Rent Stabilization Board

DATE: June 16, 2008

TO: Honorable Members of the Rent Stabilization Board

FROM: Jay Kelekian, Executive Director
BY: Stephen Barton, Ph.D., Principal Planner

SUBJECT: **Review and discussion regarding possible changes to the Condominium Conversion Ordinance**

RECOMMENDATION

Provide comments on the attached reports and approve forwarding them to the Housing Advisory Commission and the City Council. Place a follow-up item on the Rent Board Agenda for July 21, 2008 to discuss specific recommendations to the Council.

BACKGROUND

The City Council requested staff review of several possible changes in the condominium conversion ordinance, specifically proposals to broaden inspections of multi-family properties, to reduce affordable housing mitigation fees or discount the fees when paid at the time of conversion rather than on sale of the unit and to create incentives or programs to assist current Berkeley tenants to purchase condominiums. This report summarizes the three attached documents responding to these proposals. The first provides an overview of the purposes of the City's condominium conversion ordinance and its regulatory requirements. The second examines the utility of creating a discounted mitigation fee. The third analyzes the financial feasibility and cost of potential homeownership assistance programs.

Purposes of the Condominium Conversion Ordinance

Condominium and TIC conversion helps solve one problem by making another worse. It puts more housing on the homeownership market, which helps make homeownership more affordable, by reducing the supply of rental housing, which generally imposes serious costs on renters. The people who can afford to become homeowners have higher incomes than the people who remain as renters, so as a result condominium conversion benefits the property owners who convert and some middle income first-time homebuyers at the expense of low and moderate income renters.

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The social costs of conversion of housing from rental to ownership can include:

- Direct displacement of renters in converted properties.
- Increased rents for all tenants due to the reduction in supply of rental units.
- A reduction in new housing construction.
- Higher risks to homebuyers, especially those purchasing TIC shares.

These social costs can be mitigated through regulatory protection of sitting tenants and payment of mitigation fees to help create additional affordable rental housing. In general the cost of the mitigations will come out of the profits of conversion and will not be passed along to buyers. These mitigations are only possible if conversions are channeled through the condominium form rather than the TIC form, since State law currently gives local governments the power to regulate creation of condominium subdivisions, but not TIC subdivisions.

Condominiums sell for substantially more than TIC shares, so there is an economic incentive for owners to go through the condominium conversion process as long as they believe that they will gain economically from that choice. Berkeley's Condominium Conversion Ordinance is an effort to mitigate the negative impacts of conversion on tenants without creating conversion costs that are so high that owners choose TIC conversion instead.

The ordinance discourages eviction of tenants for TIC conversion by disqualifying the property from subsequent condominium conversion for up to 10 years. It protects sitting tenants by ensuring that after conversion of the unit to a condominium they can remain in their home for as long as they wish to stay, paying a rent that is no more than they would pay if the unit remained under rent control. Once the unit is vacated and sold it requires payment into the Housing Trust Fund of a fee of 12.5% of the sales price of the condominium. (Technically this percentage is a cap on the base fee, which is much higher, but for practical purposes, it serves to describe the fee.) This amount is sufficient only to fund creation of approximately one permanently affordable housing unit for every four or five units converted, but combined with Federal and State funding for affordable housing it can generate one permanently affordable unit for every two units converted.

Possible Ordinance Changes

Several Council members have expressed concern that the cost of mitigations required for condominium conversion may encourage owners to choose TIC conversion instead. Suggested changes include more equal regulation of all sales of multifamily property to help equalize costs, reductions in the affordable housing mitigation fees to increase the profitability of condominium conversion, and discounted mitigation fees for up-front payment to benefit both property owners and the City.

<u>Inspections</u>

Currently TIC conversion does not require the property owner to have an inspection of the property by the City, while condominium conversion does. This creates a cost advantage for the TIC conversion option, and also a sales advantage, since when code violations are found in a condominium conversion the violations must either be corrected or recorded in the property records. Where work has been done without permits, a frequent occurrence, this creates a finding of violations even where there is no apparent threat to health or safety, simply because the work was not inspected when it was done and some of the work is likely now hidden behind walls or under floors. This has discouraged some property owners from continuing with the condominium conversion process.

The City should consider a requirement that all sales of multi-family rental property be accompanied by a City inspection for compliance with zoning and building code. This would ensure equal treatment of condominium and TIC conversions and also ensure review of rental properties when they change hands.

Reduction in Affordable Housing Mitigation Fees
Council's past discussion and actions expressed a desire to set the affordable housing mitigation fees at the highest practical level. Some Council members suggested auctioning off the conversion rights to the highest bidders. At present the 12.5% fee is likely at the highest level that allows parity with TIC conversions and property owners have argued that it is set too high. The original staff proposal was 10%.

Since condominium conversion costs more than TIC conversion, particularly due to the mitigation fee, previous staff analysis found that to be more profitable to the property owner condominiums need to sell for 20% more than TICs.1 The staff analysis looked at the differential between condominium and TIC prices in San Francisco, drawing on data from real estate firms specializing in both types of conversion. This analysis suggested that condominiums sold for a premium over the price of TICs of from 27% to 50%.

Some have suggested that the fee should be lowered because there are currently fewer units in the conversion process than the ordinance allows. In order to evaluate this suggestion we need to understand why this is the case. Initially the owners of more units applied and there was a waiting list, but a large number dropped out when they were not selected, more dropped out due to lengthy delays in getting the program under way, and still more dropped out because of the now-changed requirement to remove all code violations, including gaining approval of work done without permits. Over the past two years the City has finally developed clear procedures, trained permit staff and reduced the requirements for repairs to those necessary to remove visible safety hazards. As a result, the processing time for applications should be much reduced. However, the state of the housing market is now dramatically different from how it was two years ago, and as a result the incentive for owners to convert their property from rentals to condominiums or TICs is also reduced.

Throughout the Bay Area home prices are declining, with the major exception of parts of San Francisco and Berkeley where they remain stable. The availability of mortgage financing and its accompanying regulatory structures are in a very uncertain state and are unlikely to settle into clear new patterns for at least another year or even two. Mortgage financing is much more limited than it was only a year ago, especially for first-time homebuyers without sufficient savings to make a 20% down payment and for purchases of non-traditional forms of housing such as TICs. As is typical when homeownership opportunities decline, market rents are now going up because higher income renters stay in the rental market for a longer period of time.

There is no apparent movement to convert rental property to TICs under the current circumstances. Most of the creative financing that had been available to first-time homebuyers is

1 "The Decision to Convert: TIC or Condominium?", Attachment 5 in "Requested Information for the Condo Conversion Ordinance Workshop", City Council Information Calendar, December 11, 2007.

now gone, so the risk of extensive TIC conversion is greatly reduced, and the demand for condominiums is down substantially. Most of the owners currently in the conversion process appear to be waiting to see whether the City will reduce the mitigation fee level before completing the process.

With the housing market in flux, it is difficult to determine the number of units that should be allowed to convert and an appropriate fee level. Since the primary purpose of the program is to protect tenants from unregulated conversion, the City may wish to simply wait and see what comes out of the current crisis before making a decision, since there is no evidence of a move towards TIC conversion in the current market. However, ***the City may wish to consider reducing the fee somewhat, on a temporary basis, in order to encourage owners who started to complete the process and to help the program develop a successful track record despite the current less favorable market conditions. Given the uncertainties, any reduced fee should be given a sunset period of no more than one or two years.***

<u>Discounted Fees for Early Payment</u>
Discounted fees for immediate payment could benefit both the City and the property owners. The discount provides the property owner with reduced costs that can compensate for the costs of buying out a tenant or holding a unit vacant rather than re-renting it while waiting to complete the conversion process. This reduces the property owner's uncertainty about when they will be able to sell some or all of the condominiums after map approval. Up front payment could enable the City to provide affordable housing more quickly, but that must be balanced against the fact that the discount reduces the amount of affordable housing that can be provided.

Since the fee is based on sales prices it rises (or falls) with changes in property values. In a rising market, up front payment of the full value of the unit is already discounted by the unit's future increase in value between the time of conversion and the time the tenant moves out and the unit can be sold. While it is likely that values will increase over the next decade, it is impossible to predict how they will change over the next several years. For this reason, ***the City may wish to consider offering a modest discount for payment at the time the map is approved rather than at the time of sale.*** For example, a 20% discount would be the equivalent of reducing the fee from 12.5% of sales price to 10%, so that the payment for a $400,000 condominium unit would be reduced from $50,000 to $40,000. Or if the fee was lowered to 10% then the up front payment would be 8% of sales price, so that the payment for a $400,000 condominium unit would be reduced from $40,000 to $32,000. Any such a discount should be done on an experimental basis and given a sunset period of one or two years.

Homeownership Program Feasibility

Without significant public subsidy, even condominiums on the low-priced end of the market are only affordable to buyers with incomes around 120% of area median or higher, the category called "above moderate income". An income of $72,000 a year is necessary to afford a one-bedroom unit selling for $310,000; $95,500 a year for a two-bedroom selling for $390,000; and $117,600 a year for a three-bedroom selling for $500,000. ***The City could encourage sales to these higher-income tenants without using subsidies by allowing affordable housing mitigation fees to be based on below-market prices when the property owner is willing to sell the unit at a discount to its current tenant.*** Owners have a significant incentive to offer units at a discount to sitting tenants, since a tenant purchase provides an immediate sale, while otherwise the owner will have to wait until the tenant decides to move or perhaps offer a payment in return for an early move-out.

For tenants with incomes at 80% of the area median ($46,200 to $66,700 depending on family size) to afford the monthly costs of ownership the necessary subsidy is from $130,000 to $295,000. For the cost of assisting each household in this way, the City could provide at least two and often three units that would be permanently affordable to tenant households with incomes at or below 50% of area median through the Housing Trust Fund's affordable housing development assistance program.

If the City wants to implement a first-time homebuyer program for low and moderate-income tenants it can do so by amending the Housing Trust Fund Guidelines to incorporate such a program. The two most useful program types are either down payment assistance as a "silent second" mortgage loan that is repayable when the homebuyer resells their home or down payment assistance that is not repaid, but is accompanied by permanent resale price restrictions and required resale of the below-market rate (BMR) unit to an income-qualifying buyer.

The silent second mortgage loan with repayment on sale would eventually return the subsidy to the City's Housing Trust Fund. Loans with repayment can be structured as repayment with interest or as an equity sharing arrangement. In either case, however, *the high level of subsidy that is required and that must then be repaid means that the buyer will not accumulate very much equity* compared with a market-rate buyer, and without significant increases in income they would not be able to afford to purchase a market rate home even with enough equity for a down payment. As a result, buyers would likely remain in place for long periods of time, and funds would be returned to the Housing Trust Fund very slowly. Although it requires somewhat less subsidy, creating *permanently affordable BMR units will shift housing subsidy from very low-income people to low and moderate-income people* since the subsidy would not be repaid.

Eligibility requirements and priorities are essential to such a program, since the funding used for a homeownership program has a high cost to the City in forgone opportunities to assist very low-income people through other programs and could easily use up all available mitigation fees. For example the program could be limited to assisting tenants to buy only the unit they currently live in, which would reduce the eligible pool to the individuals and families in the 100 units allowed to convert annually. It could require several years of residency and set a minimum income threshold to ensure the tenant had the ability to maintain the unit. A point system could reflect additional priorities such as longer residency, employment as a teacher or other staff in the Berkeley Unified School District, or other employment in Berkeley.

Limited equity housing cooperatives (LEHCs) are an alternative form of homeownership that provides resident control, modest equity accumulation, and permanent affordability. Membership in an LEHC is similar to purchase of a condominium with resale restrictions. City policy has long encouraged creation of LEHCs, which are exempt from the restrictions of the condominium conversion ordinance.

The City may wish to consider allocating a portion of the affordable housing mitigation fees received from condominium conversion to creation of affordable homeownership through LEHCs by making it a priority within the Housing Trust Fund process. Development of LEHCs through acquisition and rehabilitation of existing multi-family buildings is eligible for other sources of affordable housing funding, such as Low Income Housing Tax Credits and State

Multi-Family Housing Program bond money. This approach to use of the mitigation fees would not require significant revision of the HTF Guidelines, would not reduce the number of units that could be assisted and could create mixed-income properties in which very low, low and moderate income tenants were all able to live.

Extensive buyer education is essential in any first-time homeownership program; especially with loan repayment on sale or permanent affordability that greatly limits the equity the owner will accumulate in the unit. Low-income buyers must also know about the potential for maintenance and repair costs to be more than anticipated, particularly when they are buying a unit in an older building.

Attachments:
1. "Introduction to Social Equity Issues in Condominium and TIC Conversion"

2. "Using Berkeley's Condominium Conversion Ordinance to Increase Homeownership Opportunities for Low and Moderate Income Tenants"

3. "Potential Changes in Affordable Housing Mitigation Fees for Condominium Conversions"

Introduction to Social Equity Issues in Condominium and TIC Conversion

Date: April 28, 2008

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About the Author

Dr. Stephen Barton is the former Housing Director for the City of Berkeley (1999-2007) and the author or co-author of numerous publications on condominium and planned development homeowners associations, including:
Stephen Barton and Carol Silverman, *Common Interest Communities: Private Governments and the Public Interest*, Institute of Governmental Studies, Berkeley, 1994.
Stephen Barton and Carol Silverman, *Common Interest Homeowners Associations Management Study*, California Department of Real Estate, Sacramento, 1987.

He received a National Planning Award from the American Planning Association in 1997 for his writing on housing issues in the *Journal of the American Planning Association.* He received the Community Associations Institute Research Prize in 1988. He has been a lecturer at the University of California, Berkeley and San Francisco State University. He received his Ph.D. in City & Regional Planning from the University of California, Berkeley in 1985.

Introduction to Social Equity Issues in Condominium and TIC Conversion

Summary

Condominium and TIC conversion helps solve one problem by making another one worse. It puts more housing on the homeownership market, which helps make homeownership more affordable, by reducing the supply of rental housing, which generally imposes serious costs on renters. The people who can afford to become homeowners have higher incomes than the people who remain as renters, so as a result condominium conversion benefits the property owners who convert and some middle income first-time homebuyers at the expense of low income renters.

The social costs of conversion of housing from rental to ownership can include:

- Direct displacement of renters in converted properties.
- Increased rents for all tenants due to the reduction in supply of rental units.
- A reduction in new housing construction.
- Higher risks to homebuyers especially those purchasing TIC shares.

These costs can be mitigated through protection of sitting tenants and payment of mitigation fees to help create additional affordable rental housing. In general the cost of the mitigations will come out of the profits of conversion and will not be passed along to buyers. These mitigations are only possible if conversions are channeled through the condominium form rather than the TIC form, since State law currently gives local governments the power to regulate creation of condominium subdivisions, but not TIC subdivisions.

Condominiums sell for more than TIC shares, so there is an economic incentive for owners to go through the condominium conversion process as long as they believe that they will gain economically from that choice. Berkeley's Condominium Conversion Ordinance is an effort to balance these factors and mitigate the negative impacts of conversion on tenants without raising costs to the point that owners choose TIC conversion instead. It also seeks to generate an ongoing supply of condominium units for sale, so that prospective buyers can choose condominiums over any TICs that are brought to the market, thus holding down the price of TICs and maintain the condominium to TIC price differential.

The ordinance discourages eviction of tenants for TIC conversion by disqualifying the property from condominium conversion for up to 10 years. It protects sitting tenants by ensuring that after conversion of the unit to a condominium they can remain in their home for as long as they wish to stay, paying a rent that is no more than they would pay if the unit remained under rent control. Once the unit is vacated and sold it requires payment into the Housing Trust Fund of a fee of 12.5% of the sales price of the condominium. This would only fund creation of approximately one permanently affordable housing unit for every five units converted, but combined with Federal and State funding for affordable housing, it is expected to generate one permanently affordable unit for every two units converted.

Introduction to Social Equity Issues in Conversion of Multi-family Rental Housing to Ownership Through Condominiums or Tenancies in Common

I. What are Condominium and TIC Conversions?

Condominiums are a form of homeownership that is used in areas of denser multi-family housing where single-family detached houses are rare or have become too expensive for all but a few families because of high land values. In a condominium subdivision, different individuals or families are able to separately own each individual unit in a building (usually defined as the air rights within the walls) while at the same time jointly owning one or more buildings and the common areas. Condominium conversion is the shorthand phrase for subdividing a multi-unit property, usually a rental property, into a condominium subdivision.

Condominiums are only one of several types of possible legal subdivision. In California condominiums, cooperatives and planned developments are all defined as "common interest subdivisions". In cooperatives the residents jointly own the entire property, and each person's share of the whole property includes an exclusive right to occupy a particular unit. (Note that the "limited equity cooperative" is a specific type of coop in which share appreciation is limited in order to keep the share price below market, but there are also market-rate cooperatives, mostly concentrated in New York City.) Common interest subdivisions are regulated under State law (the Davis-Sterling Act) and in addition, local governments have the power to regulate the construction of new subdivisions and to regulate or ban the conversion of multi-family property to any kind of common interest subdivision.

Condominiums are much more popular than cooperatives for two main reasons. First, people consider condominiums as a form of individual homeownership, while the term cooperative reminds them that they share ownership of the building and are interdependent with their neighbors. Secondly, mortgage lenders prefer to have a clearly separate property to lend against and it can be difficult to find financing for cooperative shares.

Tenancy in common can be used to create a form of homeownership (commonly referred to as a TIC) in which residents jointly own the entire property and have separate contractual agreements that provide each owner with the right of exclusive occupancy of a particular unit. Thus a TIC is similar to a cooperative except that the right of exclusive occupancy is based on a contract rather than inherent in the real property itself. As a result, the courts have held that TICs are not regulated as common interest subdivisions, and have made it virtually impossible for local governments to regulate conversion of existing multifamily rental properties to TICs. TICs are not popular with homebuyers because of the difficulty in obtaining financing and refinancing for the purchase of TIC shares and because TICs do not have the legal protections and framework that State law provides for condominiums. As a result, this form of ownership is almost unknown outside of San Francisco and Berkeley, where extremely high single-family and condominium prices are accompanied by near bans on condominium conversion.

II. What Are the Effects of Condominium Conversion?

The driving force behind condominium conversion is the simple fact that under certain circumstances it can be extremely profitable. People will pay much more per month in order to own their own home than they will for a rental because homeownership offers greater control over use of the residence and a chance to obtain capital gains from increases in property value. Conversion is a complex legal process, but the costs are only a few thousand dollars per unit, while the process can double or triple the value of a multi-family property in hot markets. In Berkeley, for example, the average price per unit of rental units sold in 2006 was about $120,000, while the average condominium price was over $500,000. Properties that are most profitable to convert are often the most valuable rental properties, but even so the process will usually more than double the value of Berkeley rental properties.

The real estate industry generally argues that condominium conversion should be allowed since it is simply a way that the market responds to demand for additional homeownership units. In addition, they argue that it has positive social and economic effects on the surrounding community because it will increase the proportion of homeowners in the community; increase property values, increase tax revenue from property taxes and may result in upgrading the properties.

Profit-maximizing activity is often accompanied by social costs, however and there are four main concerns about condominium conversion. First, it will force out renters. Second, it will reduce the overall supply of rental housing, thus driving up rents and imposing additional costs on all renters. Third, it may reduce construction of new housing by increasing the supply of condominiums for sale. Fourth, it creates serious risks for TIC and condominium buyers, especially first-time homebuyers.

All of these social costs can be substantially reduced through careful regulation to protect tenants and homebuyers and through use of mitigation fees to create replacement housing. Both Berkeley and San Francisco regulate the condominium conversion process, but California law does not currently allow local governments to regulate TIC conversions.

Finally, there are the concerns about the effects of regulation of condominium conversion. The real estate industry typically argues that regulation will drive up the cost of condominiums and harm first-time homebuyers. Affordable housing advocates have made the countervailing argument that since conversion results in windfall profits; the converters should pay fees that can be used to help mitigate the harmful social impacts that inevitably result from conversions.

Since local governments are unable to regulate TIC conversions, a critical issue in establishing condominium conversion regulation is to ensure that condominium conversion is generally a more desirable and profitable alternative for the property owner than TIC conversion. I review each of these points in more detail below.

1. Displacement of Renters

No-one denies that renters are displaced by condominium conversions, and there is extensive evidence that the impacts of moving, especially forced moves, are particularly severe for elderly people who suffer more from the stress and the loss of daily routines and their connections with family and friends who may live close by. Disabled people are also likely to be more severely affected, since finding suitable accessible units is often difficult.

Regulatory protections for tenants in converted buildings range from lifetime leases (for all tenants in Berkeley, for elderly and disabled tenants in San Francisco) to grace periods of anywhere from 5 years down to three months. There is often a right of first refusal to purchase the unit, although few tenants have enough money to exercise this right.

Since tenants often do not understand their situation and legal rights as well as the property owner, it is important to have an outreach and education process to ensure that the tenants do not give up their right of occupancy based on incorrect fears. One of the effects of strong protections against displacement of tenants is that, rather than wait until the tenant moves on their own, property owners will have a strong incentive to offer to sell the unit to the tenant at a discount and, if the tenant can not afford to buy, to offer money to tenants in return for their agreement to move out voluntarily.

2. Reduction in Supply of Rental Housing

The most critical problem with condominium conversion is that it helps solve one problem by making another one worse. It puts more housing on the homeownership market and thus helps make homeownership more affordable by reducing the supply of rental housing, which thus creates serious costs for renters. Since most renters are low-income, while the renters who are close to being able to afford to become homeowners are the highest income renters, condominium conversion risks imposing costs on low-income people for the benefit of middle and high-income people.

It should be noted that in California it is typical for around 20% of condominium units to be rented out.1 So it would be fair to consider this in determining the rate of loss of rental units. It is also important to consider the fact that all rented condominium apartments are exempt from rent stabilization.

The real estate industry frequently argues that there are many vacant apartments and that this means there is a surplus of rental housing that can be converted to condominiums without harm to tenants. This involves a fundamental misunderstanding of the role of vacancies in the rental housing market, particularly in California. Vacancy rates are important to the housing market as a necessary precondition for adequate tenant mobility and as an indicator of the balance between supply and effective demand. However, in regional markets where there is a long-term housing shortage, vacancy rates may not serve as a good indicator of the balance between supply and demand because they are affected by cyclical short-term economic changes as well as by the underlying balance between the supply and the need for housing.

1 Stephen Barton and Carol Silverman, *Common Interest Homeowners Associations Management Study*, California Department of Real Estate, Sacramento, 1987, p.7.

Vacancy rates go up and down with the state of the overall economy and they also go up and down with the rate of development of new housing in relation to population growth, so at any given time the vacancy rate reflects both of these factors. Since these factors often vary independently, changes in vacancy rate may then result from changes in only one of these factors. For example, vacancy rates typically increase during recessions, which reduce what consumers are able to pay for housing and thus reduce what economists call “effective demand” for housing. Such an increase in vacancies does not mean that the need for housing has decreased, nor does it mean that the utility of housing to consumers has decreased. Rather, it simply means that due to the recession consumers have less money with which to purchase housing and landlords have not reduced rents in step with reduced consumer ability to pay. This is because landlords typically accept a certain level of vacancies to maximize future net operating income. Even if vacancies increase, landlords will be reluctant to lower rents for new tenants, since they may then be pressured to reduce rents for older tenants who moved in at higher rent levels. Within limits the gain from keeping higher rents on current tenants can more than compensate for the loss of revenue from vacant units.2 Only if a recession is so severe that it leads to a decline in population does the actual need for housing also decline during such a short-term cycle.

The coastal areas of urban California have a long-term, underlying housing shortage, caused by the widely recognized shortfall of new housing development in relation to population growth.3 Despite this it is perfectly normal to also have short-term increases in the vacancy rate that result from a recession or economic slow-down. Then when the cycle changes, vacancies go down again and rents start to increase again.

In the Bay Area, then, vacancy rates are subject to short-term cycles varying with the state of the local economy, even though there is a long-term shortage of housing that is expected to last for the foreseeable future. An increase in the vacancy rate in the Bay Area does not mean that sufficient new housing has been constructed to balance the market, nor does it mean that there is a sufficient housing supply to stabilize market prices over the long run without public intervention. For this reason, it is important not to respond to short-term fluctuations in the vacancy rate with public policies that result in a long-term loss of rental units. Condominium conversion permanently removes the great majority of the converted units from the rental market.

Finally, even looking at long-term vacancy rates, there is no consensus on what vacancy rate is necessary to balance the market. Many ordinances use a five percent long-term vacancy rate as the measure of a healthy rental market, largely because ordinances tend to follow one another. The empirical evidence on appropriate vacancy rates is mixed. Gabriel and Nothaft support the five percent estimate, while Gilderbloom and Appelbaum review a number of studies and

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2 Eric Belsky, “Rental Vacancy Rates: A Policy Primer”, *Housing Policy Debate*, V.3#3, 1992, pp.793-813, http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_0303_belsky.pdf

3 John Landis, Michael Smith-Heimer, et al. *Raising the Roof: California Housing Development Projections and Constraints, 1997-2020*, Department of Housing and Community Development, Sacramento, CA 2000.
Hans Johnson, Rosa Moller & Michael Dardia, *In Short Supply? Cycles and Trends in California Housing*, Public Policy Institute of California, San Francisco, March 2004.

suggest that a vacancy rate of 9% or 10% is necessary.4 The U.S. Census Housing Vacancy Survey has reported national average vacancy rates in the 9-10% range for the last several years, even as rents have gone up, which provides further evidence that the "normal" vacancy rate is generally higher than 5%. Eric Belsky argues that the equilibrium or "natural" vacancy rate varies from one local market to the next, and will also vary by size of building and property holdings, since small landlords tend to "minimize vacancies" while larger landlords tend to "maximize rents". 5

In order to limit the economic impacts of conversion on tenants as a class, San Francisco allows only 200 units to convert each year out of a stock of 200,000 multi-family rental units. San Francisco has a lottery to allocate conversions, only allows conversions in properties with six units or less, and charges no mitigation fee. TIC conversion creates priority in the lottery for condominium conversion, with the result that there is a regular market for TICs in San Francisco.

Berkeley sets a cap on conversions at 100 units per year, out of a multi-family housing stock of 20,000 rental units, with the properties taken on a first come first served basis. Berkeley requires payment of an affordable housing mitigation fee payment into the housing trust fund. The Berkeley fee is set using a two-step process. The first step calculates a fee based on the capitalized value of the increase in annual housing costs that results from conversion of a rental unit to an owner-occupied condominium. If the owner agrees to protect any tenants from future rent increases beyond those allowed under the Rent Stabilization Ordinance CPI formula, then the fee is capped at a maximum of 12.5% of sales price of each unit and can go down to zero for the unit of an owner-occupant at the time of conversion who has lived in the unit or another rented unit in Berkeley for at least ten years prior to the conversion.

The mitigation fee is at a level that will allow the City to create one permanently affordable unit for every two units converted to condominiums, but only if the affordable housing project receives substantial additional subsidies from the State or Federal government. This could largely mitigate the effects of loss of rental units on tenants. Without additional subsidy, the ratio would likely be only one affordable unit for every five units converted.

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4 Gabriel, Stuart A. & Frank E. Nothaft, "Rental Housing Markets, the Incidence and Duration of Vacancy and the Natural Vacancy Rate", Journal of Urban Economics, V.49, 2001, pp.121-149.
John I. Gilderbloom & Richard P. Appelbaum, *Rethinking Rental Housing*, Temple University Press, Philadelphia, 1988, pp.52-56.

5 Eric Belsky, "Rental Vacancy Rates: A Policy Primer", *Housing Policy Debate*, V.3#3, 1992, pp.793-813, http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_0303_belsky.pdf

3. Possible Reduction in New Multifamily Construction

The real estate industry argues that conversion of rental housing to owner-occupancy makes more renters into homeowners, thus reducing the demand for rental housing so that there is no effect on the balance of supply and demand. This is not correct, especially in a regional market such as the Bay Area with an overall shortage of housing for people at most income levels. The renters who can afford to buy converted condominiums are the higher income renters whose demand helps support new construction of either condominiums or high quality rentals. Since new construction of rental housing is typically aimed at the high end of the market, taking those people out of the rental market will reduce the market for new construction of rental housing. In addition, increasing the supply of condominiums by converting rental property reduces the demand for newly constructed condominiums and discourages new construction in that sector of the market as well. As a result, there will be less new housing built overall and less older housing will be available to the lower income people who make up the vast majority of renters.

Presumably the rent increases on all tenants that result from decreased supply of rental housing will at least partially counterbalance this effect and encourage some new construction of rental housing, but only at the cost of decreased affordability for all tenants. In order to provide a certain type of homeownership opportunity to the highest income tenants, condominium conversion risks creating both a decrease in new housing construction and a decrease in housing affordability for tenants.

4. Risks to New Homebuyers

Converted multi-family properties have many risks for new homebuyers as well as for the tenants who may be displaced. Appreciation is lower in condominiums and TICs than in single-family detached homes, and buyers move more frequently, so there is greater risk of being caught in a downturn in housing prices or changes in mortgage lending requirements. Under certain circumstances, especially during a market downturn, a high percentage of units may be purchased by investors who rent them out, rather than by homeowners, with the result that there will often be conflicts within the homeowners association caused by the different interests of residents and investors. It can be harder to determine the condition of a multi-family building than a single-family wood frame house. This creates the risk that there will turn out to be serious problems in the building structure that may require special assessments that will be hard for new homebuyers to afford.

There are many issues regarding homeownership in condominiums that are troubling, since it is in reality a form of collective ownership of a building, yet people bring to it their ideals of single-family detached housing in which they can do what they want with their own property.[6] Homeowners generally believe that they are entitled to use their residence as they see fit, and unlike tenants a homeowner who disturbs the neighbors cannot be evicted so conflicts among neighbors can be severe. This is one reason the Building code typically requires greater sound separation for condominiums than for rental units. Many localities require that a building being

6 Stephen Barton and Carol Silverman, *Common Interest Communities: Private Governments and the Public Interest*, Institute of Governmental Studies Press, Berkeley, 1994.

converted to condominiums be brought up to a higher code standard than was required at the time of original construction, and especially that sound separation meet current building code. Some also require that higher parking standards be met, on the grounds that homeowners will have higher incomes and own more cars, and more parking will be necessary to reduce the impact on the surrounding neighborhood.

Severe as these issues are for converted condominiums, they are far worse for TICs, where conversion takes place entirely without local regulation and review. There is limited State review, because in both condominiums and TICs with five units or more the seller is required to obtain approval of a "public report" by the California Department of Real Estate, though these are rarely reviewed carefully by the buyer.7

At present, Berkeley property owners who want to convert a property to condominiums are required to have an inspection for compliance with building code, including any work done without permits, and with the zoning ordinance. Although code violations that are not an immediate health or safety hazard only have to be recorded and not necessarily corrected prior to sale, from the owners' perspective TIC conversion in Berkeley has an advantage over condominium conversion because the owner is not required to have the City inspection prior to sale as a TIC, nor to acknowledge or remove code violations. At the last City Council discussion of the ordinance on March 25, 2008, Mayor Bates suggested that the City require an inspection for building code and zoning compliance prior to any sale of a multi-family property in order to level the playing field, protect TIC buyers, and also ensure that new owners of rental properties are aware of any issues at the time they buy.

III. What Are the Costs and Benefits of Regulation?

Condominium and TIC conversion helps solve one problem by making another one worse. It puts more housing on the homeownership market, which helps make homeownership more affordable, by reducing the supply of rental housing, which generally imposes serious costs on renters. The people who can afford to become homeowners have higher incomes than the people who remain as renters, so as a result condominium conversion benefits the property owners who convert and some middle income first-time homebuyers at the expense of low income renters. As we have seen, the social costs can be greatly reduced through regulatory protections for sitting tenants and through use of mitigation fees to create additional affordable housing.

The real estate industry typically claims that the costs of regulation of condominium conversion will automatically be passed on to the buyer in increased prices and thus make homeownership less affordable. The tenant advocates' response is that no owner sells at a lower price than they can get on the open market, and thus there is no room for owners to increase prices. Instead, the costs of regulatory requirements will come out of the windfall profit that results from the conversion. A classic example of the fallacy of this type of industry argument came in California with Proposition 13, which lowered property taxes. The proponents claimed that with lowered costs to the landlords, rents would be reduced, but of course they were not. In Berkeley

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7 Carol Silverman and Stephen Barton, *The Effects of California's Residential Real Estate Transfer Disclosure Requirements*, California Department of Real Estate, Sacramento, 1989.

rental property owner representatives are now calling for reductions in Berkeley's mitigation fee for condominium conversion on the grounds that since the owner does in fact absorb the fee it reduces the advantage of condominium conversion over conversion to TICs, rather than claiming that it increases the cost to the buyer.

While the tenant advocates position is largely correct, there are two caveats that should be kept in mind. First of all, if the form of regulation reduces the overall supply of condominiums, then the reduced supply will indeed result in higher prices for the condominiums on the market. It is not clear whether restrictions on condominium conversion have such an effect because converted condominiums are in competition with newly constructed condominiums. As a result, a reduction in conversion will help support new construction as the means to meet the demand. Since older housing is the primary stock of affordable housing, and new construction is very expensive, there is social benefit to protecting the existing stock of older housing from conversion and meeting the demand for condominiums through new construction, but new construction may not create as many condominiums or they may be more expensive on average.

Secondly, sellers do make trade-offs between price and time on the market. Market prices in housing are a range, not a fixed amount like products in a retail store, and sellers with higher costs may well decide to try to get the highest possible price within the range of what buyers will pay, even if that means they must wait additional months for the unit to sell, with all the attendant interest costs and opportunity costs. So higher regulatory costs might result in slightly higher prices, although variations in mortgage interest rates will be much more powerful in their effects on what buyers can pay and the prices sellers will be able to charge. Over all, the upward pressures on the price of condominiums that result from restrictions on condominium conversion seem minimal, while the social costs to renters from unrestricted conversion are clearly very significant.

Government action can create opportunities for private actions that generate windfall profits, sometimes called an "unearned increment", which can legitimately be taxed or regulated in ways that mitigate the social impacts of the actions. When government supports property owners desire to subdivide their property, typically the property owner does little to upgrade the property but is able to walk away with very substantial profits because people will pay so much more on a monthly basis for homeownership than they will to rent (even taking tax benefits into consideration). It is fair and equitable to direct part of the increased property value that is created by this government action into uses that mitigate the economic harm conversion of rental property to ownership does to low-income renters who cannot afford to own property.

IV. Setting An Appropriate Mitigation Fee

Ultimately, there is a certain level of mitigation that is necessary in order to prevent conversion from imposing inequitable costs on tenants. If owners cannot provide this level of mitigation and still profit from conversion, then condominium conversion is simply not desirable. However, in Berkeley the City must also consider the competitive position of condominium conversion in relation to TIC conversion and may find it better to accept condominium conversion with partial mitigation of social costs rather than TIC conversion with none.

The current situation is that it is not possible either to prevent conversion of rental units to owner-occupancy or to set conversion fees high enough to mitigate all the negative effects of conversion. In light of this, Council's past discussion and actions expressed a desire to set the affordable housing mitigation fees at the highest practical level.

It is difficult to determine the number of units that should be allowed to convert and an appropriate fee level because the housing and mortgage-financing markets and their accompanying regulatory structure are in a very uncertain state and are unlikely to settle into clear new patterns for at least another year or even two. Home prices are declining and the availability of mortgage financing is much more limited than it was only a year ago, especially for first-time homebuyers without sufficient savings to make a 20% down payment and for purchases of non-traditional forms of housing such as TICs. As is typical when homeownership opportunities decline, market rents are now going up.

There is no apparent movement to convert rental property to TICs under the current circumstances. Most of the creative financing that had been available to first-time homebuyers is now gone, so the risk of extensive TIC conversion is greatly reduced, and the demand for condominiums is down substantially. During this time it may be useful to think about what the City wants to have in place to protect its social equity interests when the market turns up again in the future.

Using Berkeley's Condominium Conversion Ordinance to Increase Homeownership Opportunities for Low and Moderate Income Tenants

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Executive Summary

This report presents background analysis to assist the City of Berkeley in deciding whether to create programs and incentives within the condominium conversion process to assist Berkeley tenants to become homeowners, and if so, of what type. Homeownership is strongly desired by most Americans, and is something that working people with stable employment and mid-range incomes expect to be able to afford. In addition, many local governments regard homeownership as an important means to retain highly valued employees of modest incomes, such as schoolteachers, and to help local employers maintain a skilled and stable work force. In Berkeley however, even more than in the Bay Area as a whole, homeownership is not affordable to the vast majority of current renters.

The Cost of Homeownership

Without significant public subsidy, even the lower priced condominiums on the market are only affordable to buyers with incomes around 120% of area median or higher, the category called "above moderate income". Even for units at the low end of the current market, incomes needed are at least $72,000 a year for a one-bedroom unit selling for $310,000; $95,500 a year for a two-bedroom selling for $390,000; and $117,600 a year for a three-bedroom selling for $500,000.

For tenants with incomes at 80% of the area median ($46,200 to $66,700 depending on family size) to afford the monthly costs of ownership the level of down payment assistance needed would range from $130,000 to $295,000 or more.

For the cost of assisting each household in this way, the City could provide at least two and often three or four units that would be permanently affordable to tenant households with incomes at or below 50% of area median through the Housing Trust Fund's affordable housing development assistance program.

First-time Homebuyer Program Models

There are several things the City could do at very little cost that would support sale of units to current tenants who can afford to buy them at or close to market rate. Since property owners have a strong incentive to sell to current tenants rather than wait until they move, and may be willing to offer modest discounts from market prices, the City could allow proportionate reductions in mitigation fees for discounts of up to 25% below appraised value. The City could also consider offering to match the owner's discount with an investment of all or part of the mitigation fee paid for that unit, to be repaid to the City when the tenant-buyer sells their unit. Once applications to convert increase beyond the 100-unit annual maximum, a priority to convert properties where tenants have serious plans to purchase could also provide an important incentive.

If the City wants to implement a first-time homebuyer program for low and moderate-income tenants it can do so by amending the Housing Trust Fund Guidelines to incorporate such a program. The two most useful program types are either down payment assistance as a "silent second” mortgage loan that is repayable when the homebuyer resells their home or down payment assistance that is not repaid, but is accompanied by permanent resale price restrictions and required resale of the below-market rate (BMR) unit to an income-qualifying buyer.

The **“loan with repayment”** would return the subsidy to the City’s Housing Trust Fund, so that the cost would primarily be in delay, rather than absolute loss of funding for very low-income people. Loans with repayment can be structured as repayment with interest or as an equity sharing arrangement. In either case, however, the high level of subsidy that is required and that must then be repaid means that the buyer will accumulate little equity compared with a market-rate buyer, and without significant increases in income they would not be able to afford to purchase a market rate home even if they have enough equity for a down payment. As a result, buyers would likely remain in place for long periods of time, and funds would be return to the HTF very slowly.

The “**permanently affordable”** BMR unit requires somewhat less initial subsidy and could gradually become more affordable over time, but since the subsidy would not be repaid it will also shift housing subsidy resources from assistance to very low-income people to low and moderate-income people. Buyers of permanently affordable units can accumulate equity under a typical resale restriction that allows the price to increase with the Consumer Price Index (CPI), as the City currently does under its Inclusionary Zoning Ordinance, but without significant increases in income they would not be able to afford to purchase a market rate home even if they have enough equity for a downpayment.

Buyer education is essential in any first-time homeownership program; especially with loan repayment on sale or permanent affordability that greatly limits the equity the owner will accumulate in the unit. Low-income buyers must also know about the potential for maintenance and repair costs to be more than anticipated, particularly when they are buying a unit in an older building.

Eligibility requirements and priorities are also essential. For example the program could be limited to assisting tenants to buy only the unit they currently live in, which would reduce the eligible pool to the individuals and families in the 100 units allowed to convert annually. It could require several years of residency and set a minimum income threshold to ensure the tenant had the ability to maintain the unit. A point system could reflect additional priorities such as longer residency, employment as a teacher or other staff in the Berkeley Unified School District, or other employment in Berkeley. The funding used for a homeownership program has a high cost to the City in forgone opportunities to assist very low-income people through other programs.

What alternative homeownership programs could be created using mitigation fees or other City resources?

> Limited equity housing cooperatives (LEHCs) are an alternative form of homeownership that provides resident control, modest equity accumulation, and permanent affordability. Membership in an LEHC is similar to purchase of a condominium with resale restrictions. City policy has long encouraged creation of LEHCs, which are exempt from the restrictions of the condominium conversion ordinance.

The City could allocate a portion of the affordable housing mitigation fees received from condominium conversion to creation of affordable homeownership through LEHCs by making it a priority within the Housing Trust Fund process. Development of LEHCs through acquisition and rehabilitation of existing multi-family buildings is eligible for other sources of affordable housing funding, such as Low Income Housing Tax Credits and State Multi-Family Housing Program bond money. This approach to use of the mitigation fees would not require significant revision of the HTF Guidelines, would not reduce the number of units that could be assisted and could create mixed-income properties in which very low, low and moderate income tenants were all able to live.

1. Introduction

Berkeley's Condominium Conversion Ordinance attempts to balance the harmful effects of a reduction in the supply of rental units with mitigations. These mitigations include regulatory protections for sitting tenants who might otherwise be displaced, and fees paid to the Housing Trust Fund to provide permanently affordable housing that will benefit low-income tenants harmed by the increased rents that result when the supply of rental housing is diminished.1

When multi-family rental units are converted to ownership through tenancy in common (TICs), there are no mitigations because the City has little regulatory authority. When conversion is to condominiums, then the City has extensive regulatory authority. Since Berkeley must consider the competitive position of condominium conversion with TIC conversion, it must select a set of mitigations for condominium conversion that leave condominium conversion preferable to TIC conversion for most owners. As a result, the City has decided that it is better to accept partial mitigation of social costs rather than risk having none.

Berkeley's regulatory protections for sitting tenants in converted buildings are very strong, providing lifetime leases for all tenants living in the units at the time of conversion and disqualifying properties from conversion if the owner forces out tenants prior to conversion. The condominium conversion ordinance also gives tenants the exclusive right to purchase the unit they live in for one year before the owner can place the unit on the market. Most tenants do not have sufficient income and savings to exercise this right, however. Prior to recent amendments, the ordinance gave priority in the conversion process to properties where tenants signed a statement of interest in purchasing their unit, or where the owner or owners lived in the property.

Berkeley also requires an affordable housing mitigation fee payment into the housing trust fund. The Berkeley fee is set using a two-step process. The base fee is the capitalized value of the increase in annual housing costs that results from conversion of a rental unit to an owner-occupied condominium. This amount, which is usually about equal to the entire gain in value from converting the property to condominiums, approximates the cost of fully mitigating the effects of the conversion on tenants. Then the mitigation fee is limited to a maximum of 12.5% of the sales price of each unit, provided that the owner offers a lifetime lease to any current tenants, including limiting future rent increases to those allowed under the Rent Stabilization Ordinance CPI formula so that rent increases can not be used to force the tenant out. For units that are already owner-occupied at the time of conversion the fee can go down to zero if the owner has lived in the unit or another rented unit in Berkeley for at ten consecutive years prior to the conversion.

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1 For a more detailed discussion of the social equity effects of condominium conversion see Stephen Barton, *"Introduction to Social Equity Issues in Conversion of Multi-family Rental Housing to Ownership Through Condominiums or Tenancies in Common"*, attached.

One of the unresolved policy issues, especially with removal of the priority for properties where tenants indicate a desire to purchase their unit, is whether it is desirable to create a program related to or within the condominium conversion process that would assist Berkeley tenants to become homeowners.

> Homeownership is strongly desired by most Americans, and is something that working people with stable employment and mid-range incomes expect to be able to afford. In addition, many local governments and private sector employers regard homeownership as an important means to retain highly valued employees of modest incomes, such as schoolteachers, and to maintain a skilled and stable work force. In Berkeley however, even more than in the Bay Area as a whole, homeownership is not affordable to the vast majority of current renters. In addition, the economic value of a tenant's decision to purchase a condominium is affected by Berkeley's rent control ordinance, since a tenant must decide whether they would prefer to remain under rent control, which ensures against future rapid rent increases, or to pay a higher monthly amount in order to own.

This report presents background analysis to assist the City of Berkeley in deciding whether to create incentives or programs within the condominium conversion process to assist Berkeley tenants to become homeowners, and if so, what type of incentives and programs.

2. How many Berkeley tenants can afford to buy market-rate condominiums?

In order to examine how many of Berkeley's tenant households might benefit from the opportunity to purchase a condominium we need to determine what income level is necessary to afford purchase of a condominium. City staff has previously reported on condominium sales in the City of Berkeley during 2006 and has recently provided the same information for 2007. 2

Alameda County property records show 102 condominium sales in 2006 with a median sales price of $494,000, while the median price for the 95 condominiums sold in 2007 was $510,000. Table 1 below breaks down condominium sales by size, as measured by number of bedrooms, and also gives the low-end and high-end prices as well as the median. The 10th percentile price is effectively the bottom of the market, since the lowest price units often have severe problems or are in some way not real market transactions. The 90th percentile price shows the high end of the market. Most of the analysis that follows will focus on the prices near the bottom of the market, which allows us to determine the low-end cost of establishing homeownership programs.

Table 1: Sales Prices of Condominiums in Berkeley, 2006 and 2007

2006	One Bedroom	Two Bedroom	Three Bedroom
10th Percentile Price	$372,000	$389,000	$500,000
Median Price	$420,000	$523,000	$602,000
2007			
10th Percentile Price	$312,000	$460,000	$510,000
Median Price	$417,000	$590,000	$691,000
90th Percentile Price	$520,000	$752,000	$800,000

The next step is to estimate the income needed to afford the lowest price units, and this information is shown below in Table 2.3 In order to provide the most optimistic scenario, we have used the lowest prices from either 2006 or 2007, rounded to the nearest $10,000. In Table 2 we assume that a mortgage lender will allow the buyer to plan to pay up to 36% of gross income in housing costs. This is also an optimistic scenario. For FHA insured loans the allowable mortgage qualifying ratio is 29%.

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2 "Requested Information for the Condo Conversion Ordinance Workshop", From Phil Kamlarz, City Manager to the Mayor and Members of the Berkeley City Council, Information Calendar, December 11, 2007, attachment 6, pp2-3.

3 This analysis draws on previous City staff analysis but adds the benefits of the tax deduction for mortgage interest and property taxes to the staff analysis, which somewhat reduces the necessary incomes and subtracts a maintenance allowance, which somewhat increases necessary incomes. Tax benefits are estimated based on a one person household for the one-bedroom unit and a two-person household for the two and three-bedroom units and represent the net benefit of the homeowner deductions, which is the value of the difference between the itemized deductions and the standard deduction. Marginal federal and state tax rates are estimated as 34% for the single person and 32% for the couple.

Table 2: Affordability of Low-Priced Condominiums in Berkeley, 2006-7			
	1-Bedroom	**2-Bedroom**	**3-Bedroom**
Interest Rate	6.50%	6.75%	6.75%
Loan Term (years)	30	30	30
Down Payment Assumed	10%	10%	10%
Taxes and Insurance Estimated Rate	2%	2%	2%
10th Percentile Sale Price	**$310,000**	**$390,000**	**$500,000**
Down Payment Amount	31,000	39,000	50,000
Loan Amount	279,000	351,000	450,000
Mortgage Payment	(1,763)	(2,277)	(2,919)
Taxes and Insurance Estimated	(620)	(780)	(1,000)
Maintenance costs	(100)	(125)	(150)
Homeowners Association	(250)	(275)	(300)
Estimated Value of Tax Deductions	574	593	841
Total Monthly Housing Costs	(2,159)	(2,864)	(3,528)
Assumed Qualifying Ratio for Buyer	36%	36%	36%
Income Needed to Support Purchase and Mortgage (rounded)	**$72,000**	**$95,500**	**$117,600**
Source: Alameda County Assessor's Office; City of Berkeley Housing Department.			

Table 3 below shows the income limits for moderate-income, median-income, low-income and very low-income households with from one to five people as defined by the United States Department of Housing and Urban Development for the Oakland-Fremont area, which includes Berkeley.4

4 These estimates are based on a median income for a family of four of $86,100 and are adjusted for family size to generate definitions of very low, low and moderate-income families. Very low income is defined as up to 50% of area median, low income as up to 80% of area median, and moderate income as above 80% and up to 120% of area median.

Table 3: HUD FY 2008 Income Limits for Alameda County5					
Income	People in Household				
Category	1 Person	2 People	3 People	4 People	5 People
Very Low					
50% AMI	$30,150	$34,450	$38,750	$43,050	$46,500
65% AMI	$39,200	$44,800	$50,400	$55,950	$60,450
Low					
80% AMI	$46,350	$53,000	$59,600	$66,250	$71,550
Median					
100% AMI	$60,300	$68,900	$77,500	$86,100	$93,000
Moderate					
120% AMI	$72,350	$82,700	$93,000	$103,300	$111,600

Comparing Table 3 with Table 2, which shows the income necessary to afford to buy a condominium, we can see that a one-bedroom unit is affordable to a single individual with an income of 120% of area median income. The required income is well over 120% of area median under any scenario for households with two or more people looking to buy condominiums with two bedrooms or more. So the market for condominiums is basically among people with above moderate incomes, over 120% of the area median. Some lower income people, such as retired homeowners who want to move into a more urban setting, will also be able to afford to buy because they have sufficient assets to invest in a down payment large enough to reduce the monthly mortgage costs to a level affordable at a lower income.

The most detailed income profile currently available for Berkeley tenants is from the 2000 Census, in which people reported their 1999 incomes. Table 4 below summarizes the 1999 income distribution in 2007 dollars. This provides an approximation of current tenant incomes, assuming tenant incomes kept up with inflation, which was 25% from 1999 to 2007. 6 This may well be an optimistic assumption, since most tenants are low income, and incomes for low-income people have generally not risen as fast as the incomes of higher income people. However, it is more likely to be approximately correct for the higher income tenants who are the potential buyers for market-priced condominiums.

5 Follows HUD convention of rounding to the nearest $50.
6 CPI index for the San Francisco Bay Area: 1999 index 172.5, 2007 index 216.0, change .

Table 4: Estimated 2007 Berkeley Tenant Household Income Distribution7		
Household Income	Tenant Households	
Less than $12,500	6,101	23.7%
$12,500 to $24,999	4,218	16.4%
$25,000 to $43,799	4,934	19.2%
$43,800 to $62,599	3,546	13.8%
$62,600 to $93,899	3,571	13.9%
$93,900 to 125,199	1,642	6.4%
$125,200 or more	1,692	6.6%
Total	25,704	100%

Sources: 2000 Census, Bureau of Labor Statistics CPI Index.
Method for estimate: 2000 Census report on 1999 tenant incomes adjusted to 2007 dollars using the change in the annual average San Francisco Bay Area Consumer Price Index for All Urban Consumers of 25.2% rounded to the nearest $100.

It is important to remember that this table is for all tenants and does not represent the income profile of tenants in rent-stabilized units. Only about three quarters of these tenants live in units subject to the Rent Stabilization Ordinance. At the time of the 2000 Census Berkeley had 4,384 single-family houses that were rentals, almost all of which are now exempt from rent control.8 In addition, the 2000 Census reported 1,720 rental units built from 1980 to 2000, and these units are also exempt from rent control.

We can get a close approximation of the number of tenant households in rent controlled units with enough income to afford a low-priced condominium by using the 2000 Census Public Use Microdata Sample, which combines Berkeley with Albany, and then applying the percentages to Berkeley tenants. There were approximately 3,850 Berkeley tenant households with one person making over $72,000 a year and able to afford a one-bedroom condominium or two or more people making over $95,500 and able to afford a two-bedroom condominium. In order to estimate the number of these higher-income tenants living in rent controlled units, we need to subtract those living in single-family houses or apartments built since 1980, since these units are largely exempt from rent control. Approximately 38% lived in single-family houses and another 7% lived in units built since 1980, leaving an estimated 2,100 of these higher income households living in multi-family rental units subject to rent control, about 11% of tenants in rent controlled units.

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7 Method for estimate: 2000 Census report on 1999 tenant incomes adjusted to 2007 dollars using the change in the annual average San Francisco Bay Area Consumer Price Index for All Urban Consumers rounded to the nearest $50.
8 The Census counts single-family structures, and single-unit properties are exempt from rent control, but multiple single-family houses may be located on one property, in which case the houses are usually subject to rent control. However a two-unit property with an owner-occupied unit that was owner-occupied in 1980 is also exempt from rent control. Units may also be exempt from rent control temporarily if they are vacant, occupied rent free or by an owner or rented under the Section 8 or Shelter Plus Care rental assistance programs, but in none of these cases is there a tenant who might be able to purchase the unit.

This does not mean that 11% of Berkeley's rent controlled tenants would be interested in buying the unit they live in or able to afford it if they were. The Berkeley rental market includes a great many people who are here on a temporary basis, students, visiting faculty, researchers and many others. Furthermore, the lowest priced condominiums will generally be smaller, in poorer physical condition, and in less desirable locations. Since the highest income tenants generally rent larger, newer units in better locations whose cost is likely to be substantially higher, they may still not be able to afford to buy the unit they live in.

We get an alternative perspective on the potential market for converted condominiums among Berkeley tenants by considering what rent the tenant is currently paying. It may be that the most likely buyers among Berkeley tenants are those who are already paying market rents that are near to the monthly cost of homeownership. Tenants who rented apartments after 1998 are likely to be paying close to current market rent at present, but in many cases this rent is still far below even the lowest monthly cost of ownership. In addition, tenants who rented their apartments before 1999 have rents that predate vacancy decontrol and typically pay substantially below current market rents. In both of these cases, even if the tenant has sufficient income to afford to buy, they face a significant financial trade-off between continuing to rent at lower rents that keep monthly housing costs down or moving to home ownership, with significantly higher monthly costs. Tenants who are already paying market rents at the high end of the market have much less to give up financially in making such a change.

Rent Stabilization Board registration data shows that there are 1,223 units in which the tenants pay at least $2,000 monthly for rent, and of these there are 433 units where the rent is at least $2,500 monthly, which means they are paying enough rent to make the payments on a one-bedroom or low-end two-bedroom condominium. In order to remove some of the groups of students who are sharing the rent, we can narrow this group down to those tenants in place for four years or more and where there are at least as many bedrooms as there are reported occupants. In this group of longer-term tenants who are not crowding the unit we have 467 units with longer-term tenants paying rents of at least $2,000, including 133 units where the tenants are paying at least $2,500 monthly. This may help provide a sense of the potential market for condominiums among tenants in rent-stabilized units. There are no such statistics readily available for tenants in units not subject to rent control.

Looking at the properties in the condominium conversion pipeline as of March 1, 2008, there are 176 units currently registered as rented with the Rent Stabilization Program, and 15 of these units have rent ceilings over $2,000 monthly.

The condominium conversion ordinance regulates conversion of multi-family property if it has been rented at any time since 1980, and most of these units are also subject to rent stabilization regulations. While the ordinance does cover newly constructed units that are exempt from rent stabilization, most new construction is either exempt from the ordinance because the developer created an underlying condominium map before renting the units, or are likely already prevented from conversion by long-term bond agreements to keep 20% of the units affordable to very low-income tenants. For that reason, most condominium conversion under the ordinance will be in the rent stabilized housing stock and the number of tenants in place who might be able to buy their units without assistance appears to be very limited.

In light of the City's overall housing priorities, it seems unlikely that the City would want to invest substantial subsidies to support market-rate purchase of units by tenants with incomes well above the area median. There are reasons to provide some support for purchase by these tenants, however. First, City policy is to encourage homeownership opportunities for tenants as long as creation of these opportunities is compatible with protecting the interests of other tenants. And secondly, while there are strong regulatory protections built into the ordinance to protect tenants from being forced to leave in order to create a vacancy, a program that enabled tenants to buy might further reduce the incentive some owners might feel to attempt to evade these regulatory restrictions.

There are several things that the City can do in order to support purchase of converted units by their tenants that would require little or no subsidy.

Property owners engaged in the conversion process already have a strong incentive to sell to sitting tenants, since then they do not need to wait until the tenant moves out in order to sell the condominium and begin to profit from the conversion. For most owners, the ability to sell the unit right away is sufficiently valuable that they are willing to offer a payment to the tenant for moving out and the same logic would apply to tenants buying their unit. When tenants have an income high enough or close to high enough to enable them to purchase the unit at market rate, owners may offer to sell at a modest discount in order to make an immediate sale. The current structure of the mitigation fee requirement may unnecessarily limit such discounts, however.

The ordinance currently allows owners to sell the unit at a discount, but the mitigation fee is paid based on no less than 90% of appraised value. This provision is intended to prevent collusion to evade part of the mitigation fee. This provision of the ordinance allows owners to sell the units to tenants at a 10% discount, but from the appraised value, rather than the "market" sales price. Appraisal is an art, and markets are in a process of constant change, so it is not uncommon for an appraisal to find that a unit has a higher value than its sale price. Since the usual purpose of the appraisal is to reassure the mortgage lender that there is sufficient value in the property, this is not usually a problem. However, it can cause problems in setting an appropriate mitigation fee. For example, if an owner discounts a unit by 10% from the owner's estimate of market value, and the appraisal then comes in 10% higher than the owners estimate of market value, so that the unit is being sold for 20% under the appraised value, then the owner must still pay a fee based on 90% of the appraised value even though they are selling the unit for 80% of the appraised value.

The City should consider changing the formula to allow proportionate reduction in the mitigation fee for sales of a unit to a sitting tenant at discounted prices of up to 25% below appraised value. It seems unlikely that an owner and a tenant would engage in a complex and illegal transaction simply in order to split the benefits of evading a payment amounting to just over 3% of the market value -- $15,633 on a $500,000 condominium.

A non-financial incentive, such as a priority in conversion could also encourage owners to offer units at a discount to sitting tenants. There will likely be times when more units are proposed for conversion during a year than are allowed under the ordinance. When that is the situation, properties over the quota will have to wait until the following year. Council requested that staff provide regular reports on the use of the condominium conversion program, so that they can make modifications to the current first-come first-served program if applications increase significantly beyond the allowed quota. Such an incentive could be considered at that time.

As an incentive to support tenant purchases, properties that have tenants seriously planning to buy could be allowed to draw against the following year's 100-unit quota if necessary so that they do not have to wait. The past practice of requiring only a signed tenant's statement of interest in purchasing is clearly inadequate, since some tenants have signed such statements simply to accommodate the owner, with no actual intention or ability to purchase the unit. The requirements to establish such a priority should at least include a pre-qualification statement from a mortgage lender, showing the lender's willingness to finance the tenant's purchase.

Planning staff has expressed concern over the administrative costs of verifying that tenants actually plan to buy their unit. Applicants for conversion already pay fees sufficient to cover the costs of processing applications. Applicants wishing to request such a priority could be required to pay a supplementary fee so that the City could contract out the verification process, or overall fees could be increased to incorporate this as a regular part of program administration.

Finally, the City could also consider offering to match the owner's discount with an investment of all or part of the mitigation fee paid for that unit, to be repaid to the City when the tenant-buyer sells their unit. While this would have costs to the City, the costs would be limited to the value of the mitigation fee for the unit purchased by the tenant. Given the limited number of tenants able to purchase the unit they live in, this would probably not have a serious effect on overall resources going into the Housing Trust Fund for other purposes.

3. What amount of subsidy is needed for low and moderate income Berkeley tenants to afford to buy a condominium?

Local governments use a wide range of homebuyer assistance strategies to assist new homebuyers. The most frequent approaches are to help with the up front costs of the purchase or the monthly carrying costs, or both, using capital subsidies, tax credits and tax-free savings accounts and creative financing strategies. Capital subsidy is the most practical strategy within the context of Berkeley's condominium conversion ordinance. Capital subsidy programs include assistance with down payment and closing costs and use of "inclusionary" requirements to create below-market rate housing opportunities. After briefly explaining why the other approaches are not currently practical for the City to implement at this time, this section reviews the amount of subsidy necessary to assist low and moderate-income tenants to buy a condominium. The various capital subsidy program possibilities will then be reviewed in more detail in the next section.

The other strategies are not practical for Berkeley at this time. Cities in California are not financially able to provide tax credits, although buyers in Berkeley can participate in the Alameda County Mortgage Credit Certificate Program, which provides a small Federal tax credit. In places such as New York City, where property taxes are much higher, tax credits serve as an incentive for developers of new housing to provide some units at below-market rates. Tax-free savings accounts for purposes of acquiring a home currently have the necessary Federal approval only in an experimental program for very low-income people called Individual Development Accounts. This program typically provides matching contributions supported by private foundations and in some cases local governments, and can help people move to homeownership in areas of the U.S. with dramatically lower housing prices than the Bay Area or in purchase of units that are already highly subsidized. Administration of these programs is very complex.

Local governments can sometimes provide financing that is otherwise unavailable. For example, in the early 1980s when interest rates were high Berkeley made tentative plans to join with other cities to use their tax-free bonding capacity to provide loans at lower interest rates, but abandoned these plans when market interest rates went down. There are community development lending institutions that work with buyers to provide non-traditional loans, substituting detailed knowledge of each families circumstances for standard credit scoring procedures. These organizations have an excellent track record, usually serving immigrant communities. There are substantial risks to involvement in creative financing strategies however. The recent mortgage-lending crisis originated in overuse of such "creative" financing strategies as no down payment loans and allowing purchase of homes with mortgage qualifying ratios of housing costs to income well above the FHA limit of 29%.

Capital subsidy programs are easier to administer than the other alternatives and can deliver more substantial levels of assistance. The least expensive of such programs are those that provide partial down payment and closing cost assistance to people who can otherwise afford to purchase a home, but who do not have sufficient savings to cover the down payment and closing costs. However, as shown previously, the tenants who can otherwise afford to purchase a condominium will generally have above-moderate incomes. Reaching low and moderate-income tenants will require a deeper level of subsidy. As we have seen, people with incomes at or somewhat above 120% of area median can afford to buy the lowest priced condominiums on the market. The

120% figure is the borderline between "moderate" and "above moderate" income. In the tables below we look at how much it would cost to make units affordable to people with exactly the median income and to people with incomes at 80% of area median, which is the borderline between "moderate" and "low" income.

Table 5 below reworks the affordability calculations from Table 2 to show the amount of down payment assistance that would be necessary in order to make the monthly ownership cost affordable to a tenant whose income is exactly at the median when buying a condominium for $300,000, $400,000 and $500,000. The table assumes that the tenant pays closing costs but makes no down payment. If the tenant contributes a down payment, then the necessary amount of subsidy would be reduced by the down payment amount.

Table 5: Capital Subsidy Needed to Make Condominiums Affordable at Median Income

	1-Bedroom	**2-Bedroom**	**3-Bedroom**
Subsidy/Down Payment Assumed	33%	59%	53%
Sale Price	**$300,000**	**$400,000**	**$500,000**
Subsidy/Down Payment Amount	**100,000**	**235,000**	**265,000**
Loan Amount	200,000	165,000	235,000
Mortgage Payment	(1,264)	(1,070)	(1,524)
Taxes and Insurance Estimated	(600)	(800)	(1,000)
Maintenance costs	(100)	(125)	(150)
Homeowners Association	(250)	(275)	(300)
Estimated Value of Tax Deductions	401	211	394
Total Monthly Housing Costs	(1,814)	(2,060)	(2,580)
Assumed Qualifying Ratio for Buyer	36%	36%	36%
Income Needed to Support Purchase and Mortgage (rounded)	**$60,500**	**$68,700**	**$86,000**

Table 5 shows that a down payment ranging from $100,000 to $265,000 makes these units affordable to one, two and four person households with incomes at the area median. The net value of the tax savings is much less for a married couple than for a single individual, since they receive a higher standard deduction. Combined with the higher unit costs for a two or three-bedroom unit this creates a large increase in the need for subsidy. For purposes of a hypothetical government program for moderate-income people we have assumed that the appropriate qualifying ratio is 36%, an amount that does not include utilities. This is an assumption that minimizes the amount of subsidy needed and may be higher than would really be appropriate. For most government housing programs, the allowable housing cost to income ratio, including utilities, is 30%, but homeownership programs and private mortgage lenders often allow a somewhat higher ratio.

Table 6 shows the extraordinary costs of making condominiums affordable to tenants with incomes at 80% of area median. This is the borderline between moderate and low incomes and it is the target affordability level the City uses in its inclusionary zoning ordinance for new condominiums. Making the units affordable to people at 80% of area median income requires City down payment contributions large enough that the buyer is responsible for obtaining and paying off a mortgage of less than $100,000. This is because there are significant fixed costs to homeownership in this model: property taxes and insurance, homeowners' association fees, and maintenance. These fixed costs use up most of the share of the buyer's income set aside for housing costs. In addition, with lower mortgage payments the net value of the tax deductions drops to zero for married couples with a below-median income. As a result, the only way to reduce monthly housing costs to an affordable level is to drastically reduce the mortgage payments by using a large capital subsidy to sufficiently reduce the size of the mortgage.

Table 6: Capital Subsidy Needed to Make Condominiums Affordable at 80% of Area Median Income

	1-Bedroom	**2-Bedroom**	**3-Bedroom**
Subsidy/Down Payment Assumed	68%	85%	83%
Sale Price	**$300,000**	**$400,000**	**$500,000**
Subsidy/Down Payment Amount	**205,000**	**340,000**	**415,000**
Loan Amount	95,000	60,000	85,000
Mortgage Payment	(600)	(389)	(551)
Taxes and Insurance Estimated	(600)	(800)	(1,000)
Maintenance costs	(100)	(125)	(150)
Homeowners Association	(250)	(275)	(300)
Estimated Value of Tax Deductions	165	0	0
Total Monthly Housing Costs	(1,385)	(1,589)	(2,001)
Assumed Qualifying Ratio for Buyer	36%	36%	36%
Income Needed to Support Purchase and Mortgage (rounded)	**$46,200**	**$53,000**	**$66,700**

There is a way to reduce one of these apparently fixed costs, property taxes, and thus reduce the cost of subsidy. If the below market price is made permanent by a deed restriction, then the County Assessor must value the property at the below-market price, which reduces the property taxes. This has the disadvantage to the City, School District, and County of reducing property tax revenue from these units.

Tables 7A and 7B show the below market rate (BMR) prices for units made permanently affordable to people with incomes at 80% and 65% of area median. Note that rows of material that is the same as has been shown in previous tables are not shown again in the interests of space.

Table 7A: BMR Prices Affordable at 80% AMI9			
	1-Bedroom	**2-Bedroom**	**3-Bedroom**
BMR Sale Price	**$170,000**	**$155,000**	**$205,000**
Market Price	$300,000	$400,000	$500,000
Discount	**$130,000**	**$245,000**	**$295,000**
Loan Amount	170,000	155,000	205,000
Mortgage Payment	(1,075)	(1,005)	(1,330)
Taxes and Insurance Estimated	(340)	(310)	(410)
Estimated Value of Tax Deductions	270	0	45
Total Monthly Housing Costs	(1,394)	(1,590)	(1,994)
Assumed Qualifying Ratio for Buyer	36%	36%	36%
Income Needed to Support Purchase and Mortgage (rounded)	**$46,500**	**$53,000**	**$66,500**

Table 7B: BMR Prices Affordable at 65% AMI			
	1-Bedroom	**2-Bedroom**	**3-Bedroom**
BMR Sale Price	**$130,000**	**$130,000**	**$165,000**
Market Price	$300,000	$400,000	$500,000
Discount	**$170,000**	**$270,000**	**$335,000**
Loan Amount	130,000	130,000	165,000
Mortgage Payment	(822)	(843)	(1,070)
Taxes and Insurance Estimated	(260)	(260)	(330)
Estimated Value of Tax Deductions	151	0	0
Total Monthly Housing Costs	(1,180)	(1,378)	(1,700)
Assumed Qualifying Ratio for Buyer	36%	36%	36%
Income Needed to Support Purchase and Mortgage (rounded)	**$39,300**	**$45,900**	**$56,700**
Source: Alameda County Assessor's Office; City of Berkeley Housing Department, IRS, Franchise Tax Board.			

The BMR price is a discount to the buyer and it can be provided in two ways, either through payment of a subsidy from the City to the seller in order to buy down the unit to the affordable price or through an “inclusionary” requirement for properties that convert to condominiums. If the City requires sale of a certain percentage of units at below-market rate prices, as it does with the inclusionary requirement for new construction, then there is no direct City subsidy, however, as will be discussed later, this requires trade-offs against payment of mitigation fees so that there are equivalent indirect costs.

9 Note that rows of material such as homeowners association fees that are the same as has been shown in previous tables are not shown again in the interests of space.

Table 7A shows that the discount or subsidy for a BMR unit that is permanently affordable to someone with an income at 80% of area median is less than the amount of subsidy needed to buy down a unit valued for tax purposes at market price by from $65,000 to $120,000. The subsidy required is still quite substantial ranging from $130,000 to $295,000 per unit. Using this method to make units affordable to tenants in the middle of the low-income range, at 65% of area median income (AMI), requires discounts or subsidies ranging from $170,000 to $335,000 per unit.

It is also within the discretion of the Assessor to value a property at only the amount paid by the buyer in cases where the City holds a silent second mortgage, depending on the totality of the circumstances. This could make the costs of both programs the same as those shown in Table 7, but would likely depend on the details of the program. With a shared-equity loan, the City can argue that the buyer benefits only from the amount of the market value that the buyers pays, and that it would be unfair for the buyer to pay taxes on the whole value. It may be more difficult to make this argument with a fixed interest loan. These alternatives are discussed in more detail in the next section on program models.

Now that we have established a general range of subsidy needed to reach low and moderate-income tenants we can examine the potential trade-offs. Under the current ordinance property owners pay a fee for conversion of units to condominiums that will generally amount to 12.5% of the sales price.

Table 8 shows the mitigation fees required to subsidize units at varying prices, as shown in the previous tables, and then shows the total number of units whose mitigation fees would have to be set aside in order to pay that subsidy. For example, if a buyer could only afford to purchase a unit if the City paid the entire cost, then it would require the mitigation fees from eight units to provide enough income to pay that subsidy. This is because, with fees at 12.5% of the sales price, the fees paid for eight identical units will equal the price of one unit (8 X 0.125=1). A buyer with an income at 100% or 80% of area median can afford to buy with the subsidy from fewer than eight units because the buyer supports a mortgage for part of the purchase price. But as the price increases over the amount the buyer can afford, all of the price over that amount must be covered by City subsidy so that the mitigation fees required will gradually approach the maximum of all the fees from eight units. (The unit sold to the tenant is included in these numbers.)

Table 8 shows that, roughly speaking, to provide a down payment subsidy for a median income buyer would require setting aside the mitigation fees from three to five units and to create a BMR unit for a buyer at 65% to 80% of AMI requires setting aside the fees from four to five units. In other words, if a five unit building converts to condominiums, the fees that it generates at the prices shown in Table 8 would basically be sufficient to subsidize purchase by one of its low or moderate-income tenants, as we saw in Tables 5, 6 and 7.

Table 8: Number of Units' Mitigation Fees That Must Be Set Aside to Subsidize Tenant Purchase of a Condominium Varied by Unit Price and Tenant Income

Market Price of Unit	$300,000	$400,000	$500,000
Mitigation Fee at 12.5%	$37,500	$50,000	$62,500

Subsidy Needed for

Down payment subsidy			
Buyer at 100% AMI	$100,000	$235,000	$265,000
Unit mitigation fees	2.7	4.7	4.2
Down payment subsidy			
Buyer at 80% AMI	$205,000	$340,000	$415,000
Unit mitigation fees	5.5	6.8	6.6
BMR sales price			
Buyer at 80% AMI	$130,000	$245,000	$295,000
Unit mitigation fees	3.5	4.9	4.7
BMR sales price			
Buyer at 65% AMI	$170,000	$270,000	$335,000
Unit mitigation fees	4.5	5.4	5.4

Tables 5-8 reflect the amount of subsidy the City will need to provide to assist tenants to buy relatively low-priced condominiums within the Berkeley market under a best-case scenario in which the mortgage-qualifying ratio is 36%. With a lower mortgage-qualifying ratio the required subsidy would be higher. Similarly, for higher priced condominiums the subsidy required will be higher, and while the mitigation fees paid will also increase with higher sales prices, since the mitigation fee is no more than 12.5% of the sales price the mitigation fee increase will be less than the increase in sales price. This means that for higher priced units the amount of subsidy will increase faster than the mitigation fees and reaching the desired affordability level will require use of the fees from more units than shown in Table 8.

4. First-time Homebuyer Program Models

A first-time homebuyers program would not require an amendment to the condominium conversion ordinance to allow the City to use mitigation fees to create such a program. The ordinance specifies that the mitigation fees, less a maximum of 20% for administration of affordable housing programs, must be used in accordance with Housing Trust Fund Guidelines. The City Council need only amend the HTF Guidelines to provide that these funds may be used to support a homeownership program, and provide for the creation of detailed homeownership program guidelines that specify the eligibility requirements, income levels to be assisted, form and amount of assistance, amount of tenant investment required, whether to include allowances for capital improvements to the unit or deterioration of the unit, resale process, and so on.

Such a program would require a major investment of affordable housing mitigation funds that would otherwise be used for the benefit of very low-income tenants through the Housing Trust Fund. Non-profit housing developers are able to leverage additional sources of subsidy for housing affordable to very low people, those with incomes at or below 50% of area median. With this additional assistance, the mitigation fees from two units converted and sold as condominiums would be sufficient to create at least one permanently affordable unit for a very low-income household. With 100 units a year allowed to convert, payment of the fees into the HTF could provide the basis for creation of at least 50 permanently affordable units annually. The same fees would be enough to assist only 20 to 30 low or moderate-income tenants a year to buy units, depending on cost of the units, the tenants' incomes and the amount of subsidy required in each case. That means that <u>the current HTF allocation process would provide twice as much permanently affordable housing and at a deeper level of affordability than would a first-time homebuyers program</u>.[10]

Homeownership programs generally make no ongoing adjustment for the income of the subsidized homeowner. Someone who starts as low-income and raises their income substantially is not required to pay off any of the past purchase subsidy unless they decide to move and purchase a market-rate home. If their income goes down, there is no provision for increased subsidy and they may be forced to sell. Most rental subsidy programs require the tenant to increase their rent payment as their income goes up, and will decrease the tenant's rent payment if their income goes down.

The central policy question for the City of Berkeley is whether it is worth trading off that greater affordability benefit in order to enable low or moderate-income tenants to purchase the unit they reside in or, more broadly, to enable low or moderate-income Berkeley tenants to purchase a condominium elsewhere in Berkeley. This is especially a concern in light of the City priority for helping homeless people get off the streets and into housing with accompanying supportive social services.

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10 This is all based on a mitigation fee of 12.5% of sales price. If the fee is reduced, then the mitigation fees generated will also be reduced and this in turn will reduce both the number of tenants who can be assisted to buy their units and the number of units that can be produced through the current HTF process.

Are there ways to recapture this subsidy and return it to the Housing Trust Fund, or are there reasons to provide such a high level of subsidy to moderate-income and low-income tenants? A close examination of alternative ways of structuring a capital subsidy program can help clarify these possibilities and the trade-offs involved in creating a homeownership assistance program.

Down Payment Assistance Repayable on Sale

A down payment assistance program is typically structured so that the assisted buyer repays all or part of the assistance when they resell their home. This repayment is secured by placing a "silent second" mortgage on the property. The mortgage is silent because no interest payments need be made. Instead, the amount of the mortgage, plus interest, is repaid on sale of the unit. The interest payment can be structured in many ways: below-market, market rate, or shared equity. This approach would return the money to the Housing Trust Fund. The median length of owner-occupancy in Berkeley was 14 years at the time of the 2000 Census. In general condominiums turn over somewhat faster than single-family homes, but this suggests that there would typically be at least a ten-year delay in returning the money to the Housing Trust Fund. During that time period, if real estate prices and construction costs increase faster than the interest rate on the silent second mortgage, then the value of the money for HTF purposes would also be reduced, in addition to the delay in providing permanently affordable housing.

Tenants would likely be interested in buying under such a program because they would risk very little of their own money, depending on how much down payment would be required, and they would gain the possibility of significant profits when they sell in the event that condominium prices rise significantly in the future. There are three main approaches to repayment in such programs: forgivable loans, loans with interest and equity sharing loans.

Forgivable loans reduce amount the homeowner must pay on resale based on the number of years of owner-occupancy so that the loan is fully forgiven after ten or twenty years. In this case little would return to the Housing Trust Fund and the City would be providing substantial subsidies to tenants at higher incomes than it currently assists through the Housing Trust Fund. The City has never provided forgivable loans for a homeownership program.

Equity sharing loans make the silent second loan as an investment, so that there are no interest payments. Instead, when the home is sold, the City would receive a share of the sales price for repayment to the Housing Trust Fund. Buyers also have the option to repay the City when they refinance. A normal shared appreciation formula, such as the City used for a previous down payment assistance program, allocates the sales price proportional to the amount of the purchase price paid by the City. For example, in the program in place in the late 1990s, the City would provide a $20,000 down payment. If the home were purchased for $200,000, then on resale the City would receive 10% of the sales price, so if the value of the home increased to $400,000 the City would be repaid $40,000.

In the examples shown in the previous section, the City investment would need to be at least half the price of the unit for median income purchasers and from two-thirds to four-fifths for low-income purchasers. This would mean that in most cases the City would receive from half to four fifths of the sales price, including half to four fifths of the increase in the price of the unit when it was sold or refinanced. Since the buyer in these scenarios puts very little money into a down payment and closing costs, however, the result is an extremely high rate of return on the homeowners' investment, and a high rate of return is virtually guaranteed unless the price of the property fails to go up during the ten-year period. For example, if the City contributes $300,000 towards a $400,000 condominium, with the owner taking out a private mortgage for the remaining $100,000 and the unit is resold ten years later for $642,000, with sales costs of $42,000, then the City would be repaid three quarters of the net sales price, $450,000, and the owner would receive $150,000, of which about $85,000 would go to pay off the mortgage, leaving an equity gain of $65,000. On the one hand, this is an excellent return on invested capital for the buyer, since the buyer only paid closing costs at the time of purchase, but on the other hand it is only just enough to cover a ten percent down payment on an equivalent market-rate unit.

Tables 9 and 10 below provide a comparison of accumulated owner equity under three different types of homeownership program (shared equity, repayment at a fixed interest rate, and below-market resale-restricted) under different rates of home price appreciation and for two different market values.

Shared equity loans can look particularly good to purchasers during times when the market is declining or stable because it results in a very low effective interest rate on the loan, but if the market turns up sharply, then it can results in a high effective interest rate and some buyers become very upset that they must share their profits with the City. This is particularly likely in a program in which the City is putting up a majority of the cost of the property and receiving a majority of the equity in return. It is essential that the City provides extensive buyer education regarding the nature of the owner's obligation to the City, and document that it has done so.

Loans repayable at a fixed interest rate would have the advantage that buyers would know exactly what their obligation would be on sale of the unit, and if their income increased to the point where they could make monthly payments they would have an incentive to refinance and repay the City in order to gain the full benefit of the mortgage interest deduction. However, there is no guarantee that such a purchase will greatly benefit the buyer, who may gain more than under a shared equity formula but also may gain much less.

Table 9 below shows an example in which the sales price of the unit is $500,000 and the City subsidy is $400,000, making it affordable to a buyer with an income at 80% of area median if they can provide an additional 5% down payment and closing costs. If the interest rate is 5% and the buyer resells after ten years, then in order to break even the price of the unit must go up by an average of 5% annually. Only then will the sale price fully repay the City's silent second mortgage as well as covering the amount of the first mortgage, sales costs and repay the owner the principal paid down on the first mortgage during the ten years. With a lower rate of price appreciation, then the owner will not gain anything financially from purchase of the unit. Indeed, the loan agreement would have to be structured to forgive part of the amount due if the interest and principal amounted to more than the net sales price, which it would if the appreciation rate was under 5%.

However, if the unit increases in value by more than 5% then the owner gains significant increases in equity. For example if the price increases by an average of 7% annually, however, then the owner will gain $178,000 in equity. If the City were to require a market interest rate on its loan however, then the owner equity would be much less, going down to $61,000 if the interest rate was set at 6.75% like the mortgage interest rate in this example.

During the forty-year period from 1960 to 2000 the annual appreciation for owner-occupied houses of all types in Berkeley as reported to the Census was 8.1%. This rate of appreciation is for a group primarily made up of single-family detached homes, and condominium prices generally do not appreciate as fast as single-family prices. From 2000 to 2007 home price appreciation in Berkeley as measured by the median sales price of single-family homes was nearly 9% annually and condominium prices went up 7.5% annually. If this ratio of single-family home prices to condominium prices applied to the 1960 to 2000 period, the average rate of increase would be about 6.8% for condominiums.

In light of the current decline in home prices and the uncertain long-term future of the American economy it is hard to say what the future will bring. Over the long-term, real estate in Berkeley has been and is likely to remain an excellent investment. However there are many fluctuations over the long term, including periods of price stability and decline. Since over the past decade Bay Area home prices increased much faster than incomes, something that is not sustainable over the long term, there is a real possibility of a lengthy period in which prices do not rise and even decline at times while incomes catch up to home prices.11 Under these circumstances, creating a program that requires minimum increases in value of 5% annually over ten years to generate owner equity may create risks to the buyers. The possible economic outcomes of the program would need to be carefully explained to prospective buyers.

Any program that helps people purchase a market-rate unit is limited to assisting people with incomes of at least 50% to 60% of the area median, even if the subsidy covers the entire purchase price of the unit. Payment of taxes, insurance, homeowners association dues and maintenance costs would generally require at least that much income even if there are no mortgage payments at all.

Below Market Rate Units With Resale Price Restriction

Creation of permanently affordable below-market rate (BMR) housing is an alternative to allowing resale of the unit at market prices. There are two main ways to do this. One is to use capital subsidies to help the buyer purchase the unit from the owner at market rate, with agreement to create permanent resale price restrictions in return for the subsidy. The other is an inclusionary program in which owners would be required to set aside a certain percentage of converted units at below-market rate prices.

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11 This process does not require increases in real income. It simply requires that incomes increase along with inflation, maintaining their buying power, while home prices remain flat, so they actually decline in terms of real dollars. Market corrections in home prices often involve prices remaining at the same dollar level for an extended period, so that the real decline in value is brought about by inflation. Homeowners generally have the option to remain in place rather than take an outright loss on the sale of their home.

Under the current circumstances of Berkeley's ordinance, a BMR program using capital subsidy would be preferable to an inclusionary program, for the reasons explained below.

A major purpose of the first-time homebuyers' assistance program is assisting tenants to purchase the units they currently live in. This creates difficulties for an inclusionary program that are not present in an equivalent program for new construction where there are no sitting tenants. In new construction one unit out of every five units being constructed is designated as inclusionary. Such an approach would not be able to accommodate variations in the number of tenants interested in purchasing, such as if a five unit property had two current tenants who both wanted to purchase their units under the below-market rate program, while another property had no tenants interested in purchase.

It is also important to understand that in the context of the condominium conversion ordinance an inclusionary program has the same costs and trade-offs for the City as a capital subsidy program, even though it requires sale of the unit at a below-market price so that the City makes no payment to the owner. As I will explain below, if the City requires creation of inclusionary units in condominium conversions it would need to reduce the payment of mitigation fees by the amount that the inclusionary unit was priced below the market.

It is City policy that owners planning to convert multi-family rental property to owner-occupancy should be encouraged to use the condominium form of ownership rather than the tenancy-in-common (TIC) form of ownership. Since the City cannot require payment of mitigation fees for conversion of property to TICs, mitigation fees for condominium conversion cannot be set at a level that fully mitigates the impact of the conversion on tenants. Instead, City policy is that mitigation fees should be set at the highest rate compatible with encouraging property owners to use the condominium conversion process rather than convert properties to tenancies in common in order to provide as much mitigation as possible. The same logic applies to use of an inclusionary requirement. In either case, whether the owner sells a unit at the market price and pays a fee to the Housing Trust Fund or whether the owner sells a unit at a below-market price, there is a reduction in the owners profit from conversion.

Within the context of the condominium conversion process, then, a BMR program would be a better way to create permanently affordable homeownership units than an inclusionary program because it provides much greater flexibility at the same cost. Such a program would use the pool of mitigation funds paid into the Housing Trust Fund to make a down payment large enough for the tenant to afford the monthly costs of ownership while paying the owner the market rate for the unit, as in the down payment assistance program. Rather than requiring repayment on sale of the unit, however, the City would establish a reduced initial price (market less City subsidy) and place permanent resale restrictions on the unit, giving it the characteristics of an inclusionary unit. These restrictions would need to be carefully explained to prospective buyers.

Depending on the affordability formula chosen, a BMR or inclusionary unit could become increasingly affordable over time. For example, if the price is allowed to increase with the Bay Area Consumer Price Index, and if area incomes increase 1% faster than the CPI, then a unit initially affordable to a family with an income at 80% of area median would gradually, over a twenty-year period, become affordable to a family with an income at 65% of area median. (This assumes that the other costs: taxes, homeowners association dues, insurance and maintenance also stay within the average rate of inflation.)

A CPI formula allows a purchaser to accumulate significant equity if they remain in the unit on a long-term basis. Table 9 shows an example in which a unit is sold to its tenant for $200,000 with a thirty-year mortgage. If there is annual inflation of 3%, then the tenant's equity on sale after ten years increased by $79,000 after taking out 7% for sales costs, including $29,000 in principle paid down. If annual inflation is 4%, equity increases by about $105,000 after sales costs. Depending on what happens in the real estate market, this may be enough to enable the owner to make a 10% down payment on an equivalent market rate unit, as long as the owner's income has increased over the years so that they can afford the monthly payments on a market rate unit.

The BMR program enables the owner to gain greater equity than the market rate programs under some circumstances but in reading this table it is important to keep in mind that over the past thirty years market values have increased faster than the Bay Area Consumer Price Index. The table shows a direct comparison of equity accumulation only when market values go up at the same rate as the CPI. If the market value of homes goes up more slowly than the CPI, the equity gain for the resale restricted unit will be higher than shown, while if market values go up faster then the equity gain for the resale restricted unit will be less than shown. In Berkeley the average home value has increased faster than the rate of inflation in every decade since 1960, sometimes by substantial margins. There is no way to tell whether this will continue in the future.

Table 9: Example of Owner Equity on Sale of a Three-Bedroom Condominium After 10 Years

		Type of Subsidy Program		
Yearly Price Inc.	Market Price at 10 years	Shared Appreciation	Repayment at Fixed Interest	Resale Restricted by CPI
2%	$609,497	$28,065	$0	$56,131
3%	$671,958	$39,683	$0	$79,366
4%	$740,122	$52,362	$0	$104,723
5%	$814,447	$66,186	$20,577	$132,372
6%	$895,424	$81,248	$95,885	
7%	$983,576	$97,644	$177,867	

Buyer income at 80% of area median
Market value at purchase: $500,000
Buyer mortgage is $100,000 in shared appreciation and repayment at fixed interest programs, with $400,000 subsidy.
Buyer mortgage is $200,000 in BMR resale restricted program, with $300,000 subsidy.
Fixed interest rate is 5%.
All other figures are as shown in previous tables.

Table 10: Example of Owner Equity on Sale of a One-Bedroom Condominium After 10 Years

		Type of Subsidy Program		
Yearly Price Inc.	Market Price at 10 years	Shared Appreciation	Repayment at Fixed Interest	Resale Restricted by CPI
2%	$365,698	$28,590	$0	$48,604
3%	$403,175	$40,208	$0	$68,354
4%	$444,073	$52,887	$2,433	$89,908
5%	$488,668	$66,711	$43,907	$113,409
6%	$537,254	$81,773	$89,092	
7%	$590,145	$98,169	$138,280	

Buyer income at 80% of area median
Market value at purchase: $300,000
Buyer mortgage is $100,000 in shared appreciation and repayment at fixed interest programs, with $200,000 subsidy.
Buyer mortgage is $170,000 in BMR resale restricted program, with $130,000 subsidy.
Fixed interest rate for repayment of City subsidy is 5%.
All other figures are as shown in previous tables.

Over all, the two repayable down payment programs, one with a fixed interest rate and the other using shared equity, offer a very modest equity accumulation that is unlikely to enable the homeowners to move into market rate housing. If buyers accumulated equity rapidly, then they would likely sell quickly in order to move into the unsubsidized market, and the City would regain use of the funds for the Housing Trust Fund's programs to assist very low-income people. This seems very unlikely. Instead, it seems likely that program participants would remain in their subsidized homes for as long as possible, since unless they had major increases in income they would lack the ability to purchase market-rate homes.

The fixed interest rate program has a high risk that in any given five or ten-year period, there will be little or no equity accumulation, although there can be major benefits during a period in which condominium prices rise quickly. In the case of the shared appreciation program, the buyer generally accumulates enough equity to make a 10% down payment on an equivalent market rate unit in the one-bedroom example, where the purchase price is one-third of the market price, but not in the three-bedroom example where the purchase price is only one-fifth of the market price. This indicates that the program would not be particularly useful in enabling people to accumulate a down payment and move out of their subsidized unit into a market-rate unit. Rather, when buyers needed to move for any reason, they would likely have to move back into the rental market, or else move out of the Bay Area to a place with lower housing prices.

The BMR program may enable buyers to accumulate enough equity for a 10% down payment on a market rate unit, as long as market prices do not increase by substantially more than the rate of inflation. If buyers accumulated equity rapidly, then they would likely sell quickly in order to move into the unsubsidized market, and additional first-time buyers could purchase these homes. This seems very unlikely. Instead, it seems likely that program participants would remain in their subsidized homes for as long as possible, since unless they had major increases in income they would lack the ability to purchase market-rate homes even though they had enough equity for a ten percent down payment.

In the BMR program the City does not receive any repayment to the Housing Trust Fund. Instead, the City makes a permanent investment that creates one permanently below market rate unit affordable to low to moderate-income people, but gives up the opportunity to create two or more units that would be permanently affordable to very low-income people.

An alternative approach to providing permanently affordable homeownership is presented in Section 5, which discusses use of Housing Trust Funds to create Limited Equity Housing Cooperatives.

It is important to determine what level of demand there is for a first-time homebuyers program, and what tenants are most interested in before investing substantial work on creating a program. We know that virtually all tenants want to become homeowners, but we do not know whether they would want to participate in programs where they must either repay any subsidy or accept permanent resale price restrictions. Before proceeding further, the City should survey current tenants to determine what they would choose if given a choice between maintaining a long-term tenancy under rent control, purchasing a below-market rate unit with permanent resale restrictions that limit equity accumulation, or purchasing a unit with substantial down payment assistance that must be repaid with interest on sale of the unit. Such a survey process would need to incorporate a significant educational component, so that the respondents understand the implications of the different programs.

First-Time Buyer Education

Any homeownership assistance program should develop educational materials that can help prospective tenant purchasers understand the responsibilities of homeownership and its potential costs and benefits. The materials should include spreadsheets that enable the prospective buyer to estimate the tradeoffs they must make between costs and benefits under varying possible scenarios for the future of the condominium market in Berkeley. Whether it makes economic sense for current tenants to buy the unit they live in depends on a combination of what they expect to gain in the future and what they are giving up in leaving the protections of rent control and a lifetime lease. In general, the monthly cost of ownership is likely to be higher than the monthly rental cost, even with the tax benefits of ownership and a substantial City subsidy to help make the unit affordable to a low or moderate-income tenant. But depending on how much this differential is and how the real estate market changes, the tenant may be able to gain as much or more in appreciation than they give up. This is only likely if they hold the unit for a substantial period such as ten years, and may be relatively unlikely for tenants who have been in place since before 1999, whose rents are likely to be significantly below market.

Prospective buyers should also be aware of the potential maintenance costs of the property they are buying. At the point of conversion the homeowners association will not have had time to build up maintenance reserves, so any major repairs to a roof, an electrical system, a plumbing system, or other part of the building owned in common may result in the need for a special assessment to pay for the repairs. As the properties converting are older buildings, there is a real likelihood that something will happen that requires expensive repairs. Buyers should examine the building's repair record as well as obtaining an inspection that goes beyond identifying immediate problems and looks at the potential for future problems.

Future maintenance and repair cost is particularly an issue for low-income buyers who are receiving City subsidy in order to purchase the unit. These buyers may not have the resources to afford a special assessment that is acceptable to the majority of owners. In addition, lower income owners may find that the majority of the homeowners association will choose a level or repair or improvement to the property that is more expensive than they can afford. This has been a significant problem in the San Francisco inclusionary housing program.

Trade-offs

A program broadly targeted to any low or moderate income Berkeley tenant interested in purchasing any condominium unit placed on the market in Berkeley could well use the entire resources made available through mitigation fees, especially if it allowed resale at market prices, because it would draw from a pool of around 6,000 tenants with incomes in the range of 60% to 120% of area median. A program that assisted sitting tenants to purchase the unit they live in would have a much smaller potential pool of applicants, since it would be limited to the tenants of the 100 units allowed to convert annually. Or a program might assist only tenants in properties converting to condominiums but not limit the assistance to the unit they currently live on. Each of these alternatives could still draw down the entirety of mitigation fees, depending on how many tenants wanted to participate and their incomes.

Any program of homeownership assistance to tenants should have a cap on the percentage of mitigation fees that will be allocated to it and should establish priorities among tenants who are interested in participating. There are two ways to establish priorities, minimum threshold requirements and point systems, and it would be possible to use both.

Threshold requirements that must be met could include requiring several years of prior residence in the unit or in Berkeley in order to participate, and requiring at least sufficient income to cover all ongoing costs of ownership after the City subsidy. The purpose of a minimum residence requirement would be to direct the benefits of the program to longer-term residents of Berkeley. The minimum income requirement would reflect the fact that people with incomes below 60% of area median would not be able to afford to pay the taxes, insurance, homeowners association fees and maintenance costs in a shared-equity program even if the City paid the entire cost of the unit. If the unit was permanently affordable, so that property taxes were drastically lowered, then households with much lower incomes could afford the monthly costs.

In addition to setting threshold requirements, a point system that can take into account a more detailed set of priorities. For example, a point system could create priorities for people such as the teachers and staff of the Berkeley Unified School District and give higher priority based on the applicant's total years of residence in Berkeley. Legal review would be needed for any priorities based on workplace, since California law bans discrimination based on "source of income" and "lawful occupation".

Use of a point system requires that assistance be allocated periodically, such as every six months, in order to compare scores. Otherwise a first-come, first-served system must be used and only threshold requirements are practical. However, since each conversion establishes a minimum one year exclusive right of purchase for sitting tenants, it seems practical to have periodic allocations based on a point system

4. What alternative homeownership programs could be created using mitigation fees or other City resources?

The City's Condominium Conversion Ordinance places no restrictions on conversion of multi-family rental housing to owner-occupancy through creation of limited equity housing cooperatives (LEHCs), and it has long been City policy to encourage them. Berkeley currently has approximately 200 units in LEHCs, three quarters in projects subsidized by the City and the rest created without City subsidy. The majority of these units were created through conversion of existing multi-family rental housing.

Limited equity housing cooperatives (LEHCs) are an alternative form of homeownership that provides resident control, modest equity accumulation, and permanent affordability. Cooperatives are organized so that a corporation owns the property, which may be the land and buildings or simply the buildings, and the residents own equal shares in the cooperative corporation. Ownership of a share gives each resident a right to exclusive occupancy of his or her home.

Purchase of a share in an LEHC is similar to purchase of a below-market rate condominium with resale restrictions. The resale price of the share is restricted to ensure that the unit remains affordable to future buyers. Typically the share price is nominal, not substantially greater than a tenant would pay for a first and last months rent and security deposit. The buyer also takes responsibility for monthly assessments, which in the coop include a share of the mortgage for the whole property. In contrast, in a condominium each unit has a separate mortgage.

LEHCs can stand alone, but an increasingly widespread model combines the LEHC with a Community Land Trust (CLT). The Community Land Trust owns the land and the LEHC owns the buildings that people live in. The residents of the LEHC elect their board of directors, and each coop also selects a representative to serve on the board of the land trust. The Community Land Trust is helpful in several ways. First, it helps preserve long-term affordability because as the landowner it ensures that the LEHC cannot convert to market-rate housing. Second, the CLT can provide technical assistance to the LEHC in educating residents about coops, educating the board about managing housing. Third, the CLT can monitor maintenance and management of the property to ensure that the coop operates properly. Finally, the CLT helps increase the overall supply of affordable housing while remaining a democratic and accountable community organization.[12]

Limited equity housing cooperatives cannot be created within the context of helping individual tenants to purchase their unit. However the City can assist tenants interested in purchasing the building they live in with the goal of converting it into an LEHC. In the past, the City of Berkeley provided subsidy through the Housing Trust Fund for creation of cooperatives by a local land trust.

The City could allocate a portion of the affordable housing mitigation fees received from condominium conversion to creation of affordable homeownership through LEHCs.

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12 Not all Land Trusts that work with housing are Community Land Trusts. Some have self-perpetuating Boards of Directors, rather than a membership-controlled structure.

This would have the advantage that development of LEHCs through acquisition and rehabilitation of existing multi-family buildings is eligible for other sources of affordable housing funding, such as Low Income Housing Tax Credits and State Multi-Family Housing Program bond money. This approach to use of the mitigation fees would not require significant revision of the HTF Guidelines, would not reduce the number of units that could be assisted and could create mixed-income properties in which very low, low and moderate income tenants were all able to live. An additional source of funding for LEHC creation could be the use of "in lieu" fees paid into the Housing Trust Fund by developers of new condominiums in lieu of providing inclusionary units within the project.

Potential Sources of Additional Funding for LEHCs

The Inclusionary Zoning Ordinance could provide a new source of funding for limited equity cooperatives. The City could allow developers of large projects, those with 100 units or more, to partner with an LEHC in order to meet their inclusionary requirement. For example, a developer planning to build a project with 100 units would instead build 80 market rate units and allocate 20% of the land plus additional in-lieu fees to a non-profit developer to build a 20-unit project next door to the market-rate project and turn the project into a limited-equity housing coop. Such an approach could be taken with either rental or condominium projects. There are a number of large, underutilized properties in Berkeley where more than 100 units could be developed. Such an approach would require a zoning ordinance amendment.

Yet another potential source of funding for low and moderate-income homeownership might be the Berkeley Unified School District and the Peralta Community College District. There is widespread agreement on the value of assisting teachers to buy homes in the communities in which they teach. In addition to teachers, many other people who work in the educational system are also low and moderate income. School districts have the ability to go to the voters for permission to sell bonds, paid for through property taxes, in the furtherance of their educational mission. The BUSD and the City could explore creation of a first-time homebuyers program for district teachers and staff as a retention policy.

About the Author

Dr. Stephen E. Barton was the City of Berkeley's Housing Director from 1999 to 2007 and is the author of numerous publications on housing policy. He received a National Planning Award from the American Planning Association in 1997 for his writing on housing subsidy programs and the Community Associations Institute Research Prize in 1988 for his work on condominium and planned development homeowners associations. He has been a Visiting Lecturer at the University of California, Berkeley and San Francisco State University and received his Ph.D. in City & Regional Planning from the University of California, Berkeley in 1985.

Among his publications are:

"The Success and Failure of Strong Rent Control in the City of Berkeley, 1978 to 1995", pp.88-109 in W. Dennis Keating, Michael B. Teitz and Andrejs Skaburskis, *Rent Control: Regulation and the Rental Housing Market*, Center for Urban Policy Research, Rutgers University, New Brunswick, 1998.

"Social Housing Versus Housing Allowances: Choosing Between Two Forms of Subsidy at the Local Level", *Journal of the American Planning Association*, V.62, n.1, Winter 1997, pp.108-119.

Common Interest Communities: Private Governments and the Public Interest, Institute of Governmental Studies, Berkeley, 1994. (with Carol Silverman)

The Effects of California's Residential Real Estate Transfer Disclosure Requirements, California Department of Real Estate, Sacramento, 1989. (with Carol Silverman)

Common Interest Homeowners Associations Management Study, California Department of Real Estate, Sacramento, 1987. (with Carol Silverman)

Date: May 30, 2008

To: Jay Kelekian, Executive Director, Rent Stabilization Board

From: Stephen E. Barton, Ph.D., Principal Planner

Subject: **Potential changes in affordable housing mitigation fees for condominium conversions**

The City Council requested that staff review the idea of allowing owners converting multi-family rental housing to condominiums to pay the affordable housing mitigation fee immediately on conversion, at a discount, rather than paying the full fee at the time of sale of the unit. The Rent Stabilization Program has asked that I prepare an analysis to help inform the staff review. The following analysis first discusses the issues involved in setting an appropriate affordable housing mitigation fee. It then explains the potential benefits and costs of discounting the fee based on early payment and lays out the basic parameters that should be considered in constructing an appropriate discount and suggests a potential policy for consideration.

Setting An Appropriate Mitigation Fee

Ultimately, there is a certain level of mitigation that is necessary in order to prevent conversion from imposing inequitable costs on tenants. If owners cannot provide this level of mitigation and still profit from conversion, then condominium conversion is simply not desirable. However, in Berkeley the City must also consider the competitive position of condominium conversion in relation to TIC conversion and may find it better to accept condominium conversion with partial mitigation of social costs rather than TIC conversion with none.

The current situation is that it is not possible either to prevent conversion of rental units to owner-occupancy or to set conversion fees high enough to mitigate all the negative effects of conversion. In light of this, Council's past discussion and actions expressed a desire to set the affordable housing mitigation fees at the highest practical level. For example, some Council members suggested auctioning off the conversion rights to the highest bidders. The ordinance uses a fee based on a percentage of the sales price rather than a fixed per unit fee or an amount per square foot. This increases the fee for the units that bring the highest prices when they convert.

At present the 12.5% fee is likely at the highest level that allows parity with TIC conversions and property owners have argued that it is set too high. The original staff proposal was 10%.

(Technically this percentage is a cap on the base fee, which is much higher, but for practical purposes, it serves to describe the fee.)

Since condominium conversion costs more than TIC conversion, particularly due to the mitigation fee, previous staff analysis found that to be more profitable to the property owner condominiums need to sell for 20% more than TICs.[1] The staff analysis looked at the differential between condominium and TIC prices in San Francisco, drawing on data from real estate firms specializing in both types of conversion. This analysis suggested that condominiums sold for a premium over the price of TICs of from 27% in three unit properties to 50% in properties with five units or more. There was little difference in the price of two-unit properties because San Francisco allows owner-occupied two unit properties to convert to condominiums as of right, outside their 200 unit per year limit at its associated lottery process. The most recent version of the San Francisco report suggests that if anything the differential between TICs and condominiums is higher today.[2]

Staff previously suggested that the City monitor demand for conversions and adjust the percentage fee upwards or downwards depending on whether owners were bringing more or less than the allowable 100 units annually into the conversion process. Once the City sets an appropriate annual number of units that are allowed to convert, the City can use a “market” approach to determine the maximum level of mitigation fees it can require. If there are too many applicants, the mitigations are set too low and if there are too few applicants, the mitigations are set too high.

Currently there are fewer units in the pipeline than would be allowed under the ordinance. Initially the owners of more units applied, but a large number dropped out when they were not selected, more dropped out due to lengthy delays in getting the program under way, and still more dropped out because of the now-changed requirement to remove all code violations, including gaining approval of work done without permits. Over the past two years the City has finally developed clear procedures, trained permit staff and has reduced the requirements for repairs to those necessary to remove visible safety hazards. However, the state of the housing market is now dramatically different from how it was two years ago and as a result the incentive for owners to convert their property from rentals to condominiums or TICs is also reduced and as a result the incentive for owners to convert their property from rentals to condominiums or TICs is also reduced. .

At present, the housing and mortgage-financing markets and their accompanying regulatory structures are in a very uncertain state and are unlikely to settle into clear new patterns for at least another year or even two. Home prices are declining in almost all surrounding communities and parts of Berkeley and the availability of mortgage financing is much more limited than it was only a year ago, especially for first-time homebuyers without sufficient savings to make a 20% down payment and for purchases of non-traditional forms of housing such as TICs. How the greater affordability of single-family homes and condominiums in nearby cities may affect the market for condominiums in Berkeley is not yet clear. As is typical when homeownership

1 “The Decision to Convert: TIC or Condominium?”, Attachment 5 in “Requested Information for the Condo Conversion Ordinance Workshop”, City Council Information Calendar, December 11, 2007.
2 Andy Sirkin, “Condominium Conversion in San Francisco”, January 29, 2008.

opportunities decline, market rents are now going up because higher income renters stay in the rental market for a longer period of time.

It is difficult to determine the number of units that should be allowed to convert and an appropriate fee level because of all these market uncertainties. There is no apparent movement to convert rental property to TICs under the current circumstances. Most of the creative financing that had been available to first-time homebuyers is now gone, so the risk of extensive TIC conversion is greatly reduced, and with it the threat to tenants. However, since it is likely that the homeownership market will turn up again in another few years, the City should consider steps to ensure that the mitigated conversion process continues and is something that owners turn to in the future.

Most of the owners currently in the conversion process appear to be waiting to see whether the City will reduce the mitigation fee level before completing the process. <u>The City may wish to consider reducing the fee somewhat, for example to 10%, in order to encourage owners who started to complete the process and to help the program move ahead under the current less favorable market conditions.</u> However, since the primary purpose of the program is to protect tenants from unregulated conversion, the City may wish to simply wait and see what comes out of the current crisis before making a decision, since there is no evidence of a move towards TIC conversion in the current market. Given the uncertainties, any reduced fee should be given a sunset period of no more than one or two years.

<u>Benefits and Costs of a Discounted Mitigation Fee</u>

Under the present ordinance, in most cases a fee of 12.5% of the sales price of the condominium is paid into the City's Housing Trust Fund as each unit is sold. Since sitting tenants are protected with a lifetime lease, it may be impossible to know when the converted units will be available for sale. This creates significant uncertainty for a property owner considering conversion unless the owner is able to stockpile one or more vacancies and has agreements from one or more tenants to move out. Such agreements are not legally binding, so the tenant can decide to stay, but they are often accompanied by payments in return for moving out. Both holding units vacant and tenant buy-outs add costs to the conversion process.

The current process also delays City receipt of the mitigation fees for conversion, but from the standpoint of City policies this is a reasonable delay, since the impact of the conversion on affordability does not occur until the tenant moves out. However, it takes a significant amount of time for the Housing Trust Fund process to generate replacement affordable housing, so in many cases the mitigation will not be in place until two or three years after the funds are received. Once the program is well established, and there is a regular flow of mitigation fee payments, the City can speed up the process by making advance commitments of funds, since the affordable housing development process can take a year or two to get permits and line up the complete financing package before the City funds are actually spent. Even so, there is likely to be a significant delay between receipt of the funds and the time when a low-income tenant moves into the affordable unit.

One way to speed up payments to the City and create greater certainty in the conversion process would be to offer converting owners the option of paying the affordable housing mitigation fees up-front, at the time of conversion, in return for a discount on the payment amount.

The primary advantages of such a discount for the owner are that it pays some or all of the costs of tenant buy-outs and of holding units vacant, thus increasing the owner's certainty of being able to sell at least some units immediately after conversion. In addition, some owners may prefer the certainty of making payments immediately, so that their costs are fixed, even if they do not know when many of their tenants may move. This will especially be the case in periods when owners believe that condominium values and thus future mitigation fee payments will increase relatively rapidly. For example, even without a discount if an owner believes that the sales price of condominiums will increase by an average of 7% over the next decade, then paying the fee immediately, at current market value, becomes the equivalent of investing that fee in a way that is expected to return 7% annually. This may not be sufficient rate of return for most owners, given the uncertainty of the real estate market. If there is a further discount for immediate payment, it then increases the potential rate of return.

Setting the discount at an appropriate rate is important, because if the discount is set at a rate higher than the gain in value to the City of the immediate payments, then the City loses value. If that happens, then the program becomes a zero sum game in which the owner's gain is the City's loss, instead of a mutually beneficial program. For the City, a discount program has the risk that, because of its complexity, the discount can become an indirect way of reducing the required mitigation fees rather than an alternative of equal value. While up front payment allows the City to begin the process of providing replacement affordable housing sooner, it also reduces the amount received and thus is likely to reduce the number of replacement units that can be produced.

Discount Analysis

The basic concept underlying the discount idea is "present value". Money received today is more valuable to the City than the same amount of money received in the future. For example, if it enables affordable housing to be created now rather than five years from now, then residents will enjoy five more years of living in affordable housing. If the City waits to create more affordable housing, then the cost of construction or of acquisition and rehabilitation is likely to go up with inflation or even faster so that it takes more money to provide the same amount of benefit in the future. If instead of spending the money, the City puts the money aside in reserves, it earns interest on the money set aside and has more money in the future.

Where the mitigation fee is concerned, however, it should be kept in mind that the mitigation fee is not a fixed amount set at the time of conversion. The current formula builds in an increase in the fee over time because the fee is set as a percentage of the sales price. This closely links the value of the mitigation fee to housing costs at the time the fee is paid. However, the City may still find it desirable to provide a discount in order to move more quickly on production of affordable housing and to encourage owners by sharing in the cost of tenant buy-outs and holding units vacant.

Present value analysis has two main components. One is the length of time involved and the other is the discount rate. In this case the length of time involved is the average time until the current tenant moves out and the unit can be sold. In order to form a reasonable estimate of this we need to look at data on tenant mobility.

Projecting future tenant mobility is not an easy task. The 2000 Census shows a median tenancy in Berkeley of three years. However, the 2000 Census was taken only fifteen months after full vacancy decontrol took effect and the mobility of tenants holding on to long-term rent controlled apartments is likely to be very different from the mobility of tenants who moved in at rates close to current market.

Current Rent Board records show that at the end of 2007 almost 25% of tenants in rent-stabilized units had been in place since Jan. 1999, a tenancy of at least nine years. Rent Board data also show that among the 14,000 units that have turned over since January 1999 the mean length of tenancy is 2.5 years. Rent Board data on the 176 rent stabilized units currently going through the condominium conversion process shows that 32 of them, 18%, have never had a vacancy increase and thus had tenants in place for at least nine years.

There are then two ways we can approach average length of further tenancy. One is to create a blended average. For example, if we assume 25% of the tenants will remain in place an average of an additional 10 years, and 75% will move in 2.5 years on the average, then the average tenancy would be 4.4 years. Or we could use two different projected average tenancies, and set different discount rates for units with pre- and post-1999 tenancies.

It should also be noted that if there is a further increase in market rents in Berkeley and the Bay Area, that could further increase tenant stability. Due to the coincidental effect of the dot com boom in raising market rents immediately after vacancy decontrol took effect, followed by the dot com bust, Berkeley and the Bay Area have had a relatively long period of relative stability in market rents. With the mortgage financing collapse currently taking place, however, more high-income tenants are remaining tenants rather than moving into home ownership and rents are beginning to increase again. Over the past eight years rent stabilization has provided very little direct economic benefit for tenants who moved in since 1999, although it has provided security, but as rents begin to increase again it is likely that it will also economically benefit tenants who stay in place for several years.

The second part of determining a present value is setting a standard for the discount rate. For example, the standard could be the City’s rate of return on cash investments. Given the purposes of the fee, a particularly appropriate standard is the change in housing costs. Over the period from 1960 to 2000 home values report to the U.S. Census for Berkeley increased by an average of 8% annually and home prices increased in every decade, despite occasional brief down turns or periods of stagnation. Since the fee is based on a percentage of the sales price of the unit, in a rising market, up front payment of the full value of the unit is already discounted by the unit’s future increase in value between the time of conversion and the time the tenant moves out and the unit can be sold. So the present value of the future fee is exactly the amount of the fee that would be paid if the unit sold today based on its current market value.

The City may want to add some additional amount of discount simply to take into account the value of creating affordable units sooner rather than later, but must also take into account that with a reduced fee it will be able to support the creation of fewer units. From the City perspective, the program already has a discount for up front payment that is roughly equal to the benefits the City receives. From the owner perspective, however, this discount is subject to the uncertainties of the housing market and is lower than a normal rate of return under conditions of uncertainty.

In general, a higher rate of return is necessary to attract investment when there is a higher level of uncertainty about the return on investment. The uncertainty involved in an up-front payment of mitigation fees depends largely on whether the owner is able to come to agreement with all tenants to move out. Where owners are able to gain such an agreement, with payment due at the time of conversion and sale of the units to come shortly thereafter, the owner will have a high degree of certainty about the market value of the units and a relatively short time frame between making this additional investment and gaining the return.

All of this suggests that if the City wishes to create a discount program, it should be on a fairly modest scale or else should be done explicitly as a means of reducing mitigation fees to encourage owner participation in the program. While it is likely that values will increase over the next decade, it is impossible to predict how they will change over the next several years. For this reason, it may be reasonable to offer a modest discount for payment at the time the map is approved rather than at the time of sale. For example, a 20% discount would be the equivalent of reducing the fee from 12.5% of sales price to 10%, so that the payment for a $400,000 condominium unit would be reduced from $50,000 to $40,000. Or if the fee was lowered to 10% then the up front payment would be 8% of sales price, so that the payment for a $400,000 condominium unit would be reduced from $40,000 to $32,000. <u>Any such discount should be done on an experimental basis and given a sunset period of one or two years</u>.

One potential model might be as follows:
Assume an average continuing tenancy of five years. Set the discount rate at the rate of future home price increases plus 4%. Set current value of the condominium at the appraised value of the unit. Then the discounted 12.5% mitigation fee would be (Appraised value X 0.125 X 0.96 X 0.96 X 0.96 X 0.96 X 0.96) or 81.5% of appraised value. A discount of 20% for immediate payment of the mitigation fees due on a building with $400,000 condominiums would then save the owner $10,000 per unit, reducing the fee from $50,000 to $40,000 per unit. It would be the equivalent of reducing the fee from 12.5% to 10% for immediate payment. Or if the fee was already reduced to 10%, it would reduce the amount further from $40,000 per unit to $32,000 per unit. It has been suggested that paying for an appraisal creates a hardship for the owner, however the cost of a set of appraisals is less than one percent of the normal mitigation fee.

It has also been suggested that a per square foot fee would provide greater administrative simplicity. A per square foot fee would reduce the fee for conversion of properties with above average values per square foot and impose higher costs on properties with below average values per square foot. Furthermore, such a fee would not automatically adjust based on changes in condominium prices in the housing market, requiring regular staff attention to ensure that it keeps up with the market.