Rent Stabilization Board

RENT STABILIZATION BOARD

DATE: February 15, 2007

TO: Honorable Members of the Rent Stabilization Board

FROM: Jay Kelekian, Executive Director

SUBJECT: Report on how the rate of interest on security deposits that must be refunded to tenants is calculated

Introduction:

At the January 18, 2007 Board meeting, a member of the public inquired how the rate of interest on security deposits that owners must return to tenants each year is calculated. Because the item was not on the agenda, the Brown Act prevented staff from responding adequately both to this individual as well as to questions from Board members. The Board asked staff to report back at the February meeting explaining how the rate is calculated, why it was changed and what the process would be to alter it to another standard, if the Board were so inclined.

Background and History:

Since its inception, the Rent Stabilization Ordinance has required that owners annually return to tenants interest on all security deposits held. In 2004, at the request of several landlords, who complained that the Board's rules on security deposit interest were confusing, costly and cumbersome, the Board reviewed and proposed revisions to the rules governing payment of security deposit interest. These proposals were crafted in consultation with individual property owners and the Berkeley Property Owners Association and were submitted for review by the Berkeley Black Property Owners Association before they were forwarded on to the City Council for placement on the November 2004 ballot. In November 2004, the voters overwhelmingly adopted the changes described below along with the other reforms proposed in Measure P.

Why is Interest Returned to Tenants?

Under state law, owners of rental property are allowed but not required to hold up to two months' rent (three months if the unit is furnished) as a deposit against unpaid rent or unrepaired damage to a rental unit. The deposit, often totaling several thousand dollars, is the property of the tenant and is in addition to any rent paid at the inception of the tenancy. The Web site for the Berkeley Property Owners Association (BPOA) summarizes the situation this way:

> *"…we must recall that a security deposit belongs to the tenant. The tenant could have spent the money on a TV, or bought shares of Google, or put it under his mattress. Instead, he's given it to the landlord to hold, and to keep if he damages the unit. In the meantime, it's the tenant's money; any investment return belongs to the tenant."*

The Pre-November 2004 Standard:

Between 1980 and 2004, the Rent Ordinance provided that a tenant's security deposit must be placed by the landlord in an interest-bearing account at a savings institution whose accounts were insured by the Federal Savings and Loan Insurance Corporation and that the interest was to be returned annually to the tenant. (B.M.C. §13.76.070.) Neither the interest rate nor the type of account was specified. Consequently, the rate of interest paid to tenants varied from property to property. Moreover, the Ordinance did not specify the consequences of a landlord's failure to deposit the funds in a bank or return the interest to the tenant.

Rent Board regulations implementing B.M.C. §13.76.070 provided that a landlord must place the deposit in an account that was clearly designated as being for the benefit of the tenants (Reg.701.B) and that a tenant could request that the landlord provide verification of the account. (Reg.702.B.) The Rent Board also required that if a landlord failed to place the security in a federally insured account, the landlord is required to pay interest at the legal rate of interest on unpaid judgments established in Code of Civil Procedure §685.010, which had long been 10%. (Reg.703.) Where a landlord failed to refund interest annually as required by the Ordinance, the tenant, upon proper notice to the landlord, was permitted to withhold the interest, calculated at the legal rate of 10%, from the rent. (Reg. 704.)

The security deposit interest provision of the Rent Ordinance generated an inordinate amount of confusion and dispute. With the relatively low interest rates for many years preceding the change in 2004, some dissatisfied tenants demanded proof that their deposits were being held in segregated accounts and of the rate paid. Even if the landlord annually refunded security deposit interest at the generally prevailing passbook rate, these tenants argued it should be at the 10% rate if the landlord fails to provide proof that the security is held in a segregated, federally insured interest-bearing account. Some tenants even argued that owners paying more than the actual rate available on a passbook should forfeit Annual General Adjustments (AGAs) if the owner could not demonstrate that the owner was holding the deposit in a separate account. Landlords complained that they were subject to excessive bank fees if they strictly complied with the regulations and that it was overly burdensome to produce bank records whenever a tenant was unhappy with the rate of interest being generated.

Other Options Considered in 2004

A variety of options were considered. Staff was interested in a standard that was uniform in application for all tenants and owners, relatively simple, externally verifiable and addressed the concerns raised by property owners. It was agreed that, because it was the tenant's money that

was being held for the protection of the owner, the standard should be reflective of what the tenant could **reasonably** receive rather than what the owner actually earned.

We looked to standards used in other jurisdictions. Payment of interest on residential tenant security deposits was mandatory in 15 states, most Canadian provinces, the District of Columbia and a number of other U.S. cities, including San Francisco, West Hollywood, Chicago, Boston and Boulder. Because of a court ruling in the case of Action Apartment Association vs. the City of Santa Monica Rent Board, we were precluded from adopting a pre-determined fixed rate on interest, like Santa Monica had used for a number of years.

In West Hollywood, the rate for security deposit interest was determined by averaging the interest percentage paid by five local banks to their customers for regulation savings accounts. The West Hollywood Rent Stabilization Commission announced the required interest rate annually and notified the city's landlords and tenants by mail. Owners in Berkeley objected to this methodology because they did not want Rent Board staff conducting a study or the Board having discretion about the rate set. For this reason, it was requested that an external/ "objective" standard be utilized.

In Chicago, the applicable rate was the average of interest rates for three types of accounts (i.e., passbook savings, insured money market and 6-month $1,000 CD) at Chicago's largest bank (Bank One) on December 31. The Chicago City Comptroller calculates and announces the rate on the first business day of the year. In Connecticut, the applicable rate for a calendar year was the average rate paid on savings deposits by insured commercial banks as last published in the Federal Reserve Board Bulletin in November of the prior year. The annual index is determined and publicized by the state Banking Commissioner.

At the time, in San Francisco, the Rent Board annually determined the interest rate to be applied to security deposits, based on the average of the 12 monthly "Discount Window" rates posted by the Federal Reserve Bank. The Rent Board calculated and announced the rate each year using the preceding 12 monthly rates ending December 31. In the spring of 2004, the Federal Reserve Bank had just discontinued posting the "Discount Window" rate, and San Francisco was in the process of amending this provision to provide that the interest rate be the average of the monthly rates posted by the Federal Reserve Bank for 6-month Certificates of Deposit.

As shown above, there were a number of indices that could have been used that would reflect a fair passbook rate for tenants. The annual average of a rate posted monthly by the Federal Reserve, such as the rate for 6-month CDs, was the easiest to administer and could be tracked by landlords throughout the year. Staff and the Board believed that the 6-month CD rate is fair because it provides tenants, who are denied access to the funds for a lengthy period, with a rate that is slightly higher than an ordinary passbook, while still being a relatively liquid investment vehicle for landlords who would be freed from the strictures of the present deposit requirements. Moreover, the Federal Reserve's 6-month CD rate is easily tracked daily on the Federal Reserve's Statistical Release Web site. (http://www.federalreserve.gov/releases/h15/update/).

Standard Adopted by the Voters in November 2004

In November 2004, upon the adoption of Measure P (relevant portion included as Attachment 1), Berkeley voters amended Berkeley Municipal Code Section 13.76.070 (Security Deposits) to provide that the interest to be paid on tenant security deposits shall accrue at a rate equal to the average monthly rate payable on 6-month certificates of deposits by insured commercial banks as reported by the Federal Reserve Board on the first business day of each month for the prior twelve months ending on November 1st , rounded to the nearest tenth. The Federal Reserve Board's Statistical Release of Selected Interest Rates is posted each business day. Each November the Rent Board calculates and publicizes the applicable interest rate to be paid in December.

Unlike the old law, Measure P does not require that security deposits be placed in a specific type of account so long as the deposit is held for the tenants' benefit and the interest is returned to the tenants at the published rate each December and when they vacate the premises. If the December interest refund payment is not made by January 10th, the tenant may recover interest at the rate of 10% by notifying the landlord in writing that the tenant intends to deduct the interest from a future rent payment.

In reviewing the changes brought on by the adoption of Measure P, the BPOA Web site states the following:

> *"When the Rent Board sat down to draft the rent law changes that became Measure P, they included something to standardize interest payments and eliminate the 'separate account' requirement. That's right: the Rent Board actually thought they were doing landlords a favor! In a sense this was true since they eliminated the time and expense required to deposit and account for each tenant's money separately. They also left housing providers free to manage their cash flow in more businesslike ways."*

Rates for Annual Payment of Security Deposit Interest Since the Adoption of Measure P	
December 2004	1.6%
December 2005	3.4%
December 2006	5.1%

Attached (Attachment 2) is the most recent information published by the Federal Reserve Web site www.federalreserve.gov/Releases/h15/Current/ , which is what we review the first business day of each month to derive the annual payment rate. As of February 9, 2007, the average return for a 6-month CD was 5.35%.

On February 12, 2007, I did a Google search for "best cd rates in the USA" and found the attached list of "High Yield Rates for 6-Month CD's" (Attachment 3), which includes information on 30 institutions that currently are offering a rate of 5% or greater.

How Can the Standard be Modified?

Board members requested that I address what discretion the Board has to modify the rate paid out for security deposits held by owners. Because the provisions for interest on tenant's security was part of the voter adopted, Rent Stabilization Ordinance, only the voters have the ability to amend the procedure. The earliest this can be done is at the November 2008 general election. If the Board felt it was desirable, and a better standard could be developed, it may ask the Council to place an amendment to Section 13.76.070 of the Rent Stabilization Ordinance on that ballot for the voters consideration. Council also has the authority to place the issue on the ballot, without a specific request from the Board. To my best recollection, the City Council has never placed an amendment to the Rent Stabilization Ordinance before the voters without the Board's request. The only other way that the Ordinance can be amended is through a citizen's initiative, which can be placed on the ballot with signatures from 10% of the votes cast for all candidates for Mayor in the preceding election – for the November 2008 ballot, just under 4,100 signatures would be required. I have attached a copy of Article XIII of the City Charter (Attachment 4), which discusses the initiative process in Berkeley.

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