



WHITE PAPER

# The Economic Challenge for the Rent Guidelines Board: Preserving Affordable Rent Stabilized Housing for the Long Run

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## White Paper

# The Economic Challenge for the Rent Guidelines Board: Preserving Affordable Rent Stabilized Housing for the Long Run

Matthew P. Murphy and Mark A. Willis<sup>1</sup>

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## Introduction

Rent stabilized apartments account for nearly half of all rental units in New York City and are a vital source of relatively low-cost rental housing. New Yorkers who live in rent stabilized apartments pay a lower median rent<sup>2</sup> and have a lower median income<sup>3</sup> than households in unregulated apartments, but are also more likely to experience maintenance deficiencies.<sup>4</sup> The responsibility for overseeing the economic viability and affordability of this important housing stock rests with the nine-member Rent Guidelines Board (RGB), which sets annual rent adjustments for rent stabilized apartments.<sup>5,6</sup> Given the importance of the rent stabilized apartment stock, it is essential to think hard about how to preserve both its quality and quantity.

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<sup>1</sup> We want to give special thanks to Eliza Ezrapour and Jiaqi Dong – this paper could not have happened without their hard work and determination. We also want to thank Patrick Spauster, Janelle Jack, Julia Konrad, Charles McNally, and Maxwell Austensen for assisting in the production of this paper. Additionally, we want to thank all of the people who volunteered their time review earlier drafts of this work. Their input and expertise greatly improved our thinking and understanding of the issues discussed in this paper. This research does not purport to represent the views of our reviewers or New York University.

<sup>2</sup> Waickman, C. R., Jerome, J. B. R., Place, R. Affordability of Rent Stabilized Units. New York City Department of Housing Preservation and Development, 2018. 6 <https://www1.nyc.gov/assets/hpd/downloads/pdfs/services/rent-regulation-memo-2.pdf>

<sup>3</sup> Waickman, C. R., Jerome, J. B. R., Place, R. Sociodemographics of Rent Stabilized Tenants. New York City Department of Housing Preservation and Development, 2018. <https://www1.nyc.gov/assets/hpd/downloads/pdfs/services/rent-regulation-memo-1.pdf>

<sup>4</sup> Waickman, C. R., Jerome, J. B. R., Place, R. Quality and Accessibility of Rent Stabilized Units. New York City Department of Housing Preservation and Development, 2018. <https://www1.nyc.gov/assets/hpd/downloads/pdfs/services/rent-regulation-memo-3.pdf>

<sup>5</sup> The rent stabilization law (NY State Senate S. 6458, <https://legislation.nysenate.gov/pdf/bills/2019/S6458>) lays out several criteria for the RGB to consider when setting the annual rent caps for one- and two-year leases. According to the statute, these include:

- (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, and
- (3) such other data as may be made available to it.

<sup>6</sup> There are several issues with the language in the statute that we do not address in this paper, but warrant additional research. These include: whether the language “affected area” should be interpreted as a city-wide analysis only, or if it leaves room to target unique sub-markets or building types; whether “housing accommodations” refers only to rent stabilized units, or, to all buildings subject to the rent stabilization requirement as of 1974; and how policymakers who drafted the original statute may have considered the implications of income from non-stabilized sources, such as commercial income or deregulated units.

In June 2019 the State Legislature passed the Housing Stability and Tenant Protection Act (HSTPA).<sup>7</sup> While HSTPA did not formally change the RGB's role, it did make its annual increases far more determinative of the long-term economic health of buildings with rent regulated units. Before HSTPA's passage, rent stabilized rents could and did rise at higher rates than the RGB's annual vote. Additional rent increases were permitted upon tenant vacancy and at lease renewals (in the case of preferential rents), or to recover the cost of investing in capital improvements. With HSTPA having eliminated or diminished these methods, the RGB is now the primary, if not sole, driver of income an owner is allowed to realize from rent stabilized units (**See Sidebar One**). This heightened responsibility requires that the RGB carefully assess the consequences of these changes, and modify its decision-making criteria accordingly.

One segment of the rent stabilized stock is at particular risk during the HSTPA era: buildings without any significant source of income other than from rent stabilized apartments. While many buildings with rent stabilized apartments also derive income from deregulated market rate residential apartments, we estimate that 60 percent of all rent stabilized apartments are in buildings that were built before 1974 (the year rent stabilization was instituted) and remain essentially composed of only rent stabilized apartments (fully rent stabilized buildings<sup>8</sup>). To understand how to protect this stock of affordable rental housing in both the short and long run, the RGB needs to focus in particular on the economics of fully rent stabilized buildings and to collect data that can help it do so.

In this paper we lay out the long-term relationship between net operating income (NOI) and the sustainability and quality of rent stabilized apartments. We then examine how best to use the tools and data available to the RGB for its deliberations. Finally, we suggest two ways that the RGB could adapt to the HSTPA era when setting guidelines for annual rent increases (or possibly even decreases in a deflationary world). One is to have increases in Consumer Price Index be a starting point for setting guideline rental increases, the other is to make guideline increases based on Consumer Price Index automatic, leaving the Rent Guidelines Board to simply monitor whether actual trends require further adjustments.<sup>9</sup>

## **The Impact of Revenue Shortfalls on Housing Quality and Economic Viability**

The long-term economic viability of rent stabilized apartments depends on having sufficient rent increases that are large enough to preserve a building's NOI to the degree necessary for not impairing the maintenance standards of a building.

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<sup>7</sup> <https://legislation.nysenate.gov/pdf/bills/2019/S6458>

<sup>8</sup> In this paper we consider a building to be fully rent stabilized if at least 95-100 percent of the residential units are rent stabilized and the building was built before 1974. We will use the term fully rent stabilized building(s) throughout.

<sup>9</sup> It is important to note that our findings and analysis are limited to the city's rent stabilized stock. Not covered by this paper are public housing, as well as the post-1974 additions to the rent stabilized stock that have occurred under programs that offer direct government subsidy through the form of low-interest loans, or property tax benefits (and governed by a property-level agreement called a regulatory agreement). Also not covered are the unregulated and therefore market-based units. These housing types are critical pieces of a comprehensive housing stock that serves the wide range of housing needs of New York City's income-diverse population. While the City of New York's affordable housing programs are aimed at the gap in affordable housing for lower-income New Yorkers, at the other end of the scale, the city as a whole has benefited from a robust, market-based, real estate industry that can add new units in response to increases in demand. The ways that government can best support these other housing sectors is beyond the scope of the analysis contained in this paper.

service on any mortgage and provides a return to the building owners. NOI also serves as a primary determinant of the market value of a building, as market values tend to rise and fall with changes in NOI.<sup>12</sup> A change in the level of NOI is seen by lenders and investors as an important indicator that rental revenue is sufficient to cover operating costs and debt service, as well as to provide a reasonable return. To guard against devaluing buildings in inflation-adjusted (so-called “real”) dollars requires that NOI remain constant in real dollars.

As **Sidebar Two** lays out, revenue increases short of what is needed to cover increased operating costs as well as basic inflation leave owners having to choose among options that could be harmful to tenants, neighborhoods, the City’s ability to raise revenue, and building owners. Trying to limit the impact on NOI, owners may first look to curtail expenditures for maintenance. They may also look to conserve cash flow by also slowing the rate of replacement of building systems that have exceeded their expected useful life. The resulting deterioration in quality from either of these actions would not just affect the tenants in these buildings but also potentially create a negative spillover effect on the surrounding neighborhood, as well as negatively impact the value of nearby buildings. An extended period of deterioration could even render a building uninhabitable, potentially leaving a vacant shell in the middle of a city block.<sup>13</sup>

A rental shortfall could also result in the sale of a building if NOI falls to the point that the owner is short of cash flow to pay the mortgage, or is in violation of a mortgage covenant regarding debt service coverage.<sup>14</sup> These pressures could result in owners allowing banks to foreclose, and as we have seen elsewhere, foreclosures in and of themselves can negatively affect surrounding properties, lead to increased crime, and decreased tax revenue.<sup>15,16</sup>

Another impact would be on the City’s ability to raise revenue from its property tax. A decline in NOI would depress the market value of affected buildings. More broadly, any reduction in property values would lead the Department of Finance (DOF) to reduce assessed values. The result would be that the City would have to raise property tax rates on other properties, or raise rates on other taxes if it needs to maintain revenue levels to fund the City’s budget. Over the long-term, lower building values could also reduce revenue raised from the Real Estate Transfer Tax and the Mortgage Recording Tax.

Inadequate income growth is likely to be particularly troublesome for the owners of smaller apartment buildings who have limited capital to make improvements on their own or have no other source of income. Their situation will only worsen if they have already maximized available mortgage financing; in this case, the periodic need to refinance that mortgage may require more equity from the owner.<sup>17</sup> Owners who have mortgaged a smaller share of the value of the property or that have more of an ability to raise additional equity may, at least in the short

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<sup>12</sup> Exactly how closely market values and NOI track each other depends on cap rates which can vary over time as interest rates, market, and building conditions change (see **Sidebar Two** for more on cap rates).

<sup>13</sup> Ellen, I. G., Lacoie, J., & Sharygin, C. (2013). Do foreclosures cause crime? *Journal of Urban Economics*, 74, 59–70.

<sup>14</sup> See **Sidebar Two** regarding bank lending criteria that include a maximum loan to value (LTV) and minimum debt service coverage ratio (DSCR).

<sup>15</sup> Immergluck, Dan and Geoff Smith, 2005. “There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values.” Woodstock Institute.

<sup>16</sup> G. Thomas Kingsley, Robin Smith, and David Price, The Impacts of Foreclosures on Families and Communities, The Urban Institute. May 2009. <https://www.urban.org/research/publication/impacts-foreclosures-families-and-communities>

<sup>17</sup> Mortgages on multifamily buildings typically come due every 5-7 years.

run, be able to avoid cutting back on maintenance by taking smaller profits. Regardless, the falling attractiveness of owning the building is likely to wear on the owner, who will inevitably have to consider cutting operating expenses or selling the building after a drop in its appraised sale value.

While these outcomes could take time to manifest, they are all but inevitable if the RGB guidelines are consistently insufficient to cover increases in operating costs and compensate for the effects of inflation.<sup>18</sup> To be able to properly address this issue the RGB needs an accurate estimate of both increases in operating costs and in inflation. It also needs to carefully monitor actual NOI trends in rent stabilized units and in particular in fully rent stabilized buildings.<sup>19</sup>

### **Getting Commensurates Right**

State law entrusts the RGB to establish annual guidelines for rent adjustments for rent stabilized apartments. To carry out this responsibility, the RGB examines data compiled by its staff (including building level income and expense data from the DOF) as well as testimony from tenants, owners, the City, and other interested parties.<sup>20</sup> As part of this process, the staff generates a set of five “commensurates” which estimate what rent adjustments would hold NOI constant in either nominal or inflation-adjusted terms. As described by the RGB<sup>21</sup>:

Throughout its history, the Rent Guidelines Board has used a formula, known as the commensurate rent adjustment, to help determine annual rent guidelines for rent stabilized apartments. In essence, the ‘commensurate’ combines various data concerning operating costs, revenues and inflation into a single measure to determine how much rents would have to change for net operating income in rent stabilized apartments to remain constant. (Rent Guidelines Board 10)

However, these commensurates have not been fulfilling their intended purpose to provide guidance to the RGB about how to maintain constant NOI. In fact, data showed for the period of 2006 to 2019 that NOI in rent stabilized units was increasing, despite RGB rent increases that were *lower* than what the commensurate guidelines intended to keep NOI level. For example, over this period, the increases allowed by the one-year guidelines trailed in all but one year

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<sup>18</sup> Of course, the government could mitigate any decline by providing operating and capital subsidies.

<sup>19</sup> Also important, but not the subject of this paper, is the funding needed to replace building systems when they wear out or become obsolete, such as plumbing, electrical wiring, and roofs. Investments in these capital improvements are particularly critical to these buildings which, by definition are nearing or exceeding 50 years of age. Funding for these investments is considered separately in the law through rent increases tied to MCIs and IAIs, both of which HSTPA significantly curtailed. It is worth noting here that these rent increases could be replaced by a reformed J-51 property tax abatement and exemption program.

<sup>20</sup> To fulfill its mandate, the RGB’s staff prepare several reports that collectively comprise the annual Housing NYC: Rents, Markets & Trends report. (For the latest annual set of reports, see Rent Guidelines Board, n.d. <https://rentguidelinesboard.cityofnewyork.us/>.) The analyses within this publication fall within three sections: Income and Expense, Income and Affordability, and Housing Supply.

<sup>21</sup> *Explanatory statement - rentguidelinesboard.cityofnewyork.us.* (n.d.). Retrieved April 12, 2022, from <https://rentguidelinesboard.cityofnewyork.us/wp-content/uploads/2021/06/2020-Apt-ES-52.pdf>

(2016) the one-year commensurates that were designed to maintain the real value of NOI (**See Table A1 in the Appendix**).<sup>22</sup> Nevertheless, NOI increased in real terms by 42 percent.<sup>23,24</sup>

The diversion between guidelines, commensurates, and actual NOI trends stems from two data shortcomings. First, the RGB was unable to quantify the impact of rent increases that occurred outside of annual lease renewals, making it impossible to determine what annual rent increase would actually hold NOI constant. Notably, HSTPA has effectively resolved this issue, as these mechanisms have been greatly curtailed or eliminated.

The second and remaining data problem is that information from the DOF the RGB relies upon to analyze trends in income and expense include data not just on rent stabilized units, but also from market-based income and expenses attributed to unregulated residential and commercial units in the same buildings with rent stabilized units. To be in the database the RGB requests from DOF (RGB/DOF Database), a building needs only to have a single rent stabilized unit, and so it includes, for example, units that have been deregulated by exceeding the high-rent/vacancy decontrol or income thresholds allowed pre-HSTPA. As **Figure 1** shows, we estimate that 40 percent of the residential units in pre-1974 buildings that still have at least one rent stabilized unit are buildings that are not fully rent stabilized buildings.<sup>25</sup> Collectively, these buildings hold over 300,000 non-rent-stabilized units.

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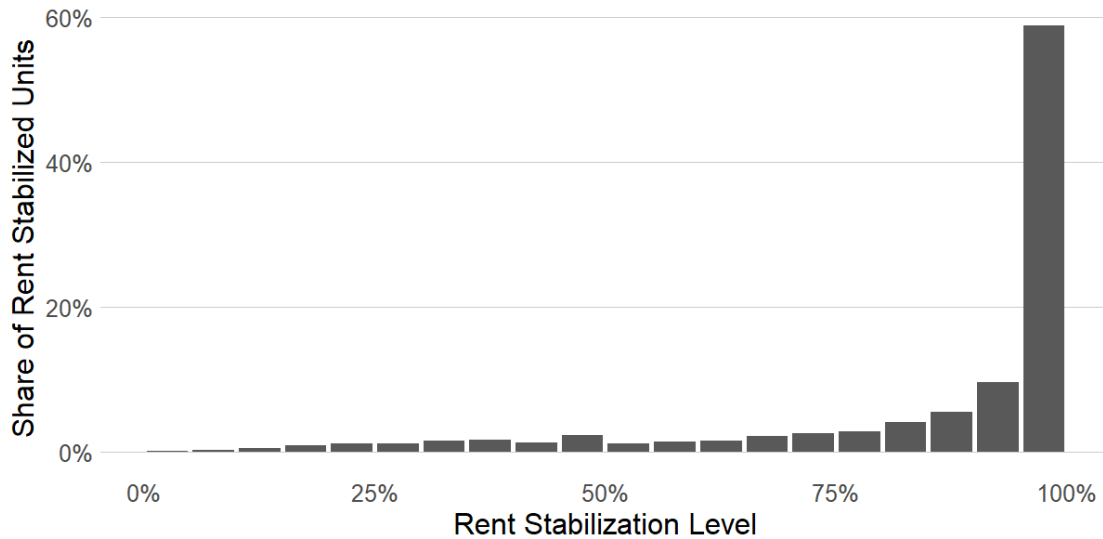
<sup>22</sup> The annual RGB guidelines are issued in June and become effective for leases expiring after October 1<sup>st</sup>, which means that the effects of the increases show up mainly in the following year. Therefore, for this analysis, we compare the actual increases in NOI over the 2006-2019 period (i.e. the base year is 2006) with the cumulative effect of the one-year guidelines and commensurates for the years 2006 through 2018. **See Table A1 in the Appendix** for a comparison of the cumulative increases based on the one-year rent guidelines and the one-year commensurates for each of the five commensurate formulas.

<sup>23</sup> One of the commensurates for one-year leases did fall below the actual one-year guidelines from 2006 to 2019. This outcome resulted from the fact that that commensurate did not adjust for inflation and assumed that income from rent stabilized units was benefiting from the median vacancy turnover rate. The cumulative effect of the one-year guidelines did exceed that of the one-year version of this commensurate, it did so by less than 7% while real NOI increased by 79%.

<sup>24</sup> For the annual trends over the same period of time in average NOI as well average income, rents, operating costs, see **Sidebar Three**.

<sup>25</sup> See the Appendix for details on the methodology used to assess the percent of residential units that were rent stabilized in buildings with at least one rent stabilized unit.

**Figure 1. Distribution of Rent Stabilized Units in Rent Stabilized Properties built before 1974 by Rent Stabilization Levels**



Sources: *DOF Property Tax Bills, scraped by Justfix.nyc, PLUTO, Subsidized Housing Database, NYU Furman Center*

Source: RGB/DOF database, Furman Center

Adding to the disconnect between commensurates and reported changes in NOI that is derived from data the RGB requests from DOF is the inclusion of buildings that were built after 1974, the year New York State instituted rent stabilization. These newly constructed post-1974 rent stabilized apartments were added to the rent stabilized stock as part of state or local government programs (e.g., 421-a, or new City subsidized housing) and their income and expense trends and levels can be very different from those of rent stabilized apartments in pre-1974 buildings.

Given how these data problems served to limit the ability of the RGB to use the commensurates as accurate guides for regulating NOI, it is important that, going forward, the RGB has data specific to rent stabilized units as well as a commensurate that can reliably estimate what level of rent increases would hold NOI constant in real terms.

### **A Commensurate for Long-Run Economic Viability**

Given HSTPA’s restrictions that limit any rent increases in rent stabilized rents outside of RGB’s annual guidelines, the RGB needs a commensurate that preserves affordability as much as possible without triggering the range of negative consequences outlined above. The calculation of that new commensurate simply requires a realistic estimate of increases in operating costs and reliance on the Consumer Price Index (New York-Newark-Jersey City, NY-NJ-PA, all urban consumers) (CPI) to estimate the rate of inflation. With data that only includes buildings that exclusively rely on income from rent stabilized units, it would also be possible to monitor how well the commensurate performs in holding constant, inflation-adjusted NOI.<sup>26</sup>

<sup>26</sup> The RGB can request these data from DOF.

To get a better handle on the growth of building operating costs, we looked to exploit the breakdowns available in the data compiled annually for the RGB by DOF, using the unadjusted filings by owners of their Real Property Income and Expense Reports (RPIEs).<sup>27</sup> These filings are required for all buildings with 11 or more units that have at least one rent stabilized unit. The data from the DOF provide breakdowns at both the citywide and community district (CD) level, and include detail on gross income, residential rental income, and line-item building operating costs.<sup>28</sup> Income includes residential and commercial rent as well as all supplemental operating income generated by services such as laundry, parking, and vending.<sup>29</sup> Operating costs consist of taxes, water and sewer fees, labor, utilities, fuel, insurance, maintenance, administrative, and miscellaneous costs.<sup>30</sup>

The RGB/DOF database allowed us to hone in more narrowly on fully rent stabilized buildings. This helps develop a better understanding of the drivers of increases in owner expenditures for operating rent stabilized units. Although these data do not provide information at the building level, as they are subject to privacy restrictions and so not directly available to the RGB, they do provide summary data at the CD level. With that, we were able to exploit differences across community districts, allowing us to focus specifically on CDs where a high share of the area's rent-stabilized units are located in buildings with a high share of rent-stabilized units. For our analysis, we looked only at the pre-1947 stock<sup>31</sup> and identified the 17 community districts with the highest share of units still in fully rent stabilized buildings. The **Appendix** lists these CDs and explains the methodology used to select these 17 (out of a total of 59 CDs across the city).

For our analysis of year-over-year changes in operating costs (Total Operating Costs), the data also allowed us to separately analyze those components that are driven primarily by government levy (property taxes and water and sewer fees) which we refer to as "Government-Driven Operating Costs", and those we refer to as "Market-Driven Operating Costs" (consisting of labor, fuel, utilities, maintenance, administration, and insurance).

Focusing on the narrower set of 17 CDs we examined the trends over time of average Total Operating Costs and Market-Driven Operating Costs for pre-1947 buildings in the RGB/DOF

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<sup>27</sup> Following the 1986 enactment of Local Law 63, owners of rent stabilized units grossing \$40,000, or more, annually are required to report detailed property revenue and expenses. The law carves out several exceptions to the RPIE filing mandate, including condominiums, cooperatives, and residential properties with fewer than 11 units. Tax Commission Income & Expense (TCIE) forms are used when an owner files a TCIE form to make a claim that their property was incorrectly assessed or improperly denied an exemption from real property tax.

<sup>28</sup> To address outliers, the RGB excludes buildings in which operating costs exceed income by more than 300% as well as buildings above the 99<sup>th</sup> percentile or below the 1<sup>st</sup> percentile from the dataset.

<sup>29</sup> The RGB uses NYS Homes and Community Renewal (HCR) rental data as a check on the accuracy of the RPIE reporting.

<sup>30</sup> Owners are not required to report tax expenses, rather DOF supplements owner reporting on the other expenses with its internal property tax calculations. "Housing NYC: Rents, Markets & Trends 2020." NYC Rent Guidelines Board, 2020. <https://rentguidelinesboard.cityofnewyork.us/wp-content/uploads/2021/01/Housing-NYC-2020.pdf>.

<sup>31</sup> The RGB/DOF database provided separate data for the pre-1947 and post-1946 rent stabilized stock. By relying on the former, we were able to exclude any of the buildings that became rent stabilized after the legislation was enacted in 1974, such as those newly built but rent stabilized under the 421-a property tax exemption program.

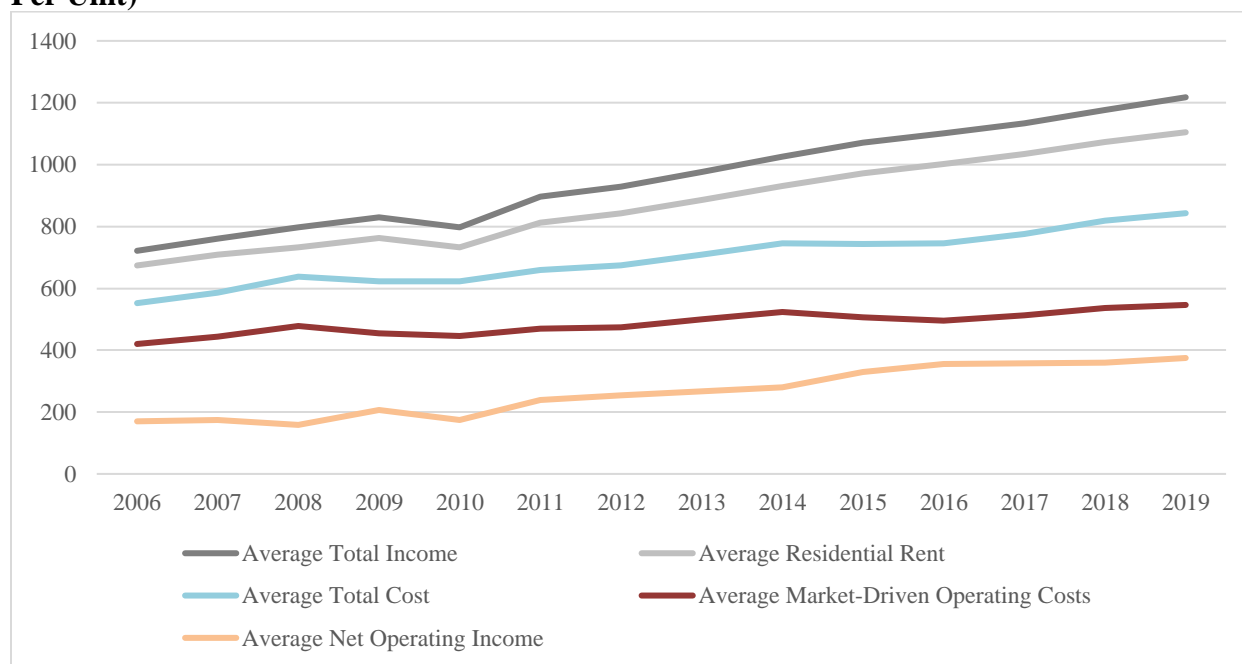


database.<sup>32</sup> This historical data drawn from owners’ unadjusted RPIE filings<sup>33</sup> provided us with a direct look at how these operating costs actually changed over time.

*CPI Increases Correlate with Increases in Market-Driven Operating Costs*

Figure 2 shows that for the 17 CDs with the highest share of rent stabilized units in fully rent stabilized buildings, the average Total Operating Costs (Average Total Cost) and average Market-Driven Operating Costs (per unit) both increased over the 2006-2019 period in nominal dollars.<sup>34</sup> To our surprise, when we took into account the rate of inflation for this region, we saw no significant upward trend in real terms, although there was some year-to-year volatility (see **Figure 3**). Our interpretation of these data is that Market-Driven Operating Costs stayed relatively constant in real terms over that period, indicating that owners found ways to maintain their buildings while keeping their overall, market-driven expenditures in line with changes in the CPI.

**Figure 2: Past Trends, Selected 17 CDs, Pre-1947 buildings, 2006-2019 (Nominal Dollars, Per Unit)**



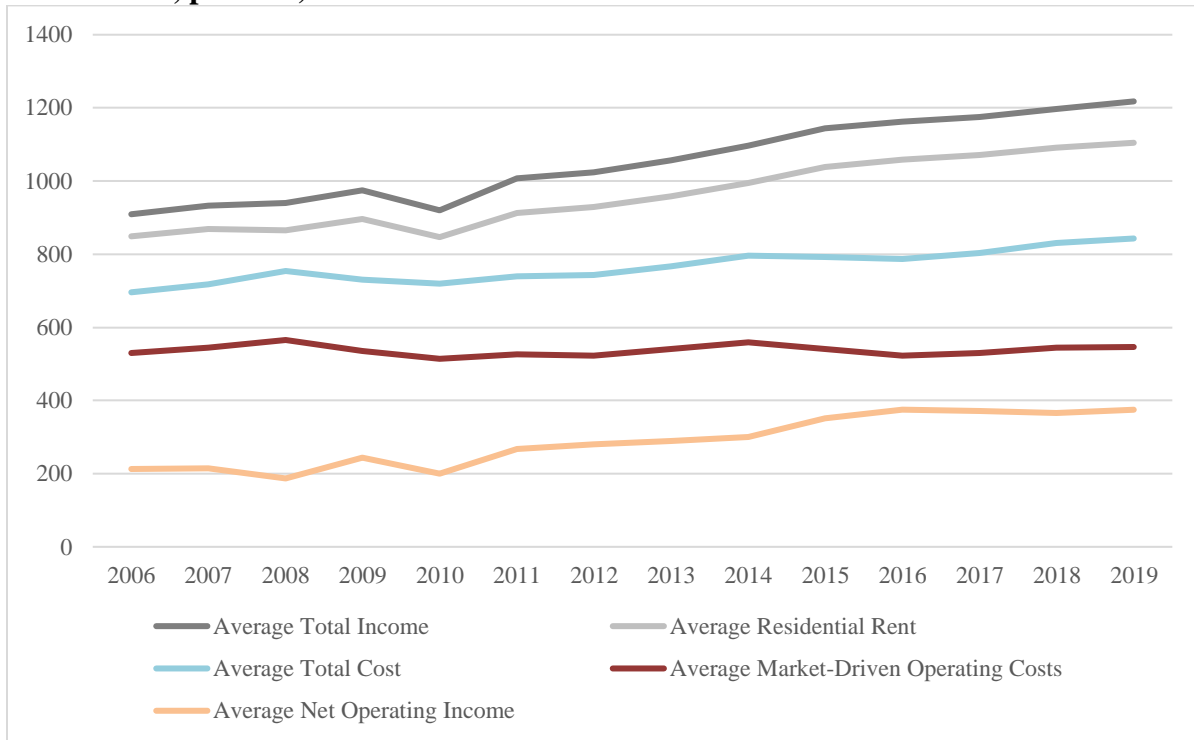
Source: RGB Data, Furman Center

<sup>32</sup> Average per unit Market-Driven Operating Costs were similar across the 17 CDs. For pre-1947 rent stabilized buildings in the RGB/DOF database, they range from \$484.08 to \$585.23 with an average of \$546.25. The citywide average across all CDs is higher at \$624.50.

<sup>33</sup> While there is concern that owners may, for example, overstate their expenses on their RPIEs, the benefit of doing so appears limited as DOF does validity checks and adjusts them as part of determining a building’s market value. While the RGB uses the numbers in the actual RPIE filings, exaggerations by a limited number of owners are unlikely to have much, if any, effect on the averages. Moreover, as noted above RGB does separately removes extreme data points.

<sup>34</sup> The averages here are from the data provided by DOF to RGB and differ somewhat from those published by RGB in their annual Income & Expense reports. RGB reweighs DOF data to align them with HVS data on the geographic distribution of the rent stabilized housing portfolio within the following categories: pre-war, post-war, core Manhattan, upper Manhattan, and by borough. For more information on the HVS data, see “New York City Housing and Vacancy Survey (NYCHVS).”United States Census Bureau, n.d. <https://www.census.gov/programs-surveys/nychvs.html>. See **Sidebar Three** for the corresponding citywide data.

**FIGURE 3: Past Trends, Selected 17 CDs, Pre-1947 buildings, 2006-2019 (CPI-Adjusted to 2019 dollars, per unit)**



Source: RGB Data, Furman Center

The fact that Market-Driven Operating Costs (the red line) moved in concert with the region’s CPI raises the possibility that CPI increases may offer the RGB a convenient proxy for estimating actual increases in expenses in rent stabilized units. Such a proxy could provide an up-to-date estimate (and has the added benefit of simplifying the calculation of the inflation-adjusted commensurate as discussed in the section below on adapting to HSTPA).

As a next step DOF should test the validity of our finding by taking advantage of its unique position as the only institution that has all the data needed to isolate what has happened in non-subsidized, fully rent-stabilized buildings. Assuming DOF’s analysis confirms this relationship, the RGB could reasonably rely on the CPI as a proxy for changes in Market-Driven Operating Costs in setting the annual rent guidelines.

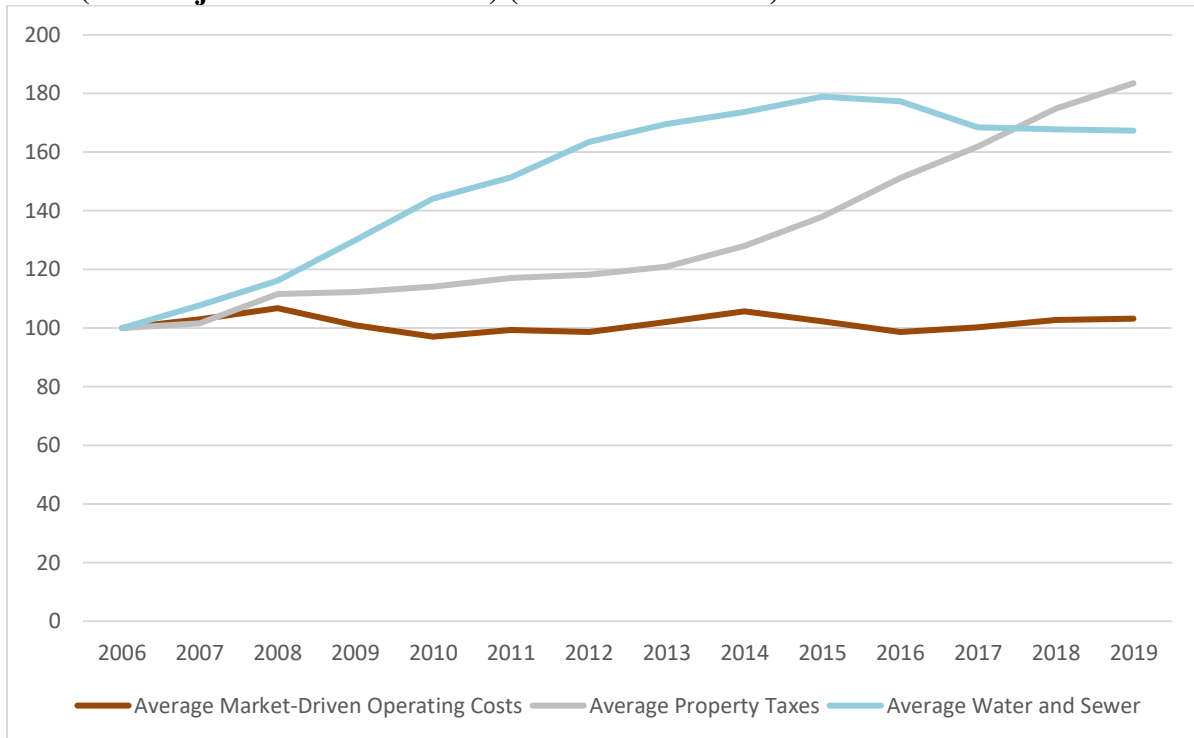
#### *A Separate Look at Government-Driven Operating Costs*

Unlike Market-Driven Operating Costs, Government-Driven Operating Costs increased in real terms (see Figure 4). Adjusted for inflation, average property tax payments increased 83.5 percent between 2006 and 2019, while those for water and sewer increased 67.3 percent. As discussed before, given the relationship between NOI and the market value of a property, the

increase of property taxes reflects real increases in NOI, the result of the inclusion of market-rate units as well as the ability of owners to increase rents over and above the guidelines.<sup>35</sup>

Real NOI increased during this same period by 75.7 percent. Over the same period, the property tax rate for these properties (Class II) increased only by 1.7 percent, indicating the importance reported NOI has on market valuations done for property tax purposes.<sup>36</sup> Adjusting for the increase in the tax rate, the increase in average property taxes pretty much aligns with the increase in NOI.<sup>37</sup>

**Figure 4: Index of Real Cost Components to Describe Trends of Market-Driven Operating Costs vs. Government-Driven Operating Costs, Selected 17 CDs, Pre-1947 buildings, 2006-2019 (CPI-Adjusted to 2019 dollars) (Index=100 in 2006)**



Source: RGB Data, Furman Center

With real NOI kept constant, property taxes on buildings with rent stabilized units could be expected to similarly remain level in real terms. Property tax bills accordingly would only rise at the rate of inflation (plus any change in the tax rate). With rents and NOI rising at the rate of inflation, owners of rent stabilized units would have the ability to pay property taxes without having to offset that increased liability in other ways.<sup>38</sup> No additional adjustment would need to

<sup>35</sup> The cap rate, which determines the relationship between NOI and market values, can vary over time based on the interest-rate environment and market conditions.

<sup>36</sup> Property tax rates apply to fiscal years which start on July 1. This calculation compared the tax rates for fiscal years 2006 and 2019.

<sup>37</sup> Year-to-year changes in property tax bills also reflect a 5-year phasing in of changes in actual assessed values.

<sup>38</sup> Again, DOF is best positioned to confirm this relationship between NOI and assessed values, and in particular, when assessed values (once fully phased in) might rise at a faster rate than NOI.

be incorporated into the annual rent guidelines to compensate for any increases in property taxes, unless there are significant changes in the tax rate.

As noted above, water and sewer fees have increased faster than inflation. The growth in these fees do not appear to be tied to property values or other building operating costs. Therefore, it may be necessary for the RGB to provide for a separate adjustment of rents to cover any increases in the fees that would be more than the rate of inflation.

### **Implications For the RGB's Rent Setting Process**

With HSTPA making the guidelines even more critical to the long-term economic viability of the rent stabilized portfolio, the RGB needs to focus on the economics of rent-stabilized units, rather than on what is happening in the universe of buildings that contain as few as one rent-stabilized unit. Such a focus is necessary, especially post-HSTPA, and practical. With a commensurate on which it can rely and the data to validate that commensurate it should be possible for the RGB to hold the NOI generated by rent stabilized units constant in real terms. Data from DOF on fully rent stabilized buildings would allow the RGB to annually monitor the need for any additional rent adjustments to account for prior misalignments between operating expense movements and inflation.

Eliminating from consideration data that includes income and expenses of non-rent stabilized units could also help hold down guideline increases, thereby promoting affordability during periods when market rents fall or rise less rapidly than inflation. While it may have been fortunate to have non-rent-stabilized rents rising faster than operating costs or inflation, the opposite could be true in the future, as there is no guarantee that market-rate residential or commercial rents will continue rising so relatively fast in the future. In fact, it now seems quite possible that those rents could even decline in real, if not nominal, terms. In such cases, relying on changes in the average NOI (as shown in the current DOF data the RGB uses) may suggest the need for higher rent increases than would the movement of NOI of rent-stabilized units alone. Such a situation could now exist as the RGB's most recent income and expense report has shown average total income falling at a higher rate than average rental income (-4.6% total income vs. -3.8% rental income).<sup>39</sup> There is no guarantee that market-rate residential and commercial rents will continue rising so fast in the future, and could also decline in real, if not nominal, terms.

To keep rent increases for rent-stabilized units to a minimum while holding NOI constant in real terms the RGB could rely upon the new commensurate in two ways.

1. **Make the new commensurate the starting point for the RGB's deliberations to set the annual rent guidelines.**

This approach would be to continue with the RGB's annual deliberations to balance affordability and the long-term economic viability of rent stabilized units. In this case the RGB would start with a strong presumption that the new commensurate be the basis for setting the guidelines. Deviations from the commensurate would be limited. For example, setting a higher guideline

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<sup>39</sup> <https://rentguidelinesboard.cityofnewyork.us/wp-content/uploads/2022/03/2022-IE-Study.pdf>

would only be allowed if the data showed NOI falling in real terms. Setting a lower guideline would be allowed only if data showed NOI rising in real terms, or in unusual circumstances where, for example, it seems prudent to protect tenants in the very short-term from a sudden and unexpected increase in rents. Even in this latter case, the RGB will have to weigh the impact of a sharp increase in rents on tenants whose incomes might be slower to adjust to inflation against the impact on landlords immediately confronted with higher operating costs. A good example of this type of event might be the sudden and steep jump in inflation during this pandemic period. The most recent (March) 12 month trailing CPI amounted to 5.1 percent, up from 1.3 percent in 2019.<sup>40</sup>

**2. The new commensurate becomes the one-year guideline with the RGB monitoring how well CPI has tracked actual increases in operating costs and periodically evaluating whether adjustments are needed.**

This second approach would be simply to rely in most years on the CPI for determining the annual increases. While the relationship between increases in CPI and increases in operating costs may exhibit some year-to-year variability, our analysis suggests a stable relationship over time. As a check against changes in this relationship (and the relationship to property taxes), the RGB would periodically convene to review trends and see if additional adjustments are needed. Such reviews could be done every so often—perhaps every five years—to prevent any systemic misalignment between CPI growth and expense increases from growing into long-term problems. This type of “automatic” system might be more credible to tenants and owners. It may also produce guidelines that, over the long-run, minimize rent increases without triggering a decline in housing quality, as well as any other negative consequences to New York City’s renters, building owners, and more broadly to New York City’s neighborhoods and tax base.

## **Conclusion**

In 2019, HSTPA imposed stronger protections to provide additional stability for renters living in rent stabilized apartments. Key to this were provisions that greatly limited building owners’ ability to raise the rents of rent stabilized units beyond what RGB’s annual guidelines allow. This change requires the RGB to look hard at how it carries out its mandate to weigh both affordability and the long-term quality and sustainability of the rent stabilized portfolio in setting the annual guidelines. The RGB is now the primary, if not sole driver of the income owners can realize from stabilized units. Contrary to the pre-HSTPA period, when net operating income consistently increased even when the guidelines fell short of the commensurates, the RGB needs to be concerned not just about setting the guidelines higher than necessary, but also about setting them so low that it could jeopardize the short and long run economic viability of the stock. This action would have long-term negative repercussions for tenants, the City’s revenue raising ability, and building owners.

As the RGB begins its deliberations for setting the 2022 guidelines, it needs to consider both the affordability and the long-term sustainability of the rent stabilized stock as the HSPTA era begins to be reflected in its reports. It can create the tools to do so by tracking data on fully rent stabilized buildings and adopting a new commensurate that accounts for increases in operating

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<sup>40</sup> [https://www.bls.gov/regions/new-york-new-jersey/news-release/consumerpriceindex\\_newyorkarea.htm](https://www.bls.gov/regions/new-york-new-jersey/news-release/consumerpriceindex_newyorkarea.htm)

costs as well as overall inflation. This brief lays out a way for the RGB to develop and be able to rely on that new commensurate. The urgency to adapt its decision-making to this new reality has been made even more evident by data recently released by the RGB showing a 7.8 percent decline in NOI between 2019 and 2020, even before taking inflation into account.<sup>41</sup> Given the importance of the rent stabilized stock not just to current, but also future generations, the RGB needs to keep the long-term economic viability of this housing clearly in focus. To do so, the RGB needs a new commensurate that reliably estimates impact on NOI and data that allows it to monitor any movements over time of NOI in rent stabilized units. For adapting to HSTPA we show how the RGB can have a commensurate and data on which it can rely, and we offer two ways to implement that new commensurate.

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<sup>41</sup> <https://rentguidelinesboard.cityofnewyork.us/wp-content/uploads/2022/03/2022-IE-Study.pdf>

## APPENDIX

**Table A1**

**Comparison of the Cumulative Percentage Increases Implied by the One-Year Rent Guidelines and the One-Year Commensurates for Each of the Five Commensurates over the Period from 2006 through 2019.**

Rent Increase Based on One-Year Guidelines	Traditional, One-Year Commensurate Adjustments	Net Revenue One-Year Commensurate Adjustments with Vacancy Increase	Net Revenue, One-Year Commensurate Adjustments without Vacancy Increase	CPI-Adjusted NOI Commensurate Adjustments with Vacancy Increase	CPI-Adjusted NOI Commensurate Adjustments without Vacancy Increase
35.00%	47.58%	28.25%	57.93%	43.71%	79.57%

Source: RGB One-Year Guidelines Effective on leases expiring starting October 1 for the years 2006 through 2018 and the One-Year Commensurates Published in Housing NY, Rents, Markets & Trends for the years 2006-2019

Note: To correspond with the data on operating costs from 2006 to 2019, we compared the cumulative effect of the one-year guidelines issued starting with the increases allowed in 2006 (but which applied to leases expiring after September 30 of 2006 and before October 1 of 2007) through the guidelines issued in 2018 (which applied to leases expiring after September 30 of 2018 and before October 1 of 2019).

## DATA AND METHODOLOGY

### Data

*Data DOF compiled from Real Property Income Expense (RPIE) filings and provided to the Rent Guidelines Board (the RGB shared with us these compiled data).*

The data RGB uses to produce its Income and Expense (I&E) report are compiled by DOF based on the RPIE filings by owners of residential buildings that include at least one rent stabilized unit and have 11 or more units.<sup>42</sup> The data are made available annually to the RGB in spreadsheets which the RGB was able to share with us and which were produced with comparable data in a consistent format for the years 2006 through 2019. DOF data are aggregated at the citywide level and also at the Community District (CD) level and provide information on average total income, average residential rental income, and total operating costs broken down into nine components.<sup>43</sup> The data also distinguishes between properties built pre-1947 (“pre-war”) and post-1946 (“post-war”) and between three property sizes (11-19 units, 20-99 units, 100 and more units, and total).

The data set also includes the number of dwelling units for each observation<sup>44</sup> which allowed us to merge the data from a subset of the CDs by weighting each of the observations at the CD level by the relative number of residential units, respectively, in each of the CDs. In some years, at the CD level, period built and property size observation might have a missing value for number of dwelling units; in those cases we use the prior or next year’s number of dwelling units as a proxy for weighting purposes.

*Data compiled by the NYU Furman Center for NYC buildings with at least one rent-stabilized unit.*

To understand the distribution of rent stabilized rental stock in each CD (see below), the NYU Furman Center created a list of residential buildings with and without rent stabilized units and not regulated or restricted by other affordable housing programs, nor public housing programs, such as New York City Housing Authority (NYCHA) developments, active 421-a or J-51 properties, Low Income Housing Tax Credit Properties (LIHTC), Department of Housing and Urban Development-assisted (HUD assisted) properties, Mitchell-Lama properties (both active and opted-out), and other smaller affordable housing programs. The rent stabilization information, the location of the property, and the total number of housing units comes from the DOF property tax bills in 2018 and 2019, scraped by JustFix.nyc. We excluded properties built after 2018 due to a lack of available data concerning their rent stabilization status. We merged that information with additional property physical characteristics, such as commercial floor area and year built, from the New York City Department of City Planning’s (DCP) 2021 PLUTO dataset. All rent stabilized rental stock indicators were computed at the CD-level to align with the geography used in I&E data.

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<sup>42</sup> DOF website: “Owners of income-producing properties with an actual assessed value of more than \$40,000 on the tentative assessment roll must file a Real Property Income and Expense Statement or a claim of exclusion.”

<sup>43</sup> Taxes, water & sewer, labor, utilities, fuel, insurance, maintenance, administrative, and miscellaneous costs.

<sup>44</sup> “Observations” technically are properties which sometimes contain more than one building. For purposes of this brief, we use the words “property” and “building” interchangeably.



In buildings of six or more residential units in each CD we relied on the New York City DOF Property Tax System (PTS) 2021 data and 2020 data from NYCHA. We exclude the properties with less than 6 units, coops, and condos to match with the characteristics of the RGB/DOF database. By extracting the NYCHA units from the total estimated rental units using PTS, we derived an estimate of the number of private rental units.

Combining the information from the data sources above, we are able to further study the CDs for the composition of rent stabilized stock by property year built, property rent stabilized level, and the existence of commercial space.

### *Methodology for Identifying the 17 Community Districts with the Highest Shares of Rent Stabilized Units in Fully Rent Stabilized Buildings.*

To get a better handle on the growth of expenditures on building operations for just rent stabilized units, we wanted to look just at fully rent stabilized buildings, i.e., those buildings without market rate residential units. While the RGB/DOF database did not allow us to isolate the data on buildings which are fully stabilized, it did allow us to narrow down the number of CDs we analyzed according to the degree to which their rent stabilized units were in fully rent stabilized buildings. To select the CDs for further analysis we used our Furman Center data to create a database of the buildings that met the same criteria as used for inclusion in the RGB/DOF database.

For this analysis we also pared down the RGB/DOF Database and the Furman Center databases to buildings built before 1947. This winnowing allowed us to focus on buildings that were rent stabilized in 1974 and to eliminate from the datasets post-1974 buildings that were subject to rent stabilization under property tax exemption programs such as the city's 421-a property tax exemption program or under an affordable housing program that would also be subject to a regulatory agreement. The restriction to pre-1947 buildings still captures about 65 percent of the current rent stabilized stock.

As for the degree to which rent stabilized units continue to be in fully rent stabilized buildings,<sup>45</sup> **Figure A1** shows the distribution of rent stabilized units in buildings categorized according to the percent of residential units in the building that are rent stabilized regardless of the year built. The figure shows that a significant percent of the units (nearly 35 percent) are in buildings where 95-100 percent of the units are rent stabilized with a higher percentage for just pre-1947 buildings. **Figure A2** shows the distribution of buildings according to the percent of their units that are rent stabilized. Here again we see the continuing prevalence of buildings that have no market rate residential units. In terms of building, fully rent stabilized buildings account for well over 50 percent of the buildings with at least one rent stabilized unit.

### *Ranking CDs according to the percent of units in fully rent stabilized buildings.*

To hone in on the trends in operating costs of rent stabilized units, we used the NYU Furman Center database of pre-1947 buildings to rank CDs according to the share of rent stabilized units

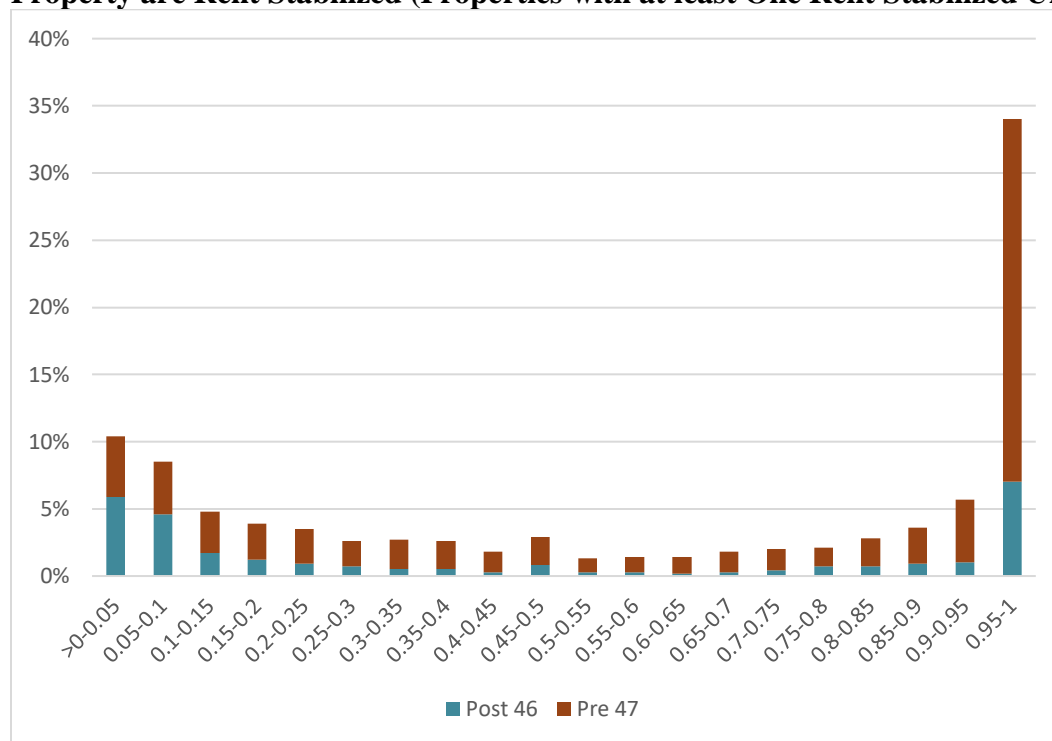
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<sup>45</sup> To account for management/super units, we consider buildings to be fully rent stabilized if at least 95-100 percent of the units were rent-stabilized.

that were in fully rent stabilized buildings. We developed two rankings: The first included in the numerator only those residential units which were in fully rent stabilized buildings that also did not have commercial space. The second included in the numerator all units in fully rent stabilized buildings regardless of the existence of commercial space. To make sure we included CDs with a share of units in fully rent stabilized buildings that did not contain commercial space, we took the highest nine from the first ranking and looked where each of them fell on the second ranking. Comparing the two lists, we found that all nine were in the top 17 of the second ranking and those are the 17 CDs (just under 30% of the CDs) we choose for our analysis of the trends in operating expenditures in the RGB/DOF database.<sup>46</sup> (See Table A3 for the 17 CDs)

None of the 17 were high on a ranking by average residential rents (note that this average included the rents for all residential units in buildings with as few as one rent stabilized unit.) Nine of the 17 were in the Bronx, six in Brooklyn, one each in Queens and Staten Island; none were in Manhattan. Most of the 17 ranked high in the share of residential units in Furman Center database that are rent stabilized. The weighted average operating costs for the 17 CDs was \$546.26 per month in 2019. (Table A2 provides data for each of the CDs on the share of rent stabilized units out of the overall private, non-subsidized rental stock, the share of rent stabilized units located in fully rent stabilized properties without commercial space built pre-1947 out of all rent stabilized units, and the share of rent stabilized units located in fully rent stabilized properties built pre-1947 out of all rent stabilized units.)

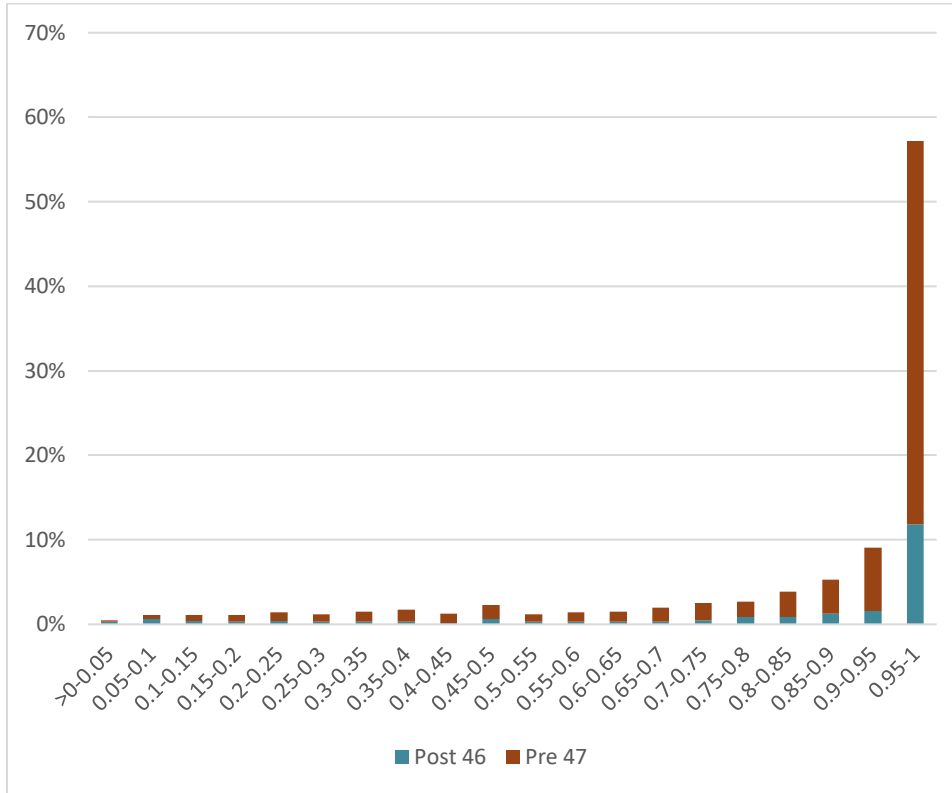
**FIGURE A1: Distribution of Units by the Degree to which the Residential Units in a Property are Rent Stabilized (Properties with at least One Rent Stabilized Units)**



Source: RGB Data

<sup>46</sup> Of the top nine in the first ranking, Flatbush/Midwood with the lowest ranking in the second ranking (17<sup>th</sup>) established the cut-off point for our sub-set of CDs.)

**Figure A2: Distribution of Properties by the Degree to which the Residential Units in a Property are Rent Stabilized (Properties with at least One Rent Stabilized Units)**



Source: RGB Data

**Table A2: Share of Rent Stabilized Units in Fully Rent Stabilized Buildings and the Rent-Stabilized Share of the Total Units in the Private, Non-Subsidized Rental Stock by CD**

CD	Share of rent stabilized units out of overall private, non-subsidized rental stock in a CD	Share of rent stabilized units located in fully rent stabilized properties built pre 47 out of all rent stabilized units in a CD	Share of rent stabilized units located in fully rent stabilized properties without commercial units built pre 47 out of all rent stabilized units in a CD
101 - Financial District	11.7%	0.7%	0.0%
102 - Greenwich Village/Soho	27.3%	10.6%	1.3%
103 - Lower East Side/Chinatown	35.5%	21.8%	3.4%
104 - Clinton/Chelsea	32.9%	19.8%	8.8%
105 - Midtown	12.6%	8.4%	2.2%

106 - Stuyvesant Town/Turtle Bay	20.0%	5.0%	2.3%
107 - Upper West Side	30.0%	8.9%	7.0%
108 - Upper East Side	24.2%	13.0%	8.8%
109 - Morningside Heights/Hamilton	47.8%	28.8%	19.4%
110 - Central Harlem	50.6%	32.4%	20.8%
111 - East Harlem	43.3%	43.7%	19.6%
112 - Washington Heights/Inwood	77.4%	41.1%	27.0%
201 - Mott Haven/Melrose	62.5%	67.5%	36.5%
202 - Hunts Point/Longwood	61.5%	71.4%	33.9%
203 - Morrisania/Crotona	44.5%	65.0%	38.3%
204 - Highbridge/Concourse	80.7%	75.0%	50.1%
205 - Fordham/University Heights	83.4%	77.3%	59.2%
206 - Belmont/East Tremont	62.6%	71.9%	50.1%
207 - Kingsbridge Heights/Bedford	88.8%	76.5%	60.2%
208 - Riverdale/Fieldston	77.3%	56.4%	42.8%
209 - Parkchester/Soundview	78.3%	72.6%	51.2%
210 - Throgs Neck/Co-op City	79.8%	52.6%	38.1%
211 - Morris Park/Bronxdale	83.6%	52.7%	41.7%
212 - Williamsbridge/Baychester	79.0%	70.0%	55.3%
301 - Greenpoint/Williamsburg	41.2%	49.5%	37.5%
302 - Fort Greene/Brooklyn Heights	30.8%	25.8%	20.3%
303 - Bedford Stuyvesant	35.4%	61.0%	48.2%
304 - Bushwick	41.3%	67.4%	63.2%

305 - East New York/Starrett City	59.2%	77.3%	60.1%
306 - Park Slope/Carroll Gardens	33.5%	32.9%	24.2%
307 - Sunset Park	60.1%	64.9%	50.8%
308 - Crown Heights/Prospect Heights	52.8%	56.0%	46.3%
309 - South Crown Heights/Lefferts Gardens	80.1%	65.0%	52.0%
310 - Bay Ridge/Dyker Heights	76.2%	61.7%	44.9%
311 - Bensonhurst	81.9%	60.9%	52.7%
312 - Borough Park	75.3%	67.2%	55.3%
313 - Coney Island	82.6%	47.0%	41.3%
314 - Flatbush/Midwood	85.0%	63.3%	59.8%
315 - Sheepshead Bay	87.1%	37.6%	33.4%
316 - Brownsville	37.8%	74.8%	57.2%
317 - East Flatbush	79.3%	62.1%	52.1%
318 - Flatlands/Canarsie	91.9%	40.6%	35.0%
401 - Astoria	67.2%	47.0%	43.5%
402 - Woodside/Sunnyside	55.7%	43.9%	39.0%
403 - Jackson Heights	82.8%	45.4%	36.6%
404 - Elmhurst/Corona	83.5%	16.7%	14.5%
405 - Ridgewood/Maspeth	71.4%	74.7%	70.7%
406 - Rego Park/Forest Hills	68.6%	17.3%	4.6%
407 - Flushing/Whitestone	75.3%	23.4%	7.9%
408 - Hillcrest/Fresh Meadows	73.9%	5.3%	4.1%
409 - Kew Gardens/Woodhaven	73.4%	46.8%	45.4%

410 - South Ozone Park/Howard Beach	38.7%	47.8%	47.8%
411 - Bayside/Little Neck	65.1%	11.1%	11.1%
412 - Jamaica/Hollis	67.9%	33.4%	32.9%
413 - Queens Village	82.5%	11.9%	11.9%
414 - Rockaway/Broad Channel	62.0%	12.1%	11.4%
501 - St. George/Stapleton	63.2%	27.6%	17.5%
502 - South Beach/Willowbrook	39.6%	7.7%	7.7%
503 - Tottenville/Great Kills	77.5%	0.0%	0.0%

Source: Furman Center Data

### TABLE A3

The 17 CDs with the highest shares of rent stabilized units in rent stabilized buildings:

BX05 (205) - Fordham/University Heights  
 BK05 (305) - East New York/Starrett City  
 BX07 (205) - Kingsbridge Heights/Bedford  
 BX04 (205) - Highbridge/Concourse  
 BK16 (305) - Brownsville  
 QN05 (405) - Ridgewood/Maspeth  
 BX09 (209) - Parkchester/Soundview  
 BX06 (206) - Belmont/East Tremont  
 BX02 (202) - Hunts Point/Longwood  
 BX12 (212) - Williamsbridge/Baychester  
 BX01 (201) - Mott Haven/Melrose  
 BK04 (304) - Bushwick  
 BK12 (312) - Borough Park  
 BK09 (309) - South Crown Heights/Lefferts Gardens  
 BX03 (203) - Morrisania/Crotona  
 BK07 (307) - Sunset Park  
 BK14 (314) - Flatbush/Midwood

## **Sidebar One**

### **The HSTPA Rent Constraint**

HSTPA has imposed a dramatically tighter regulatory regime. HSTPA eliminated or substantially restricted previously existing avenues for building owners who own rent stabilized units to increase their revenues by raising rents on those units, including the elimination of vacancy allowances, which had allowed rents to rise by up to 20 percent upon a unit's turnover, the elimination of an owner's ability to raise what are called preferential rents (rents set below the maximum rent allowed for the unit) to the full amount allowed by the rent stabilization law for existing tenants at the time of lease renewal, and greatly diminished the attractiveness of using Major Capital Improvements (MCIs) and Individual Apartment Improvements (IAIs). Furthermore, it eliminated the possibility for owners to enhance their revenues by decontrolling individual rent stabilized units allowing the rents in those units rise to market levels.<sup>47</sup> As market rate units replaced rent stabilized units, not only did the owner benefit from the one-time change in the status of the unit, but overall revenue from a building became increasingly driven by market forces and not just by the RGB guidelines. All of these changes took away most, if not all, of the chances for owners to promote tenant turnover simply to raise rents.

While HSTPA did not eliminate the ability of building owners to raise rents to help cover the costs of capital improvements, it greatly diminished both the size and duration of the allowed rent increases and excluded buildings with 35 percent or fewer residential units that are rent stabilized from eligibility (**see Chart S1**). Supporters of these changes were concerned about both fraud and the attractiveness of MCIs and IAIs for owners to undertake improvements solely to drive up their bottom lines.<sup>48</sup> In the HSTPA era, MCIs and IAIs do still lead to rent increases, albeit smaller in size than were allowed before HSTPA. Such rent increases could be further reduced or even eliminated if the government were to provide more help with capital repairs by increasing the availability or tax abatements and exemptions under a reformed J-51 program.<sup>49</sup>

As rent regulation is presently structured, the rules allowing rent increases for MCIs and IAIs are important tools for owners to fund needed capital improvements. These investments generally require upfront cash which can be raised in the form of additional equity and/or debt, both of which need to be paid back over time along with interest. Equity requires compensation for the "opportunity cost" foregone by devoting money to this use as opposed to what could be earned on other investment opportunities. Borrowed money incurs fees, interest costs, and amortization of the principal. Another on-going cost of a capital investment could come from an increase in property taxes if the investment itself or the increase in NOI triggers an increase in a property's assessed value.

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<sup>47</sup> The Rent Reform Act of 1993 permitted both high-rent vacancy deregulation and high-rent high-income deregulation. HSTPA eliminated both of these options. As reported in Housing NYC: Rents, Markets & Trends 2019, since 1994 a total of 160,292 units had been deregulated through high-rent vacancy deregulation and 6,455 through high-rent high-income deregulation. <https://rentguidelinesboard.cityofnewyork.us/wp-content/uploads/2020/08/Housing-NYC-2019.pdf>, p.145.

<sup>48</sup> Building owners have expressed concerns that the new rules are not even adequate to compensate for the cost of making needed capital improvements.

<sup>49</sup> If properly reformed, the J-51 property tax abatement and exemption program could obviate the need for MCI/IAI rent increases by reducing property taxes sufficiently to offset the full costs (including financing) of making the improvements. By replacing MCI and IAI rent increases with J-51 tax reductions, tenants would not need to be concerned that MCIs or IAIs were being used to unnecessarily raise their rents.

Looking more closely at the economics for funding the cost of a capital improvement with debt, an owner would, if possible, do best by adding it on to an existing mortgage at the time of a regular refinancing—generally done every 5-7 years.<sup>50</sup> Among debt options, mortgage financing is likely to offer the lowest interest cost and allow for a 30-year amortization of the outstanding principal—comparable to the length of time that the rent increase stays in effect. Borrowing the full cost of the capital improvement may not be possible if, however, the owner has already maximized the size of the mortgage a bank will approve based on LTV or DSCR. The bank will likely reject a request to increase the principal of the mortgage unless the capital improvement lowers operating costs. For instance, if the capital improvement is a more efficient boiler, then the investment itself could expand the borrowing potential based on DSCR.

If the building's finances can support an increase in the mortgage, the economics are, nonetheless, tight. HSTPA limits the size of an MCI rent increase to 1/150<sup>th</sup> of the cost of the improvement and imposes a 2 percent ceiling on increases in any one year. Even without the 2 percent ceiling, recouping the cost of an MCI via rent would take 12.5 years (significantly longer than the pre-HSTPA timeline of 9.0 years). Were the owner able to fully fund the capital improvement through an increase in a 30-year, fixed rate mortgage, the cash flow from the rent increase will only be sufficient to cover a mortgage with an interest rate that does not exceed 7 percent, meaning that debt service on a 30-year, self-amortizing mortgage with a rate higher than 7 percent would exceed the funds generated by the allowed rent increase.

If the value of a building is insufficient to support an increase in the mortgage that would cover the full cost of a capital improvement, and the building itself does not have sufficient reserves, the owner will need to source additional funding out of pocket or from other investors. As noted above, this equity has an "opportunity cost" which, in today's capital markets, is likely to exceed double digits in percentage point terms. In this case the combined cost of debt and equity now must meet the same 30-year, 7 percent test to be covered by the rent increases. With equity costing more than 7 percent, debt funding would have to be less than that for the blending rate to come in below 7 percent, before it would provide additional equity back to the owner in the form of cash.

Further dampening any ideas an owner may have for using MCIs to improve a building's cash flow are the uncertainties regarding timing and the vagaries of the approval process of the State's Homes and Community Renewal agency (HCR). The agency takes months to process applications, rejects a significant portion of the applications, and often approves a fraction of costs. Recent data from HCR showed that it took 21 months to process the majority of the applications (compare to 12 months in the prior year), 46 percent of the applications were at least initially rejected for a number of technical reasons (compare to 50 percent in the prior year), and of the applications approved, HCR granted 61 percent of the original dollar amounts requested (compare to 46 percent the prior year).

The combination of the tight financial considerations and the HCR process limits the attractiveness of using MCIs. Determining whether to make that investment would, it seems, be

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<sup>50</sup> Multifamily mortgages are generally for 5-7 years at which time they need to be refinanced. Repayment of the principal may be based on an amortization schedule as long as 30-year years.



simply a function of how necessary the investment is and the degree to which the investment might pay for itself by yielding a comparable reduction in the costs of maintaining and operating the building.

As for IAIs, the economics are even less favorable than those for MCIs. HSTPA limits the monthly rent increase to recoup IAIs to 1/180<sup>th</sup> (1/168<sup>th</sup> for buildings with less than 35 units) of the number of eligible investments. HSTPA further imposes a ceiling of \$15,000 over a 15-year period even if investments in excess of that amount would otherwise be eligible per HCR’s criteria. Such higher costs are not unusual, for example, when an apartment turns over after having been occupied for many years by one household. The potential rent increase is further constrained by HCR's fixed schedule of reasonable costs for different types of improvements, regardless of actual costs.

As a result of these constraints, financing an IAI requires an even more favorable interest rate to break even. To cover the debt service with a 30-year amortization for an eligible improvement, the owner would need an interest rate of no more than 5.3 percent. Expenditures in excess of those HCR deems eligible for an IAI rent increase or higher funding costs would negatively affect the cash flow available for uses other than debt service. Again, any increase in property taxes as a result of the investment would further detract from that cash flow.

The above economic realities of financing building-wide and individual apartment capital improvements and the complications of securing approval to recoup the full dollar amount of those improvements makes it unlikely that owners of rent stabilized units will seek, in the HSTPA era, to generate MCIs or IAIs simply to improve extra cash flow. More significant perhaps is that, when MCI and IAI increases do not even cover the cost of funding a needed capital improvement, the owner may have to choose between passing on the investment or cutting back on other expenditures, including potentially those for maintenance and operations.

**Chart S1: MCI and IAI Rules Pre- and Post-HSTPA**

	Pre HSTPA		Post HSTPA	
Building Size	<35 Units	≥35 Units	<35 Units	≥35 Units
MCI Rules	Increase can't exceed 6% of the rent  96 month recoup period	Increase can't exceed 6% of the rent  108 month recoup period	MCIs prohibited in buildings with 35% or fewer rent stabilized units  144 month recoupment period  2% annual cap  Rent increases are temporary, spanning a maximum of 30 years	MCIs prohibited in buildings with 35% or fewer rent stabilized units  150 month recoupment period  2% annual cap  Rent increases are temporary, spanning a maximum of 30 years

<b>IAI Rules</b>	<p>Owners could collect a monthly rent increase of: 1/40<sup>th</sup> the cost of the IAI.</p> <p>96 month amortization period.</p> <p>Annual rent increases capped at 6% in NYC.</p>	<p>Owners could collect a monthly rent increase of: 1/60<sup>th</sup> the cost of the IAI.</p> <p>108 month amortization period.</p> <p>Annual rent increases capped at 6% in NYC.</p>	<p>Owners can collect a monthly rent increase of: 1/168<sup>th</sup> the cost of the IAI.</p> <p>Rent increases are temporary, spanning a maximum of 30 years.</p> <p>Recoupable IAI costs are capped at \$15,000 over a 15-year period during which no more than three IAI increases can be collected.</p>	<p>Owners could collect a monthly rent increase of: 1/180<sup>th</sup> the cost of the IAI.</p> <p>Rent increases are temporary, spanning a maximum of 30 years.</p> <p>Recoupable IAI costs are capped at \$15,000 over a 15-year period during which no more than three IAI increases can be collected.</p>
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As a result of HSTPA’s changes building owners now have much more limited means to raise rents beyond what the RGB guidelines allow, or to look to MCIs or IAIs to improve their bottom lines.

**[End of Sidebar One]**

## **Sidebar Two**

### **Economics Sidebar: The Economic Implications of Shortfalls in Revenue Growth for Multifamily Properties**

The Rent Guidelines Board (RGB) is challenged with striking a balance between maintaining rental affordability and ensuring the long-run financial sustainability of the city's portfolio of rent stabilized units. This sidebar examines one aspect of this challenge: what can happen if rents go up so slowly that they do not cover increases in operating costs and otherwise account for inflation? Any shortfalls in revenue growth can affect the value of a multifamily rental property, how much building owners allocate for maintenance and operations, a building owner's ability to refinance their mortgage without having to add equity, and, in the extreme, their ability to retain ownership of the property. To understand why one or more of these outcomes are likely, this sidebar takes a deeper look into the economics of owning and maintaining a residential rental building.<sup>51</sup>

The income a building produces from rents and fees covers the costs of maintaining and operating that building ("operating costs"). Income is also needed to pay both debt service for mortgaged properties and a reasonable return to the investors who provided the balance of funding ("equity") used to acquire land and buildings, as well as do any necessary rehabilitation or construction work. Over time, additional funding in the form of debt or equity may be needed to undertake any capital improvements, such as replacing major building systems. Equity can come from the principal owner as well as from other investors who will share in the ownership of the property. Operating costs fall into two categories: those where the prices are market-driven, such as labor, fuel, light & power, maintenance, administrative, insurance, and miscellaneous expenses ("Market-Driven Operating Costs"); and those driven by government fiat, including property taxes and water & sewer fees ("Government-Driven Operating Costs").

A key determinant of the value of a building is Net Operating Income (NOI) which is the amount of revenue remaining after covering operating costs (but before accounting for obligated debt service or property taxes). Changes in NOI often foretell longer-term trends in a building's basic financial condition. More directly, changes in NOI affect the market value of buildings through what is called the capitalization rate (cap rate)—a market-determined ratio of NOI to market value for similar types of buildings, similarly situated. A market cap rate of 5.00% (0.05), for example, translates NOI into a building value 20 times higher (the inverse of 0.05). Even though cap rates are not static and can move up or down based on changes in the interest-rate environment and the local and national economic outlook, market values generally tend to move over time in concert with changes in NOI. The market value of a building with a constant NOI, therefore, is unlikely to fluctuate very much over time unless overall economic conditions change substantially, or the change in NOI foretells a decline in a building's longer term financial sustainability. This relationship also holds in real terms: when NOI remains constant in

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<sup>51</sup> The economics of new construction involves further considerations such as the ability to raise the capital needed to acquire a site and construct the building

real dollars (i.e., adjusted to reflect the rate of inflation), then the market value of the building will tend to stay steady in real terms.<sup>52</sup>

NOI can increase or decrease depending on the relative movements of building revenue and operating costs. On the income side, economic cycles can lead to either increases or decreases in the gross income the building can achieve. On the other side of the ledger, inflation can drive up market-driven operating expenditures, thereby dampening any increase in NOI or even causing it to decline. While the portion of owners who would be able to raise rents beyond what would be needed to cover increased real operating costs have the option of whether to upgrade their properties, the building owners facing the opposite scenario have no option but to adjust downward operating costs and/or inflation adjusted NOI to accommodate the revenue shortfall.

Faced with this revenue shortfall, an owner may first attempt to **cut back operating costs** needed to maintain the quality of the building. While this action may suffice in the short run, over time any fall in property quality could make it more difficult to attract tenants, resulting in increasing tenant turnover with concomitant periods of vacancy and additional costs from having to prepare more units for re-rental.

To the extent that cut backs in expenditures are insufficient to maintain NOI, the market value of the property is likely to fall, this fall may be more severe if the building's poor financial outlook drives a rise in the applicable cap rate. With the costs of debt service, property taxes, and water and sewer fees fixed in the short term, the **equity investors' return will also fall**. This outcome would be especially hard on those small business building owners who have relied on this income to cover basic living expenses and were already facing a drop in the value of what may be their major asset.

In the longer term, any decline in market value resulting from trimmed down NOI may constrain an owners' ability to refinance a mortgage. Lenders cap mortgages based on a maximum loan to value (LTV) ratio and the minimum ratio for NOI to exceed debt service payments (called Debt Service Coverage Ratio, or DSCR). If the outstanding mortgage amount exceeds that permitted under either of these tests, the owner must either come up with **additional equity** from themselves or other investors in order to reduce the size of the mortgage. An inability to borrow more could also cause an owner to defer undertaking any capital expenditures such as those to replace worn-out building systems.

In the extreme a property owners would **surrender ownership**. This would most likely arise when the property no longer generates enough income to cover the costs of maintaining the property in compliance with minimal building codes. Alternatively, the owner may find it preferable to simply default on the mortgage if the market value of the property falls below the balance due on the mortgage, thereby allowing the lender to **foreclose**. In the 1970s, when owners stopped paying their property taxes, the City ultimately foreclosed on the properties under a process called "in rem."

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<sup>52</sup> Inflation adjustments for New York City are made using the Consumer Price Index (CPI) for All Urban Consumers for New York-Newark-Jersey City, NY-NJ-PA,

The short- and long-term implications of these dynamics for the RGB's annual setting of rent guidelines is discussed in the main body of this brief.  
**[End of Sidebar Two]**

## **SIDEBAR THREE**

### **Past Citywide Trends: Why the RGB/DOF Data on Rent Stabilized Buildings Can Paint a Misleading Picture**

As part of its annual *Income and Expense Study*, the RGB uses the RGB/DOF database to compare trends over time for average total income, residential rents, total costs, and NOI for residential units in buildings with 11 or more units and that contain at least one rent stabilized unit. Because the RGB/DOF database includes buildings with revenues from market-rate residential units, non-residential units (e.g., retail units) and miscellaneous fee income (e.g., cell towers, parking, laundry rooms), the city-wide and community district-wide statistics are averaged over the total number of residential units and include income from and expenses for all of these units. If interpreted incorrectly, the data can easily portray a misleading story, glossing over the trends for, for example, NOI in those fully rent stabilized properties that are without any significant, supplemental sources of income.

Looking at past trends in average total income, residential rent, total costs and NOI in rent stabilized units sheds light on the difficulty of interpreting the data the DOF compiles for the RGB. Limiting RGB/DOF database to buildings built before 1947 (i.e., pre-war) allows us to filter out post-war buildings such as those built under the 421a program.<sup>53</sup> The resulting database contains about 65 percent of the city's current portfolio of units in buildings with at least one rent stabilized unit. Because these buildings were automatically covered at the time the rent stabilization law was enacted in 1974, the existence of any market rate residential units in these buildings today has to have come from subsequent circumstances. We plot trends for this subset of buildings from 2006 to 2019.

**Figure S1** shows the data in nominal dollars and **Figure S2** shows the same data inflation adjusted, i.e., all of the figures are in 2019 dollars. For both figures we have broken operating costs into two categories: Market-Driven Operating Costs (those components of maintenance and operation with costs that are driven mainly by market forces) and Government-Driven Operating Costs (i.e., property taxes and water and sewer fees).

Given that most of the data comes from a pre-HSTPA period, it is not surprising that average residential rental income went up over the 14 year period with only a slight dip during the great recession from 2008 to 2009, and a somewhat larger dip from 2016 to 2017, possibly driven by the softening of market rents for both market rate and perhaps even for rent stabilized units (note: market rents are subject to market pressures and so can go down as well as up). During this period, owners of buildings with at least one rent-stabilized unit not only had the ability to capture any increases in income from any market rate residential and commercial units that co-existed with rent stabilized units, but also had a number of different avenues open to raise the rents of rent-stabilized units beyond the RGB guidelines. Owners could take advantage of MCI and IAI expense rent increases, the ability to raise preferential rents to the legal rents upon the expiration of a standard one- or two-year leases, the ability to decontrol of units that exceed the

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<sup>53</sup> The 421a program, for example, previously provided participating buildings with a property tax exemption for affordable and market rate units, on the condition the units remain rent stabilized. Inclusion of these units would skew the dataset to include new apartments that rent at very high rates, and that have relatively high operating costs to run luxury amenities.

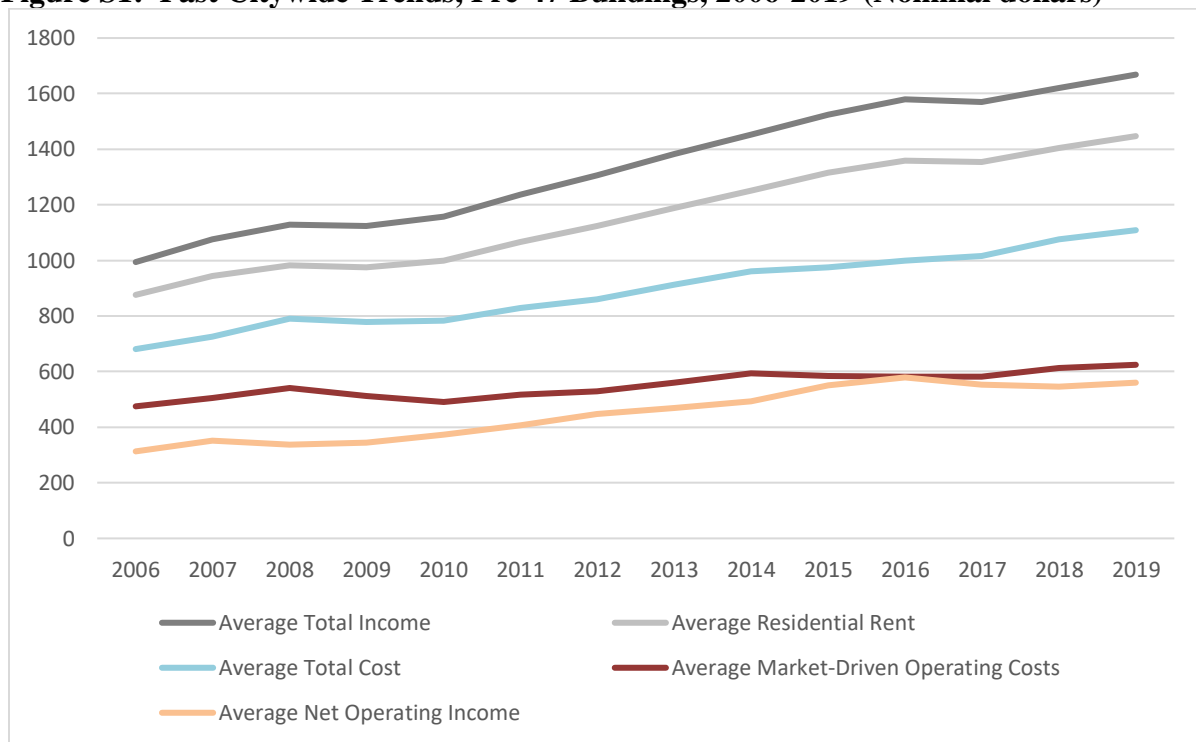
rent stabilized rent or income ceilings, or the vacancy allowance which allowed for a rent increase of up to 20 percent upon tenant turnover.

As can be seen in **Figure S1** average total income rose even faster than residential rents which presumably resulted from the inclusion in the database of buildings with significant amounts of additional rental income from, for example, commercial space, and cellular towers. Yet, not all buildings with rent stabilized units benefit from these additional revenue sources. Average total costs also significantly increased. This also is not surprising as the costs of providing a standard level of maintenance and operations grew over time, but the increase could also be fueled by an enhanced level of service in those buildings with a growing mix of market rate residential units.

With total costs rising somewhat slower than total income it is not surprising to see that NOI rose fairly steadily over the same period. It is not possible to determine, however, the degree to which this is attributable to the rent increases for rent stabilized units. While we can see how much total income increased faster than residential rents, we do not have separate data on the income from rent-stabilized versus that from market-rate units. Interestingly, if we subtract out the average cost of Government-Driven Operating Costs (i.e., property taxes and water and sewer fees), we find a slower growth rate for all the other, market-driven operating costs.

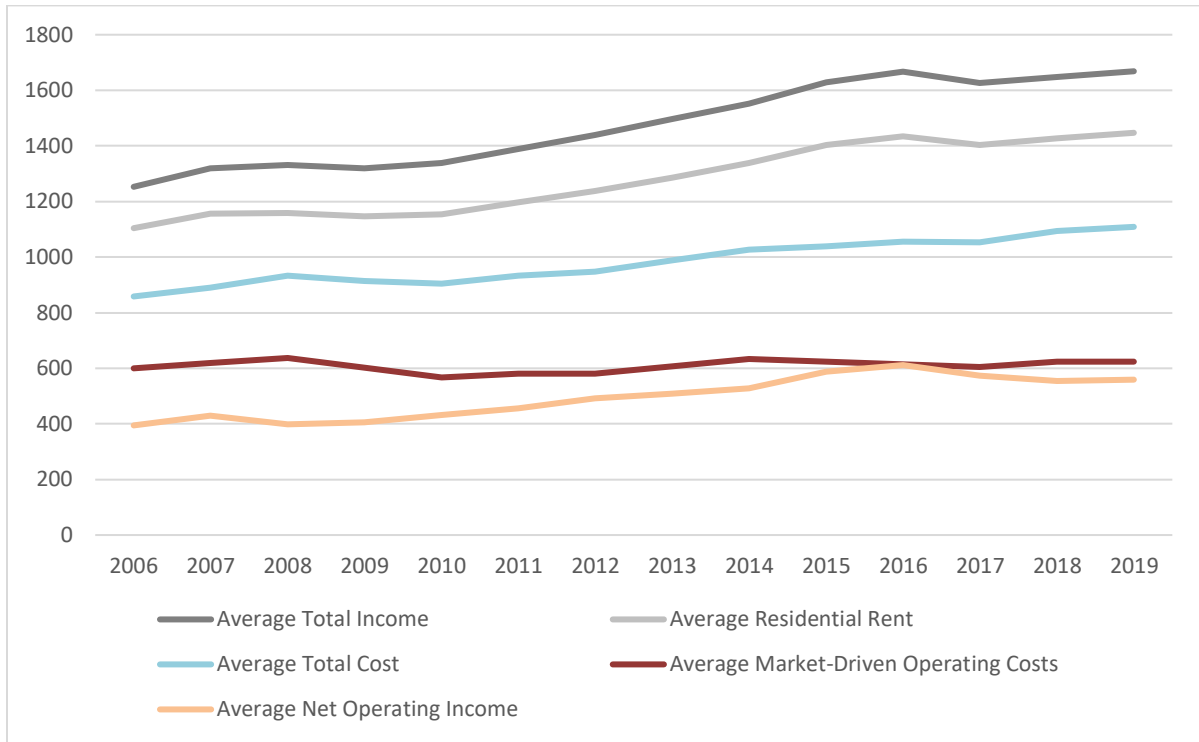
Once we control for inflation by converting all the data into 2019 dollars (see **Figure 2**) we see slower rates of increase, with the graph for Market-Driven Operating Costs hardly rising at all. In the main text of this brief, we further analyze the trend of market-driven costs by honing in on the data from CDs with the highest percentage proportion of rent stabilized units in fully rent stabilized buildings.

**Figure S1: Past Citywide Trends, Pre-47 Buildings, 2006-2019 (Nominal dollars)**



Source: RGB Data, Furman Center

**Figure S2: Past Citywide Trends, Pre-47 Buildings, 2006-2019 (2019 dollars)**



Source: RGB Data, Furman Center

**[End of Sidebar Three]**