

# The Challenges of Balancing Rent Stability, Fair Return, and Predictability under New York’s Rent Stabilization System

A mid-20th century response to New York City’s housing shortage was the introduction of a rent stabilization system that regulates annual permitted rent adjustments. The legacy of this response has a major impact on New York City’s housing stock today: about half of the city’s rental apartments are rent stabilized,<sup>1</sup> housing about 2.5 million residents.<sup>2</sup>

Housing advocates and policymakers look to rent stabilization to protect existing tenants from excessive rent increases and to preserve the affordability of the overall housing stock. In tension with these goals is the fundamental need for portfolio-wide rent increases to fulfill the constitutional obligation to allow private owners to receive reasonable rates of return on their investments (referred to as a fair return).<sup>3</sup>

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1 New York City Housing Preservation & Development. (2018, February 9). *Selected Initial Findings of the 2017 New York City Housing and Vacancy Survey*. Retrieved from <https://www1.nyc.gov/assets/hpd/downloads/pdf/about/2017-hvs-initial-findings.pdf>

2 New York City Housing and Vacancy Survey microdata. (2017).

3 “The Takings Clause of the Fifth Amendment, made applicable to the states and local governments through the Fourteenth Amendment, provides that private property shall not ‘be taken for public use, without just compensation.’ U.S. Const. amend. V. In some instances, government regulation of private property may be so onerous that its effect is tantamount to a direct appropriation or ouster—and that such ‘regulatory takings’ may be compensable under the Fifth Amendment.” *Harmon v. Markus*, 412 Fed. Appx. 420, 422 (2d Cir. 2011) (quoting *Lingle v. Chevron U.S.A. Inc.*, 544 U.S. 528, 537 (2005)) (upholding New York City Rent Stabilization Law against a takings challenge). See U.S. Const. amend. XIV (“[N]or shall any State deprive any person of...property, without due process of law.... ”); *id.* amend. V (“No person shall...be deprived of...property, without due process of law; nor shall private property be taken for public use, without just compensation.”). To help meet this constitutional requirement, all jurisdictions with rent regulations provide processes through which landlords may petition for rent increases necessary to provide fair returns, also known as hardship increases.



Setting allowable annual rent increases while accommodating these competing goals is a central challenge for the maintenance of the rent stabilization system.

This brief lays out some of the challenges of balancing affordability and a reasonable rate of return; explains how New York City’s local governing body (the Rent Guidelines Board) incorporates building operating cost data to make rent adjustments; scans approaches used in other jurisdictions; and explores the potential consequences of eliminating rent increase mechanisms designed to be supportive of investment in repairing and improving the housing stock.

## The Process for Balancing Affordability and Fair Return

The Rent Guidelines Board (the Board) is a nine-member body whose members are appointed by the Mayor of the City of New York,<sup>4</sup> with a full-time staff (the Staff) that provides data and policy analysis. The Board sets an annual basic adjustment owners can apply to rents on one- or two-year rent stabilized lease renewals.<sup>5</sup> While other mechanisms within the rent stabilization system

also allow rents to increase,<sup>6</sup> the Board’s responsibility for establishing basic annual adjustments means that its decisions have major implications for both residents of rent stabilized units and the long-term quality of New York City’s housing stock.

New York state law requires the Board to consider a number of factors when setting the basic annual adjustment that owners of rent stabilized units can make to rents in one- and two-year lease renewals.<sup>7</sup> Of particular focus in this brief is the Board’s task of balancing the goals of affordability and fair returns to owners when setting the basic

4 Rent Guidelines Board Board & Staff. (n.d.). Retrieved from <https://www1.nyc.gov/site/rentguidelinesboard/about/board-staff.page> The RGB consists of nine members, all of whom are appointed by the mayor. Two members are appointed to represent tenant interests. One of these serves a two-year term, and the other a three-year term. Two members are appointed to represent owner interests. Like the tenant members, one serves a two-year term, and the other a three-year term. Five members (including the chairperson) are appointed to represent the general public. One of these serves a two-year term, another a three-year term, and two serve four-year terms. The chairperson serves at the pleasure of the mayor.

5 New York City Rent Guidelines Board. (2019, May 7). *Rent Guidelines: Proposed Apartment/Loft & Hotel Guidelines*. Retrieved from <https://www1.nyc.gov/site/rentguidelinesboard/rent-guidelines/rent-guidelines-proposed.page>; see also Emergency Tenant Protection Act of 1974 (ETPA), New York State. (1974). Retrieved from [http://tenant.net/Rent\\_Laws/ETPA/etpa.html](http://tenant.net/Rent_Laws/ETPA/etpa.html)

6 Rents can also increase upon a vacancy with an as-of-right vacancy allowance of up to 20 percent, which can be coupled with a longevity bonus for longer term renters. Rents are also allowed to be increased when owners invest in Individual Apartment Improvements (IAIs) or building-wide Major Capital Improvements (MCIs). These latter investments can vary greatly across buildings, and the rent increases are determined on a case-by-case basis through separate formulas and therefore do not need to be built in or otherwise taken into account by the Board in setting the one- and two-year rent increases.

7 CLS Uncons Laws of NY ch 249-B, § 4 [b]. (2017). The Rent Stabilization Law (RSL) sets forth these factors for the Board to consider:

- (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 (added in 1983), 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.

Collins, T. L. (2018). *An Introduction to the New York City Rent Guidelines Board and the Rent Stabilization System* (p. 59) (United States, New York City Rent Guidelines Board). New York, NY. Retrieved from <https://www1.nyc.gov/assets/rentguidelinesboard/pdf/history/intro.pdf>

In reviewing these factors the Board’s publication, *An Introduction to the New York City Rent Guidelines Board and the Rent Stabilization System*, lists three protections for tenants—affordability, habitability and security of tenure—and a fair return to owners who invest in rental property.)



annual adjustment.<sup>8</sup> New York state law does not prescribe a specific formula for determining how to limit rent increases in a way that fulfills the requirement of achieving a fair return, leaving this decision to the Board’s discretion.

One important aspect of maintaining fair returns for owners is allowing rent increases that reflect basic inflation and rising operating costs. In New York City, the Staff provides the Board with guidance on what degree of rent adjustments would be sufficient to compensate owners for these increases. The Staff creates a table of “Commensurate Rent Formulas” using five different approaches for determining what level of rent adjustments would, on average, cover owners’ cost increases so as not to impair their Net Operating Income (NOI). (For discussions of NOI and of Commensurate Rent Formulas, see Sidebars). The menu of commensurate rent formula results, coupled with testimony and other research the Board may consult in its discretion, informs the Board as to the level of adjustment necessary to provide a fair return.

### Net Operating Income and Why it Matters

Net Operating Income (NOI) is the gross revenue a property produces minus operating costs, not including any debt service. If a building produces positive NOI, the income can be used to pay back any debt (commonly referred to as a mortgage) or equity investment used to buy, rehabilitate, or build the building. Basic operating expenses include property taxes, labor costs, fuel, utility payments, basic maintenance, and insurance.<sup>9</sup> They do not include the costs incurred in making major capital repairs, such as a large investment to fix a heating system, or the costs of improvements made to individual apartments. The scope of these latter types of investments varies greatly by building and by year, whereas operating costs are more likely to move fairly consistent over time and across buildings. In order to prevent NOI from falling in an environment in which operating costs increase over time, revenues must likewise increase.

8 Collins, T. L. (2018). *An Introduction to the New York City Rent Guidelines Board and the Rent Stabilization System* (p. 74) (United States, New York City Rent Guidelines Board). New York, NY. Retrieved from <https://www1.nyc.gov/assets/rentguidelinesboard/pdf/history/intro.pdf>. The legislative emphasis on housing affordability is found in the City Council’s Findings and Declaration of Emergency under the Rent Stabilization Law of 1969, stating “...that such action is necessary in order to prevent exactions of unjust, unreasonable and oppressive rents and rental agreements and to forestall profiteering, speculation and other disruptive practices tending to produce threats to the public health, safety and general welfare...” The Board recognizes the importance of “steady and predictable behavior on the part of the Rent Guidelines Board...to allow new investors to make a rational assessment of whether or not the asking price of a particular building is competitive relative to other investments.”

9 Operating expenses do not include debt service payments, which are a function of market interest rates and principal balance owed.



## Commensurate Rent Formulas: Accounting for Changes in Operating Costs (And More)

The calculations used in the commensurate rent formulas rely on information the RGB Staff gathers about the rate of increase or decrease of building operating costs, and the share of total revenue consisting of operating costs, under the assumption that all units in a building are rent stabilized.<sup>10, 11, 12</sup>

As part of the process of estimating recent movements in operating costs, the Staff produces its own Price Index of Operating Costs (PIOC) using data gathered from government agencies, vendors and contractors, unions, utility companies, and owners of rent stabilized buildings.<sup>13</sup> The city-wide average share of building revenue that consists of operating costs is derived from Income and Expense data collected by the NYC Department of Finance from owners that are mandated by law or choose to file voluntarily.<sup>14</sup>

While commensurate rent formulas are relatively straightforward to compute,<sup>15</sup> the Board is free to decide how much weight to give the PIOC as part of its overall decision making process. In 2018, for example, the Board set one- and two-year increases of 1.5 and 2.5 percent respectively—well below any of the increases generated by the commensurate rent formulas. In contrast, in 2016, the allowed increases of zero and two percent exceeded the increases derived using the commensurate rent formulas. In 2019, the proposed increases again fall below those produced by the commensurate rent formulas in both nominal and real terms. Other jurisdictions with rent regulation systems do not appear to permit this level of discretion.

<sup>10</sup> The calculations are done in both real and nominal dollars. Real dollars account for general inflationary effects, while nominal dollars do not.

<sup>11</sup> As a starting point, NOI needs to be adjusted to a level that meets the “fair return” standard.

<sup>12</sup> For buildings with a mix of rent stabilized units and market rate residential or commercial units, revenue will increase slower or faster than what is allowed for the rent stabilized units, depending on the relative rate of increase (or decrease) of market rents.

<sup>13</sup> New York City Rent Guidelines Board. (2019, April 18). *2019 Price Index of Operating Costs* (p. 10). Retrieved from <https://www1.nyc.gov/assets/rentguidelinesboard/pdf/pioc19.pdf>.

<sup>14</sup> The owner of a building with a property tax assessed value in excess of \$40,000 must file a Real Property Income and Expense Statement.

<sup>15</sup> Assuming that there is agreement on the validity of the PIOC as a reflection of the relative cost pressures of the various components of operating costs.

### Commensurate Rent Formula Adjustments

The Staff of the Board relies on five variations of commensurate rent formulas. All of the commensurate rent formulas rely on the increases in the PIOC and the share that operating costs compose of revenues. The variations include whether the calculation is done in nominal or real dollars; whether it adjusts for the fact that some leases are renewed for one- and some for two-years at a time; and whether it takes into account the normal rate of turnover of apartments, at which time an owner is allowed to increase a unit’s rent by up to 20 percent upon vacancy. Specifically, the five are:

- 1) The “Net Revenue” formula, designed to maintain the dollar amount of NOI while accounting for the mix of lease terms as well as the latest increase or decrease in operating costs;
- 2) The “CPI-Adjusted NOI” formula replicates the “Net Revenue” formula but adjusts NOI using real or inflation-adjusted dollars (based on movement in the regional CPI index);
- 3) The same approach as “1” with an added adjustment to account for average turnover-driven vacancy allowances;

4) The same approach as “2” with an added adjustment to account for average turnover-driven vacancy allowances; and

5) The “Traditional” formula, which takes into account historic and projected changes in operating costs, but not the effect of inflation on NOI. This is the only formula that takes into account not only recent changes in operating costs but also a projection of how much operating costs are likely to go up in the coming year.

#### 2019 Commensurate Rent Formula Adjustments

<i>Formulas</i>	<i>1-Year Lease</i>	<i>2-Year Lease</i>
“Net Revenue” Commensurate Adjustment	4.00%	8.00%
“Net Revenue” Commensurate Adjustment with Vacancy Increase	3.00%	5.25%
“CPI-Adjusted NOI” Commensurate Adjustment	4.75%	9.25%
“CPI-Adjusted NOI” Commensurate Adjustment with Vacancy Increase	3.75%	6.75%
“Traditional” Commensurate Adjustment	3.60%	4.70%
<b>2019 Preliminary Ranges (as of 5/8/2019)</b>	<b>.05%–2.75%</b>	<b>1.75%–3.75%</b>

There are other factors which keep rent increases lower than what the commensurate rent formulas suggest. Because the Board is tasked with taking into account all factors that affect fair return, two of the five commensurate rent formulas also account for the increases that result from the

as-of-right allowance to increase rents upon a vacancy (Vacancy Allowance). This adjustment applies the overall rate of unit turnover to every unit, and when taken into account, lowers the resulting suggested rent adjustment, even though not all owners experience turnover at the same rate.



## Portfolio-Wide Rent Adjustments Affect Tenants and Building Owners in Inequitable Ways

All of the assumptions that lead to the estimated adjustments needed to cover the increase in operating costs and inflation are based on portfolio-wide averages: average operating costs and their average share of revenue, regional-wide inflation, average turnover rate, and the overall or average mix of one- and two-year leases.

Use of averages can create unintended inequities for both tenants and owners. For example, while changes in operating costs may be fairly similar across all rental units (because the cost of goods and services does not reflect the particularities of any given location), operating costs as a share of revenue are likely to vary greatly with rent levels. In areas of the city with higher rents, operating costs will likely be a much lower share of revenue than in areas with lower market rents. As a result, any city-wide commensurate rent formula may underestimate the percentage change in rents needed to cover increased costs for buildings in lower-rent neighborhoods, and overestimate what would be required for one in a higher-rent neighborhood. Similarly, the NOI of owners of buildings with a mix of market and rent stabilized units will fare better or worse depending on the rate of increase or decrease in their local market rents versus the increases or decreases allowed for the stabilized units.

Most relevant, eliminating rent increases that reflect investment (including Major Capital Improvements and Individual Apartment Improvements) could cause the Board to account for these costs with higher across-the-board, basic rent adjustments. Any resulting increases in the annual rent adjustments could be borne by all tenants, even those who have not benefited from any investment in their unit or building. While turnover can happen as a matter of course, the need for investment in improvements is conditional on building level factors, such as the physical condition of a building, and an owner's access to capital. Thus, without some form of MCIs and IAIs, the Board may need to account for those costs when fulfilling its constitutional obligation to provide owners a fair return. Even if they do take the average rate of investment into account, the incremental rent increase that the Board authorizes will not necessarily provide owners with sufficient compensation for the costs of the normal level of improvements they would otherwise make. This could leave owners with limited incentive to make investments where costs exceed the city-wide average, and over time, any resulting reductions in the level of investment could lead to quality declines following an era of major improvement of the quality of the housing stock.<sup>16</sup>

<sup>16</sup> In 1991, the share of renter occupied units that reported "No Maintenance Deficiencies" in their housing was 38.2%. In 2017, it was 51.9%. New York City Housing Preservation & Development. (n.d.). 50 Years of Housing in New York City. Retrieved from <https://www1.nyc.gov/site/hpd/about/50-years-of-housing-in-new-york-city.page>



## How Other Jurisdictions Account for Increases in Operating Costs and Inflation Adjustments

Most rent regulation systems in jurisdictions outside New York appear to rely on pre-determined formulas—rather than discretionary processes—to set across-the-board, annual allowable rent adjustments. And, rather than creating a separate price index of the operating costs of rent stabilized stock, as New York does, they rely on their respective regional consumer price indexes produced by the U.S. Bureau of Labor Statistics. Relying on third-party indexes and fixed formulas generally means that other jurisdictions’ processes for setting annual rent adjustments are more transparent, predictable, and insulated from political influence than the discretionary procedures used by New York City’s Rent Guidelines Board.

The pre-determined calculations used by other jurisdictions implicitly reflect decisions to use different approaches contained within the Board’s five commensurate rent formulas. Some base their calculations on an explicit assumption as to the share of revenue that consists of operating costs, while others assume that operating costs are increasing at the same rate as overall inflation. None of them builds into the allowed, across-the-board changes a factor for the costs of investments in building-wide or individual apartment improvements. Most offer a separate, discretionary process for applying for rent increases to cover these costs and, in any case, allow rents to increase to market rate upon turnover, whether or not they subsequently remain subject to rent regulation. See sidebar for a sample of the approach taken by other jurisdictions.

### Examples of How Other Jurisdictions Account for Increases in Operating Costs and Inflation

San Francisco, CA, stands out relative to the rent regulation systems we have examined in how its regulators focus on maintaining nominal NOI. San Francisco’s rent stabilization ordinance benchmarks to the regional CPI-U but allows an increase of only 60 percent of that increase, in essence mirroring the approach used for the Board’s commensurate “net revenue” formula. This system makes the implicit assumption that operating costs (excluding utilities and property taxes) rise at the same rate as inflation, and that operating costs equal 60 percent of revenues.<sup>17</sup> Annual increases are capped at 7 percent, with the ability to “bank,” or carry forward, increases in excess of the cap. Separately, increases in utilities and property taxes can be passed through to tenants.<sup>18</sup>

Los Angeles, CA, also uses the regional CPI-U, with a minimum of 3 percent and a maximum of 8 percent allowed for basic annual increases. Owners who pay utilities may increase by an additional 1 percent per utility. By benchmarking the rent adjustment to 100 percent of CPI-U, Los Angeles appears to focus on maintaining NOI in real terms: this system implicitly assumes that operating costs (other than utilities) are increasing at the same rate as the overall regional CPI. Thus, Los Angeles essentially replicates the logic behind the Board’s commensurate “CPI-Adjusted NOI” formula.

Oakland, CA, also looks to regional CPI-U but benchmarks only to the changes in the non-shelter components of the index, presumably to avoid the risk

of double-counting if rent increases drive up the regional CPI-U.<sup>19</sup> In some years the subcomponent goes up faster than the measure for All Items; in other years the opposite is true.<sup>20</sup> As with Los Angeles’ approach, relying only on the price index implicitly assumes that operating costs increase at the same rate as inflation, at least as measured for All Items minus Shelter. Accordingly, Oakland’s system looks to be seeking to maintain NOI in real terms.

Washington, D.C., relies on a different version of its regional price index, CPI-W, which tracks price changes for purchases of wage earners and clerical workers. The annual basic increase granted to owners is two percentage points above the increase in the CPI-W. The additional two percentage points may allow for the possibility that government-driven costs, such as property taxes and utilities operating costs, are increasing faster than overall inflation.

In New Jersey, both Newark and Jersey City allow rent increases based on the regional CPI-U with a maximum of 4 percent at any lease renewal. In both cases, the annual basic increases are consistent with the Board’s commensurate “CPI-Adjusted NOI” formula when inflation is less than 4 percent. Newark allows for owners to apply for surcharges for increases in property taxes and utilities as well as for increases based on the costs of major capital improvements. Jersey City imposes a 15 percent cap on increases based on capital improvements over the course of a year, but increases in excess of the 15 percent can be carried forward and imposed in following years.

<sup>17</sup> New York City Rent Guidelines Board. (2019, April 4). *2019 Income and Expense Study* (p. 10). New York, NY. Retrieved from <https://www1.nyc.gov/assets/rentguidelinesboard/pdf/ie19.pdf>. To calculate the 2019 commensurate rents, the Board uses a cost to income ratio of 64.6%.

<sup>18</sup> In NYC, property taxes and utility costs are included in the index of operating costs.

<sup>19</sup> For the San Francisco-Oakland-Hayward, CA, regional CPI-U, shelter comprises just under 43 percent of the index. See <https://www.bls.gov/cpi/tables/relative-importance/2018.pdf>

<sup>20</sup> Bureau of Labor Statistics. (n.d.). *Relative importance of components in the Consumer Price Indexes: U.S. city average, December 2018*. Retrieved from <https://www.bls.gov/cpi/tables/relative-importance/2018.pdf>. For the San Francisco-Oakland-Hayward, CA, regional CPI-U, shelter comprises just under 43 percent of the index.





## Conclusion

The Rent Guidelines Board’s annual decisions on basic allowed rent adjustments are critical to both affordability and the long-term quality of New York City’s rent stabilized housing stock. Given the Board’s current mandate to find the right balance between maintaining affordability and allowing owners to earn a fair return, policymakers should be mindful to guard against any changes that may lead to the unintended consequences of inequitable rent increases or a gradual decline in the long-term quality of the housing stock.<sup>21</sup> As long as the annual rent adjustments only needs to reflect increases in operating costs and inflation, policymakers should consider following the example of jurisdictions in other states and replacing the Board’s discretion with a third-party generated cost index, thereby making the system more predictable, transparent, and relatively free from political influence.<sup>22</sup> In addition, as the description of the possible consequences of eliminating MCI and IAI increases demonstrated, changing any part of the system should only be done with full consideration of the impact on the Board’s requirement to balance affordability and fair return.

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<sup>21</sup> Similarly, legislators considering an indirect cap on rent increases as part of good cause eviction legislation (i.e., treating as “unconscionable” rent increases in excess of 1.5 times the increases in the consumer price index) need to consider its broader implications for both tenants and owners. Tenants could see more frequent and larger annual rent increases than they might otherwise have as owners regularize the imposition of annual increases so as to be best able to pass on their costs over time. Owners could also have less incentive to maintain the quality of their non-regulated rental units. As noted earlier in the main text, limits on rent that do not allow increases to compensate owners for expenditures necessary to properly maintain the housing stock, e.g., for replacement of building-wide systems, may well lead to underinvestment and ultimately to a decline in its quality.

<sup>22</sup> For New York City, it may make sense to also incorporate in the index adjustments for cost increases attributable to government action such as property taxes and water and sewer increases.