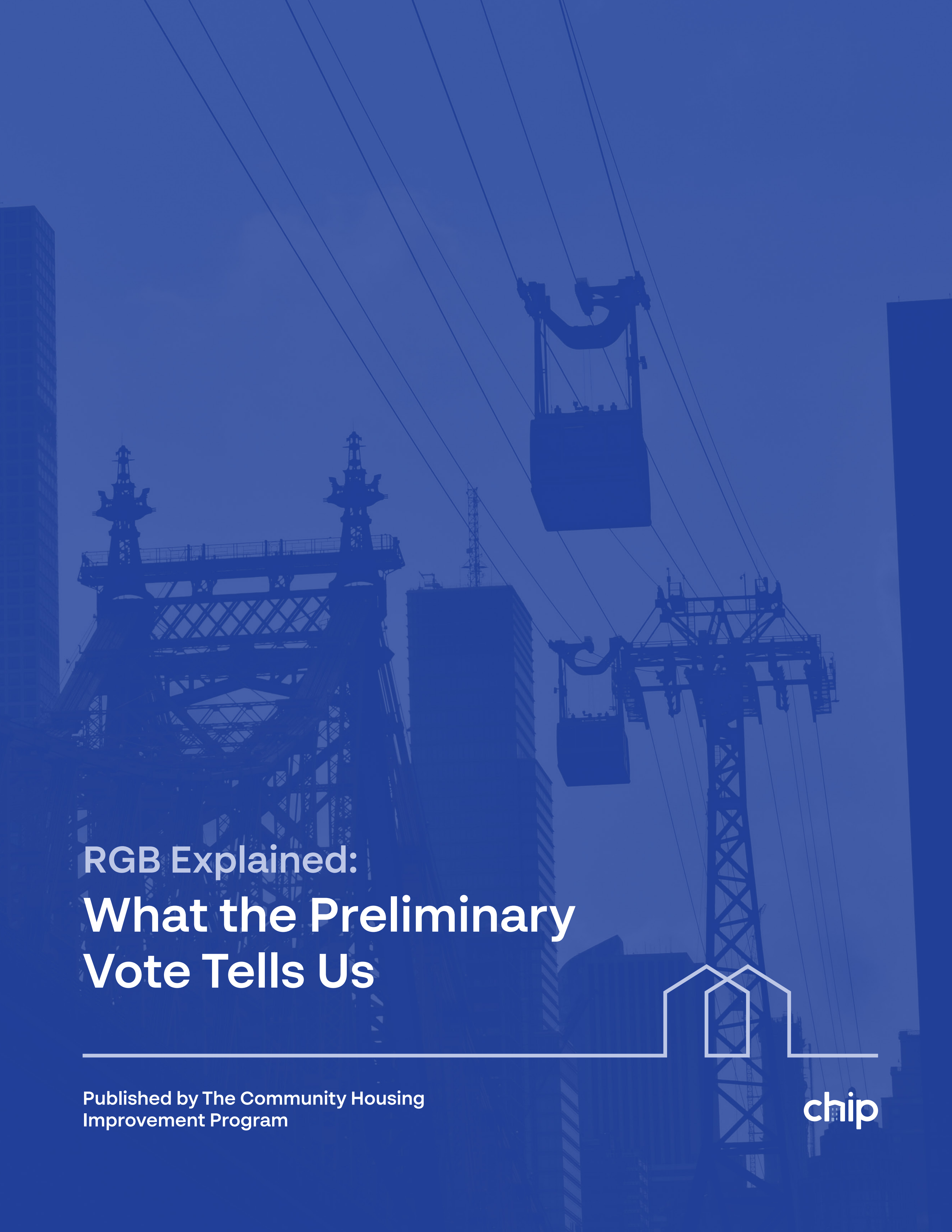


RGB Explained:

What the Preliminary Vote Tells Us

Published by The Community Housing
Improvement Program

chip

Index

The RGB Explained: What the Preliminary Vote Tells Us.

On May 2, 2023, the New York City Rent Guidelines Board voted to set a preliminary range for rent adjustments at 2% to 5% for one-year leases and 4% to 7% for two-year leases. This was well below the current rate of inflation for the NYC area (6.2%) and below the commensurate adjustments that included inflation, which determined an 8.25% increase on a one-year lease was necessary for owners to keep up with rising operating costs.

While the approved range has been presented by many in the media as the largest increase in recent history, the data suggests differently. A focused look at the majority of rent-stabilized buildings shows that they are in danger of deterioration due to inadequate rent adjustments for more than a decade. Net operating income (NOI), or the amount of revenue left over after paying all of a building's operating costs, has not declined as rapidly in these buildings, the decline has been more steady and more consistent over time.

When NOI declines, the value of the building declines. This means more of the building's income is spent on debt service, forcing maintenance and mandatory upgrades to be deferred. In short, the buildings are defunded.

Owners of these buildings need to either figure out ways to cut costs, or need to find alternative revenue sources to make up this difference. In both cases, many rent-stabilized buildings have no options. The majority of rent-stabilized buildings have few or no free-market units where an owner could raise the rent to subsidize the rest of the building. Demand for commercial space has been declining, leading to lower rents for storefronts. On the cost side, taxes, insurance, fuel costs keep going up. Additionally, the City Council continues to pass laws with unfunded mandates that drive up costs, like Local Law 97 of 2019 and Local Law 66 of 2019.

The declining NOI and devaluing of buildings, coupled with skyrocketing interest rates, has virtually eliminated all access to capital for the majority of property owners. This delays or completely wipes out the ability for owners to turnover empty apartments, especially ones that need significant work to comply with recently passed Local Laws.

The argument from the RGB for advancing rent increases that defund buildings has been a concern that rent-stabilized tenants cannot afford to pay their rent. We believe this conversation cannot simply be a binary choice between tenants and property owners. Both renters and housing providers need help from the government. Elected officials must act now to advance pro-housing policies that will save aging rent-stabilized buildings.

Impact of Preliminary Vote

Last year, the RGB advanced a final vote of 3.25% in a one-year lease and 5% in a two-year lease. This was below the CPI-adjusted commensurate calculated in the 2022 Price Index of Operating Costs (4.5% for a one-year) and well below inflation at the time of the final vote in June (6%). Additionally, the 2022 PIOC projected operating costs would increase by 4.7%, when the 2023 PIOC reported an actual increase of costs of 8.1% or nearly double the projection.

In short, the RGB chose to adjust rents below operating costs, inflation, and the projected costs for the following year. This was a decision that had consequences, as the net operating income (NOI) for buildings with more than 80% regulated units fell again for the third straight year in 2021. When NOI declines, the value of the building declines. That means there is less money for mandatory maintenance and upgrades.

The RGB tends to focus on the average NOI and not the median NOI. This is misleading since the average NOI for newer buildings that are under rent-stabilization is $1,181, driving the overall average NOI to $576.

But the majority of rent-stabilized apartments are in older buildings in the outer boroughs. The median NOI for these units is $384, or roughly 2/3rds of the average. The median cost of operating these apartments is $890, which is only $201 less than the average operating costs for all apartments.

Median rents in the older, outer borough buildings are $1,189. A 2% rent increase would raise the rent to $1,212.75, or 78 cents a day. A 7% increase would bring the rent to $1,272.25 or $2.74 a day. A couple making more than $50,890 a year, or 47.6% of the Area Median Income, would not be rent burdened by this increase.

Unfortunately the proposed rent increases won't keep up with the projected rise in operating costs. In 2022, operating costs went up 8.1%, well below the combined rent adjustments advanced by the RGB in 2021 and 2022.

Analysis of Income & Expense Report

The Income & Expense (I&E) Report, compiled from Real Property Income & Expense (RPIE) filings required for all rent-regulated buildings with over 10 units, determines the costs of operating buildings and the remaining income, which typically goes toward debt service or capital repairs.

The data from the I&E is on a two-year lag, so the 2023 report looks at filings from 2021. The RPIE is filed in May for the prior year (May 2022 for 2021 filings), and the RGB report is released in March (two months prior to the May 2023 filings for 2022). Because of this two-year lag in data, the RGB consistently uses outdated information to determine rent adjustments, and often misses troubling trends in the current funding and maintenance of properties. The 2023 I&E report analyzed about 700,000 apartments in about 15,000 buildings.

The main takeaway from the I&E is the net operating income (NOI), or how much income is left over after RGB-tracked operating costs are calculated. This is not profit, as it is often portrayed in the media, but used instead to pay for debt service, capital repairs and other expenses not included in the RGB calculations. A responsible debt service coverage ratio is 1.25, or no more than 80 cents to the dollar, and well-operated buildings should set aside $150 to $200 per unit, per month, in reserve funds to cover emergency expenses and repairs.

The RGB reported a 9.1 percent drop in NOI from 2020 to 2021, the largest single decline in RGB history, more than the 8.7 percent decline in 2002 after the impacts of September 11, 2001. There has been a 13.9 percent decline in NOI from 2016 to 2019 as rent increases in 100 percent stabilized buildings failed to keep up with operating costs. NOI for buildings constructed before 1974 outside of Manhattan's core fell 5.1 percent and was $401 per unit, which was roughly 69% of the average NOI for all buildings containing rent stabilized units.

The average rent in pre-1974 buildings outside the core of Manhattan was $1,238, but more importantly the median rent was $1,189. Average costs to operate these apartments were $948 a month when the data was collected in 2021. When adjusted for inflation costs have grown to $1,031.50 (though likely higher because of rising tax assessments), while rent increases have been minimal in the past two years, with average rents estimated to have increased by only $50. This means the NOI for older rent stabilized buildings has likely declined by $33 in the past two years, putting them in dire stress.

In 100 percent stabilized buildings, rents rose by 1.4 percent and income by 2 percent, but operational costs rose by 5.5 percent and NOI dropped by 4 percent. Compared to 2020, rental income in 2021 decreased citywide by an average of 1.2 percent, total income declined an average of 0.2 percent, and operating costs rose an average of 5.2 percent.

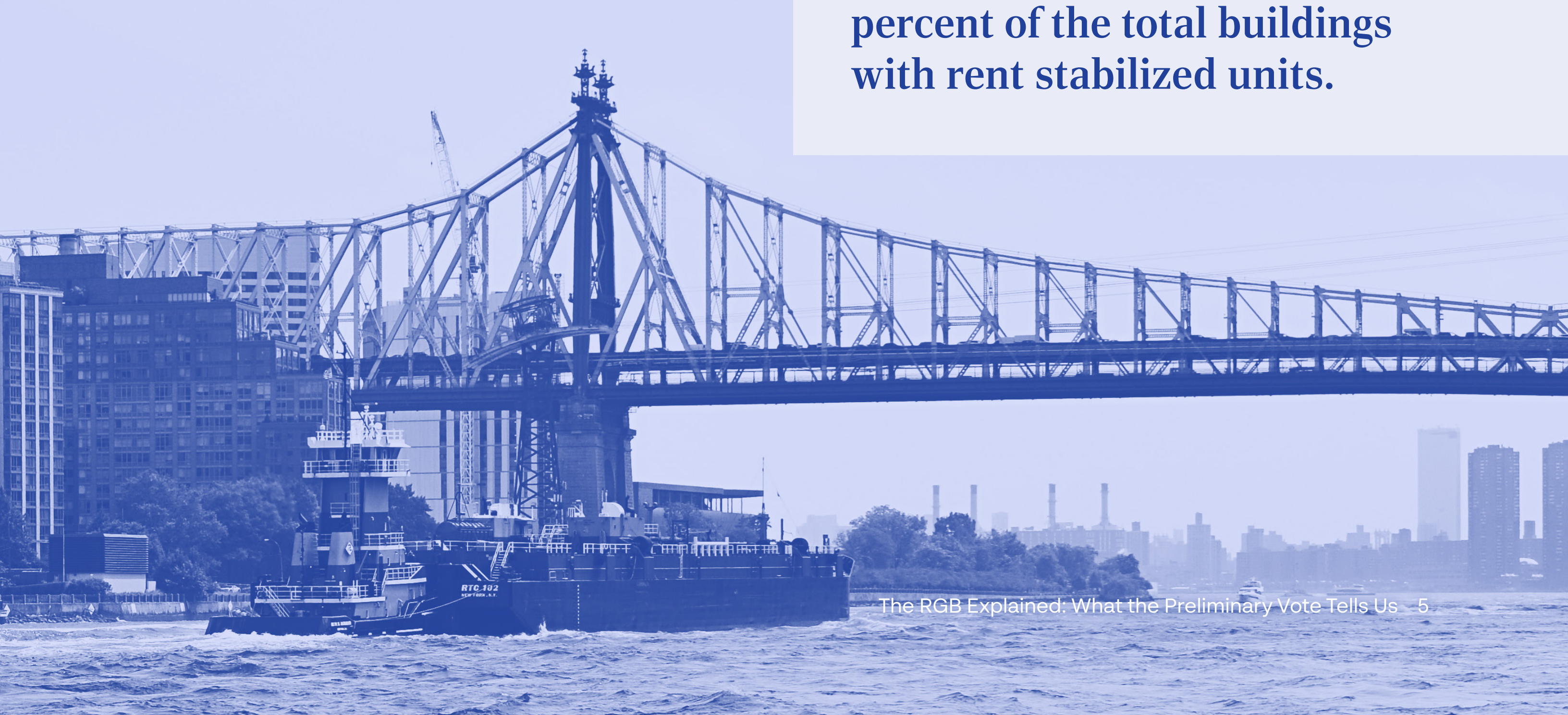
From 2020 to 2021, there was a 3.4 percent decline in the gap between rent collections and legal rents. Rent collections are often lower than legal rents due to preferential rents and vacancies. The trend in recent years is for that gap to increase, but likely decreased this year due to rent arrears paid by the Emergency Rental Assistance Program (ERAP).

Distressed buildings, which have operating and maintenance costs that exceed gross income, rose by 2.3 percent to 8.8 percent of the total buildings with rent stabilized units. Nearly 9 percent of all rent stabilized buildings in New York are now considered distressed and there is no reason to think that number will shrink with high interest rates, inflation and no more room to reduce costs of rent-stabilized buildings.

This year's report made some notable updates, including a breakdown of changes in rent, income, operational costs and NOI by percentage of rent-stabilized units in the building, giving a clear snapshot of the current financial state of the 100 percent rent-stabilized buildings that are at the highest risk for disinvestment and make up 53 percent of the total housing stock. The report also breaks down the data by date, pre-1974 (legally rent-regulated) or post-1974 (units could be rent-regulated through 421-a or other tax break). Finally, it does away with the old and outdated audit-adjusted number, replacing it with a new model that uses a respectable scientific methodology.

The report shows the dire straits outer borough rent-stabilized properties without any other subsidy source are facing. Without additional income sources other than rent, most of these buildings will continue to become distressed. The RGB has a responsibility to ensure rent-stabilized buildings have the income necessary to maintain properties.

Distressed buildings, which have operating and maintenance costs that exceed gross income, rose by 2.3 percent to 8.8 percent of the total buildings with rent stabilized units.



Analysis of Price Index of Operating Costs

The Price Index of Operating Costs (PIOC) Study looks at the real-time costs of operating a building and then calculates commensurate adjustments to determine rent adjustments necessary to keep NOI constant. NOI declined by 7.8 percent in 2020 and 9.1 percent in 2021, which plunged thousands of rent-stabilized buildings into distress when factoring for responsible debt service payments.

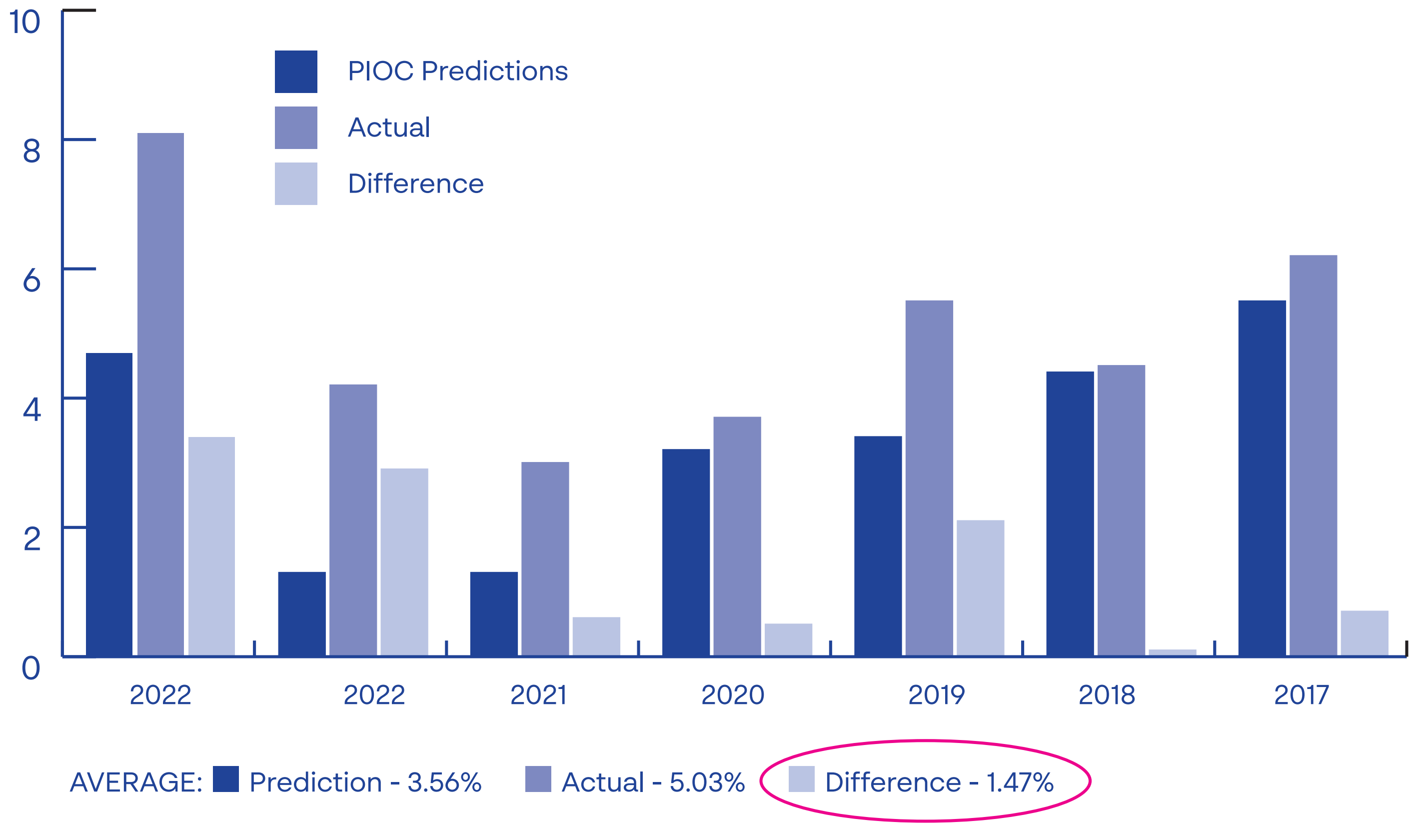
There are five commensurates – based on rent revenues from vacancy leases, net revenue, Consumer Price Index (CPI)-adjusted Net Operating Income (NOI), and projected costs – but only the CPI-adjusted NOI accounts for inflation, which was at 6.2 percent at the time of the report. Using the CPI-adjusted NOI commensurate, the RGB's data determined that an 8.5 percent increase on a one-year lease and a 16 percent increase on a two-year lease would be necessary to keep these buildings from becoming defunded.

When rent adjustments are set below commensurates, the RGB is defunding buildings. In 2021, the RGB also defunded buildings by issuing a rent increase below all commensurate calculations.

The PIOC showed an 8.1 percent increase in costs for rent-stabilized buildings, 3.9 percentage points higher than last year's increase of 4.2 percent, with increases in all components of operating & maintenance costs. The PIOC records changes in the cost of seven components in the operation and maintenance of buildings: taxes, labor costs, fuel, utilities, maintenance, administrative costs, and insurance.

The RGB historically relies on the "traditional" commensurate when setting rent adjustments and has since the board's inception. The commensurate relies on the current changes and projected changes, which are often unreliable and difficult to predict. This year's "traditional" commensurate adjustment called for a 5.3 percent increase on a one-year lease and a 6.6 percent increase on a two-year lease.

Last year's projected cost for 2023 was 4.7 percent, which was 3.4 percentage points less than the actual costs reported in this year's PIOC. In 2022, fuel was projected to decline by 1.7 percent but instead rose by 19.9 percent, a 21.5 percentage point difference, utilities were projected to increase 2.4 percent but rose to 8.8 percent, projected maintenance cost increases of 5.7 percent actually were 9.4 percent, and taxes, which account for nearly 30 percent of the total PIOC, was projected to rise 5.1 percent but rose 7.7 percent. The RGB's PIOC predictions have been consistently lower by an average of more than 1.47 percent for the past seven years.



Last year, the inflation-adjusted commensurates suggested a rent adjustment of a 4.5 percent increase on a one-year lease and a 9 percent increase on a two-year lease. Despite this data, the RGB only authorized a rent adjustment of a 3.25 percent increase on a one-year lease, which was slightly above the suggested commensurates when inflation was not considered, and a 5 percent increase for a two-year lease, which was a full percentage below the non-inflation adjusted commensurates.

This year, the RGB has voted on a preliminary range of 2 to 4 percent for a one-year lease, well below the "traditional" commensurate, and 4 to 7 percent for a two-year lease. When rent adjustments are set below commensurates, the RGB is defunding buildings. In 2021, the RGB also defunded buildings by issuing a rent increase below all commensurate calculations. The same thing happened in 2020, 2019, 2018, and 2017. For the past seven years, the RGB has consciously decided to adjust rents below all of the commensurates calculated by their own staff.

Analysis of Mortgage Survey

The 2023 Mortgage Survey, like previous years, is unfortunately limited in its scope and significance. The RGB's efforts to gather valuable information about financing of buildings and the impact of interest rates has been hindered in part by a lack of participating banks and lenders. Still, the report provides some important insights into the trouble rent-stabilized buildings are facing.

There are two key numbers to understand when looking at the Mortgage Survey: The Loan-To-Value (LVT) ratio and the Debt Service Coverage Ratio (DSCR). Both of these typically do the same thing. They determine the responsible amount of debt service a building can have based on its value or operating income.

The LVT, simply stated, is that lenders feel comfortable loaning a building about $7 million to purchase a $10 million building. The DSCR calculates this same thing in a different way. It looks at the net operating income (NOI) of the building, and determines that a responsible owner could spend 80% of the NOI on debt service.

Typically speaking, LVT and DSCR don't change much. These are basically the rules of the road at which banks and lenders feel comfortable operating.

When NOI declines, as it has consistently for several years, the value of the building declines. This means that an owner, when they have to refinance every 5-7 years, has to make up the difference in the declining value of the building in order to keep the LVT and DSCR in a comfortable range.

For example, if a building worth $10 million five years ago took out a responsible $7 million loan and now has to refinance, they would find themselves in a difficult situation. Declining NOI likely has plunged the value of the building to closer to $8 million, meaning the bank will only loan the building $6.4 million. This means the owner has to come up with roughly $600,000 in cash to secure the refinancing.

Unfortunately, this scenario does not account for rising interest rates. In the past 16 months, interest rates for refinancing multifamily properties has shot up from about 3% to close to 8%. This dramatically impacts the DSCR.

Let's say the NOI has remained constant in a building for the past five years, so it still has an NOI of $1 million and a reasonable debt service payment of $800,000. The bank will provide financing to the building, keeping debt service payments at $800,000. But due to rapidly rising interest rates, an $800,000 per year loan payment would only cover a $9 million multifamily loan, when two years ago it would have covered a $15.5 million loan.

To put it another way, the rapidly rising interest rates have wiped out roughly 40% of the value of a building if an owner has to refinance. In many cases, this means the equity in the building has evaporated, leaving no access to funding for maintenance, repairs, or mandatory upgrades. Other buildings are not so lucky. They won't be able to refinance unless property owners can come up with millions of dollars in additional financing.

The rapidly rising interest rates may be the single biggest threat to the future of rent-stabilized housing, and must be factored into any decision by the RGB.

Future of Rent-Stabilized Housing

The future of rent-stabilized housing is very much in the hands of the Rent Guidelines Board. This was not necessarily the case in previous years. For the first 25 years of rent-stabilization, the housing stock was not nearly as old and in need of as much constant maintenance and repairs. In order to prevent the degradation of housing, the RGB often advanced rent adjustments that kept up with, or exceeded inflation, in order to make sure buildings remained funded.

Despite the efforts of the RGB in the 70's and 80's, the housing stock still deteriorated due to incredibly strict policies that eliminated any incentive for an owner to invest in their buildings. Reforms to the laws in the 1990's changed this mechanism, allowing for investment in buildings, and allowing the RGB to advance smaller rent adjustments to preserve affordable housing.

Since the passage of rent law reforms in 2019, the paradigm has again shifted back to a reliance on the RGB to approve adequate adjustments in the rent to make sure buildings don't fall into disrepair. Property owners of buildings with more than 80% rent-regulated properties rely almost entirely on the actions of the RGB. There is no other pathway to increase revenue on the building, and therefore there is no other way to balance the books of a building with rapidly rising costs. As we outlined in this report, the NOI for heavily rent-stabilized buildings outside of the core of Manhattan is below $400 a month, with the vast majority of that going to debt service. This leaves virtually no money for buildings to make mandatory upgrades for energy-efficiency, lead abatement, or other necessary costs. Additionally, buildings have little to no access to capital due to high interest rates. The inevitable conclusion is deterioration of buildings.

We implore the RGB to take a holistic view of their role and advance a rent adjustment that protects the viability of this vital housing stock.

Since the passage of rent law reforms in 2019, the paradigm has again shifted back to a reliance on the RGB to approve adequate adjustments in the rent to make sure buildings don't fall into disrepair.

Rent-Stabilized Housing is in Trouble.

Aging buildings that rely solely on the income from stabilized apartments are at particular risk. Costs have increased across the board, like utilities, property taxes, interest rates and insurance—which has tripled in the past decade.

The NYC Rent Guidelines Board needs to put forth adequate adjustments if we're going to save rent-stabilized housing.

"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."

– NYU'S FURMAN CENTER

Learn more at:
rentadjustmentnyc.com

chip