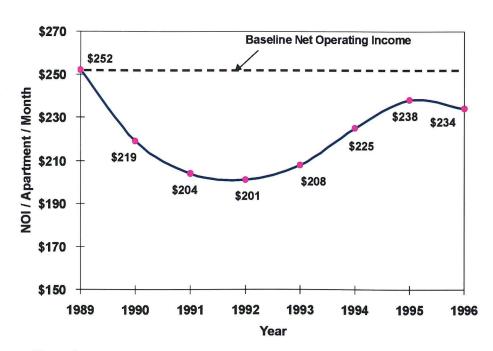


Figure 2
Source: 1998 RGB Income and Expense Study.

The rise and fall of the City's housing stock is reflected (see Figure 2) in terms of inflation adjusted net operating income (the residual income after the costs of operation and maintenance). The same observation would result if looking at operating ratios (the percentage of rental dollars or gross income which pays for the costs of maintaining and operating buildings).

Most housing industry observers believe that over an even longer term, since the inception of rent stabilization, stabilized housing has been in slow and steady decline, as measured by operating cost ratios. For instance, it appears that operating ratios averaged 55% when sta-

bilization began and are now about 65% after having risen as high as 72%. However, even such historical claims are in contention because of discontinuities in the data sources, which make precise comparisons difficult.

 1993 RSA submission to RGB Relative to Order 25 Some commentators contend that the absolute level of operating ratios or net operating income at any point in time is not as important as the change in these measures from year to year. While a trend line is certainly significant, the absolute



value of operating ratio for stabilized housing is very important because it reflects the competitive position of the City's housing and its ability to attract new capital investment. For example, if net operating income for stabilized properties is 60% as reported in this year's survey, while net operating income for rental properties throughout the rest of the country does not exceed 50%³, there would seem to be a clear incentive to invest outside of New York where return on investment is potentially greater.

For this reason, the industry has contended that operating ratios as represented in RGB Income and Expense Surveys have been understated, and that such understatement should be considered critically by the Board. We believe operating ratios have been understated for the following reasons:

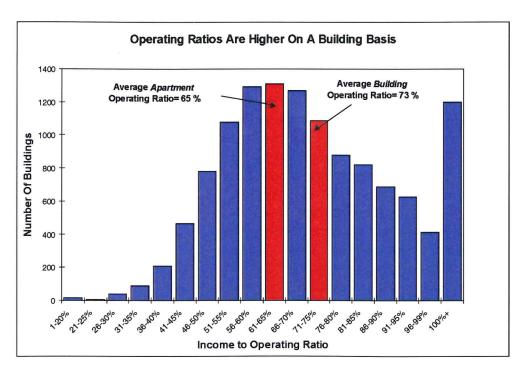


Figure 3
Source: 1997 DOF Income & Expense Reports.

The RGB Income and Expense Survey reduces expenditures reported by owners by approximately 8% based on a one-time DOF audit. However, there is no indication that the disallowed costs were not expended--just that they were misallocated. It is not surprising, therefore, that the survey of income and expenses by the New York Equity Fund used the unadjusted numbers as a benchmark against which to gauge its portfolio, citing "the absence of supporting data for the RGB's readjusted numbers..." On an unadjusted basis, the *income* to operating cost ratio for all stabilized apartments

would be 65.2% rather than the adjusted 60.1%. Unadjusted *rent* to operating ratio is even higher at 72%.

The RGB income and expense survey excludes all stabilized buildings which contain 10 or fewer units (approximately 10% of stabilized buildings), and are therefore not required to file income and expense statements. These buildings are known to have lower rents, higher operating costs and thus lower net operating income than larger buildings. For example we know that the rent to cost ratio for buildings containing 11-19 units is 82% versus 72% for all stabilized buildings. We can readily infer that inclusion of all stabilized buildings would result in a higher average operating cost ratio.

^{3. &}quot;1997 Income Expense Analysis: Conventional Apartments;" Institute of Real Estate Management, Chicago, IL



- The operating ratios in the RGB survey are inappropriately calculated on a per unit rather than per building basis. Yet, since we know that operating costs vary greatly based on the size of the building, it only makes sense to think about these costs on a per building basis. When we examine operating costs on a per building basis we find that at 72% they are substantially higher than the 65% on an apartment basis, as indicated in figure 3.
- Finally, the operating ratio most commonly reported in the RGB Income and Expense Survey is based on gross building income rather than rental income. Only a small percentage of stabilized buildings contain commercial space or derive substantial income from sources other than rents. Yet, the presence of commercial income, primarily in Manhattan, inappropriately creates the impression that all buildings benefit from the lower gross income to operating cost ratio. Since the RGB only has control over rental income to regulate the economics of stabilized housing, a more appropriate measure to use would be the rent to operating cost ratio, which stands at 72% versus 65% for the income to cost ratio on an unadjusted basis.

The significance of the absolute level of operating ratios is highlighted by this year's finding that the average rent to operating cost ratio for buildings in the RGB 1998 Mortgage Survey is 48 percent, similar to the national average but significantly lower than the average for all stabilized buildings. In other words, the private banking sector has placed its stamp of approval on operating ratios below 50% and has rejected those buildings with operating ratios above 50% as financially imprudent investments. All these factors argue that New York City housing has not maintained a competitive position and that rents need to increase in order to attract new capital to the existing rental market.

The Price Index Fails to Adequately Measure Increased Costs.

Items Not Included In The Price Index:

- ♦ Local Law 10 Facade Inspection costs
- ♦ Code Enforcement Re-inspection fees
- ♦ DOH lead paint abatement costs
- DEP recycling regulation costs
- HPD annual building registration fees
- ♦ NYS DEC oil tank registration fees
- DHCR annual registration fee

Each year, the Price Index of Operating Costs surveys a constant market basket of goods and services representative of those used by property owners to maintain and operate their buildings. Yet, the costs incurred by property owners have changed over time, with many of these changes resulting from government mandates, new bureaucratic requirements and increased regulatory fees.

Because of inevitable changes, most price indices are periodically updated. The Federal

government, for instance, updates its consumer price index every ten years. But the PIOC has not been updated in more than 15 years. In the interim,



many new cost elements have been added, some of which are highlighted here. And each year, it seems there are new requirements which add costs for property owners not included in the price index. This year, for instance, the City Council amended Local Law 10, the facade inspection requirement, to now require the inspection of all exposed building facades, not just those which front on the street. This new requirement will double and triple inspection costs but, like the original requirement, is not reflected in the price index.

In addition, less tangible but very real costs exist which increase each year including the costs of maintaining an ever aging housing stock. The City is considering replacing Yankee Stadium because it is 75 years old and falling apart. But a quarter of the City's stabilized housing is that old or older and is also steadily deteriorating. This winter's rains have accelerated that deterioration and highlighted the need for the expenditure of significant funds just to keep our buildings standing.

Higher Rents Result in Improved Housing

This year's RGB research provides additional evidence that increased rent translates directly into increased expenditure on building maintenance and improvement and, presumably, to improved housing conditions for tenants.

Maintenance Deficiency Indicators and Contract Rent (All Stabilized Units) Rent **Mean Number of Maintenance** In dollars **Deficiency Indicators** Less than 500 1.90 500-599 1.79 600-699 1.51 700-799 1.36 **800+** 1.00

Figure 4

Source: 1996 NYC Housing and Vacancy Survey

Tenant advocates consistently make the argument that owners simply pocket increased rental revenues and the benefits of increased rents accrue solely to owners. The available evidence, now more than ever before, flatly contradicts such contentions.

Data from the NYC Housing and Vacancy Survey (HVS) has consistently demonstrated a direct relationship between higher rents and improved housing conditions. In other words, we find that categories of housing with higher rent exhibit fewer maintenance deficiencies than categories with lower rents, as illustrated in Figure 4.

Last year's RGB research helped establish that unregulated rental buildings spend considerably more on operating and maintenance costs (\$529 per month)

than regulated buildings (\$425 per month), leading the RGB staff to conclude that "the typical level of service offered in the private market stock may be higher" and "growth in maintenance and labor costs [for unregulated buildings] may reflect improvements in service levels."

The higher expenditures on maintenance in the unregulated stock are

^{4. 1997} RGB Income and Expense Study



made possible by slightly higher rent levels. And we now find that higher rents in the stabilized stock also translate into higher expenditures on maintenance. The 1998 RGB Income and Expense Survey found significant increases in expenditures on maintenance costs. The staff speculated that "some owners may have parlayed the benefits of three years of growth [in rental income] into refurbishment of their buildings."

All of the data clearly indicates that limitations on rental income limits owners' ability to repair, maintain and improve their buildings. When rental income increases, owners spend more on maintenance, and building conditions improve. The RGB should vote for higher rents and improved housing conditions for tenants.

Low Rent Buildings Require A Low Rent Adjustment.

Despite the presence of a supplemental increase for low rent apartments in the last four years of rent guidelines, inadequately low rents remain a prevalent and serious problem. The low rent adjustment is an acknowledgment that a percentage increase translates into lower dollar amounts for lower rent apartments and that many apartments rent for less than the cost of maintenance, let alone financing.

Majority of Buildings Have Low Average Rent Average Monthly Building Rent per Decile (%)

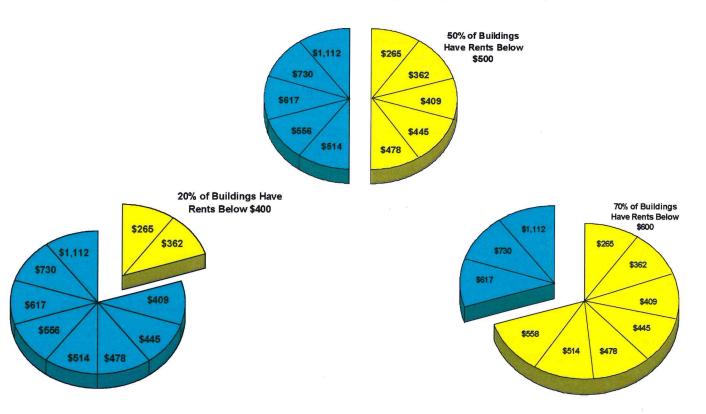


Figure 5

Source: 1997 DOF Income & Expense Reports

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The problem of low rent apartments becomes more evident when we look at average rents per building rather than just average rents. This is because rents are not evenly distributed throughout the city, but are clustered into low, moderate and high income neighborhoods. A building with generally low rents is, therefore, not likely to also have significantly higher rents to ameliorate the negative effects of low rents.

The most recent income and expense filings show that 50% of buildings still have average rents below \$500 per month, and 20% have rents below \$400 per month (See Figure 5). This is a slight improvement from the last reporting period when 60% of buildings had rents below \$500 and 30% had rents below \$400. The increase in rents, partially attributable to guideline increases and partly to low rent adjustments, demonstrates that there is more rent paying ability at the low end of the rent scale and that the low rent adjustment can help move those extremely low rents upward. But while low rents have been rising, so has the cost of operating and maintaining buildings. With average 1996 operating costs of \$444 reported in the RGB income and expense survey, it is clear that many buildings are not meeting their costs of operations, before even considering financing costs, let alone profit. Assuming even a moderately high operating ratio of 65%, the required rent would come close to \$700 per month.

This year's income and expense survey by the New York Equity Fund indicates that even low rent buildings have relatively high operating costs. The survey reports operating costs of \$341 per month in projects which do not pay real estate taxes and have virtually no debt service. Assuming that these projects paid an average private sector real estate tax burden of \$101 per month, their monthly operating costs would rise to \$442, exactly in line with the average for all stabilized buildings.

After an absence of the supplementary adjustment for low rent apartments for four years from 1990-93, the low rent adjustment was reinstituted in 1994 for apartments with rents below \$400 per month, and has not been increased since. In light of rising costs of operation and the increase in the minimum dollar amount needed to maintain and operate buildings, we urge the Board to increase the threshold for the low rent adjustment to \$500 per month.

Real Rents Have Increased By Less Than 1% Per Year.

While the annual deliberations before the Rent Guidelines Board are often characterized as a balancing act between profitability for property owners versus affordability for tenants, the issue of affordability is really a red herring. Rent stabilized apartments remain affordable for the majority of tenants, with a median rent to income ratio below 30%, the Federal stan-



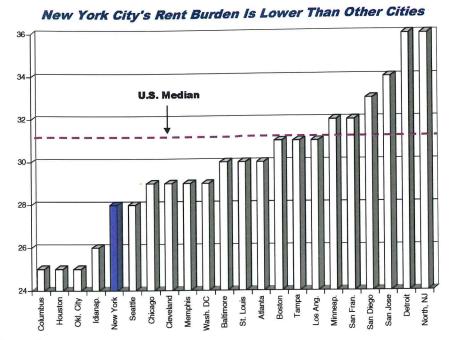


Figure 6
Source: 1996 RGB Income and Affordability Study.

Low Rents Have Room To Rise (All stabilized households)

Percent Households with Rent/	Units with Contract Rent Less Than:		
Income Ratio Below:	\$300	\$400	\$500
1 5 %	31.2%	27.4%	26.3%
2 0 %	43.4%	39.9%	37.9%
2 5 %	5 4 . 0 %	49.7%	46.9%
3 0 %	62.9%	56.4%	54.2%

Figure 7
Source: 1996 NYC Housing and Vacancy Survey.

dard for housing affordability, as indicated in Figure 6. Even though New York is characterized as a high cost town, the median rent of \$600 per month compares favorably with rents in other large urban centers and results in favorable rent burdens compared to other urban centers.

That the median asking rent for vacant apartments is \$600 per month, exactly the same as the average for all occupied apartments, defies the common conception that only high rent apartments become available for rent. This is confirmed by the fact that the average asking price for vacant apartments (\$654) is lower than the average rent for occupied apartments (\$680).

The issue of affordability is one which potentially affects only lower income New Yorkers, but even there the impact is far from universal. As indicated in Figure 7, a majority of tenants at low rent levels are paying less than thirty percent of their income for rent and therefore have a greater rent paying capacity. Moderate increases in rent will not have a significant increase on such households.

As for those households which are already paying more than 50% of their income for rent, there is little the RGB can do. There has been substantial evidence over the last few years that rent levels for the City's poorest residents are capped by rent paying ability, not by legal



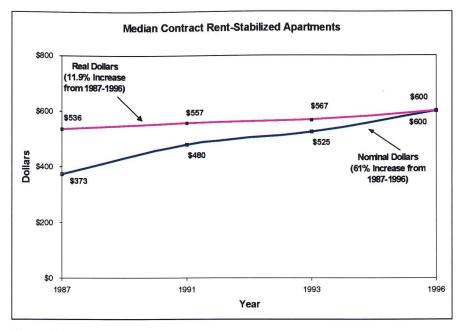


Figure 8
Source: RGB Order 1987-96; 1991, 1993, and 1996 Housing Vacancy Survey.

regulated rent levels. For example, in the poorest neighborhoods of the City, we know that the rents actually paid are less than those which can legally be collected. Therefore, RGB guidelines are not likely to affect those with the highest rent burdens.

From tenants' perspective, RGB has held rents to extremely low levels. Over the last ten years, stabilized rents adjusted for inflation have increased at a rate of just over 1% a year as indicated in Figure 8. Any possible rate of rent increase under consideration this year will have a similarly benign effect on housing affordability.

There Is A Need For A Vacancy Allowance.

Last year, with the enactment of a State-mandated vacancy allowance under the Rent Regulation Reform Act of 1997, the RGB decided to provide only a vacancy allowance to govern allowable rent increases in sublet situations. But the State legislation did not preclude the RGB from authorizing a vacancy allowance.

While the 20% State vacancy allowance would appear to be a substantial benefit, there are many situations in which its benefits will actually be quite meager. This will generally occur in low rent apartments where the owner does not have the financial resources to increase rents through individual apartment improvements, but the rents are inadequately low to maintain and operate the building and the owner must rely solely on the guidelines as the only method of increasing rents. For example, if a \$325 per month apartment became vacant, the State vacancy bonus would have permitted a maximum increase of \$100, raising the rent to \$425, still inadequate to meet building operation and financing costs.

The housing industry has long argued that it does not serve the purpose of the rent stabilization law to constrain the level of rent increase upon vacancy. Vacancy rents should be part of the normal process of free market bargaining between owner and tenant. This process, by definition, does not disadvantage any existing tenant.



There are many other reasons to provide a generous vacancy allowance including the correction of rent skewing and compensation for the extraordinary costs of refurbishing vacant apartments.

As a result, vacancy rents should be allowed rise to the level of comparable rents in the building or neighborhood. Since comparable rents may have been constrained by regulations to less than the amount necessary to meet operating costs, as an alternative, rents upon vacancy should rise at least to a pre-determined minimum rent level. Westchester County has maintained a system of vacancy rents based on comparable rents without adverse effect and without legal challenge even after the Rent Regulation Reform Act of 1997.

Much the same argument can be made on the issue of the Special Guideline for Initial Stabilized Rents, applicable when rent controlled apartments enter the stabilization system. While the RGB has generally specified a percentage increase for this guideline, there is no reason why a comparable rent or minimum rent should not be specified instead.

Guideline Recommendations

In light of the RGB's mandate to preserve the economic viability of rent stabilized housing in New York City, and in the face of rent guideline increases which have failed to keep pace with rising operating costs, the Rent Stabilization Association proposes the following rent guidelines:

- ♦ 4% for a one-year lease and 8% for a two year lease.
- ♦ A supplemental allowance of \$20 per month for apartments renting for \$500 per month or less.
- ♦ Upon vacancy, a minimum rent of \$600 per month, the highest rent for a comparable apartment in the building or neighborhood, or the State vacancy allowance, whichever is highest.
- ♦ The special guideline for initial stabilized rents shall be the same as the vacancy guideline.

These guideline proposals will be easily affordable to the majority of stabilized tenants who had a real increase in rents of just over 1% per year for the last ten years. These increases will allow owners to recoup lost ground and to meet the ever growing burden of increased real property taxes, water and sewer charges and the costs of maintaining an aging and deteriorating housing stock. The vacancy allowances, on the other hand, are a means of injecting much needed capital into the housing stock without affecting any sitting tenant.

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