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Rent Control Makes a Comeback as Housing Crisis Grows

Rent control seemed to be on the ropes a few years ago. Some state laws were repealed, and economists on both the left and right agree that it is a counterproductive solution to the affordable housing problem. However, years of above-trend rent growth have led to a renewed push for states to set limits. Three states passed new laws in 2019 limiting rent increases, others are considering their own measures and housing is set to be on the agenda in the 2020 presidential election.

Unfortunately, what passes for action to alleviate the crisis is often short-sighted. Solutions that are more likely to have an impact—such as increased density, a streamlined entitlement process and additional subsidies—are difficult to implement in the current political climate.

The average rent for an apartment in the U.S. has risen by nearly one-third since January 2012, well above both the inflation rate and income growth. Rent gains are driven by the combination of strong demand from Millennials and downsizing Baby Boomers, while housing supply growth was sharply reduced for years in the wake of the Great Recession.

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The gap between income and rent has led to a large increase in the number of rent-burdened households. Upward of 20 million renter households pay more than 30% of their income on housing, and 80% of renters and 63% of owners making less than $30,000 are cost-burdened, according to the Harvard Joint Center for Housing Studies.

As the situation worsens, it creates political pressure to act. Legislators in three states—Oregon, New York and California—passed rent control measures in 2019, and the wave may be just beginning. The National Multifamily Housing Council says that since 2017 more than a dozen other states—including Washington, Colorado, Illinois and Massachusetts—have considered legislation and/or ballot initiatives that would limit rent growth.

Of the rent control measures passed to date, New York's is the most punitive and has had the most immediate impact. The larger problem, though, is twofold: Once in place, it is easier to progressively tighten the screws and make the laws more onerous for property owners. The second problem is that rent control gives the appearance of action and diverts attention from the real solution, which is that we need to build more units that are affordable.

Three States Enact Laws in 2019

Of the three states to pass rent control laws in 2019, Oregon's is the least onerous, allowing landlords to increase rents by 7% plus the cost of inflation. The law applies only to properties that were built before 2004.

California's law sets rent caps at 5% plus the cost of inflation. The law applies to properties that are at least 15 years old, although the age limit rolls, so each year it applies to more properties as they reach 15 years of operation. In addition to caps on rent increases, California also made it more difficult to evict residents that have lived in an apartment for at least one year. Owners must have just cause to evict a resident and must make a relocation payment if an eviction displaces tenants for purposes like rehabilitating a unit.

Given long-term rent growth trends, the Oregon and California rent caps are likely to have a minimal effect on the market. The long-term average annual rent growth in the U.S. is 2.5%, according to Yardi Matrix. Some metros have seen larger spikes in recent years—average rents in Sacramento rose 40% between 2014 and 2018—but that's rare. Some contend that caps might have an effect opposite to that intended—causing rents to rise more than they would otherwise, because the limits provide an incentive for owners to raise rents the maximum amount. Another concern is that it will reduce development and investment if potential owners are worried about the risk of future limits on income.

New York's law is much stricter and has thrown the New York City apartment market into turmoil. The law—the Housing Stability and Tenant Protection Act of 2019—affects 1.1 million rent-stabilized apartments in New York City alone, representing somewhere between one-third and one-half of the apartment stock in the five boroughs. The new controls have many troublesome provisions, but the two most problematic are the repeal of individual unit deregulation and the limits on Major Capital Improvements (MCI) and Individual Apartment Improvements (IAI).

Unit Deregulation: Owners were formerly authorized to raise rents by 20% when stabilized units were vacated, and they were able to deregulate units when rents reached $2,775 and/or residents had an income of $200,000 per year for at least two years. Now, increases are limited to an inflation-indexed percentage set by the New York City Rent Guidelines Board. In recent years, increases have been set at 1% to 2% annually.

This is a particularly large blow to owners that bought buildings with the expectation of raising rents as residents change. Because property values account for future rent growth, buildings have lost value that can't be regained unless the law is altered.

MCI, IAI: Owners formerly could increase rents in conjunction with capital improvements to properties. Now, however, rent increases are capped on investments over $15,000 for improvements over a 15-year period. Anyone who owns housing or lives anywhere near New York City knows that $15,000 doesn't buy much in the way of improvements.

The limits on capital improvements are insidious for several reasons. Most important, it will lead to a deterioration of existing stock. If landlords can't recoup capital spent on improvements, they either won't make the improvements or will do it with lesser-quality materials. Either outcome is to the detriment of renters. It's also particularly critical given that the law applies to older buildings that, by definition, are the most in need of fixing. New York City is filled with pre-World War II apartment buildings that have—among other issues—old roofs, decaying HVAC systems and inadequate electrical systems.

A related impact is that deferring maintenance will lead to less work for trades. Stories abound of contractors laying off workers such as carpenters, plumbers and electricians because of reduced demand for those services. Blackstone Group, owner of the 11,000-unit Stuyvesant Town and Peter Cooper Village in Manhattan, has announced that it will curtail all but legally required improvements.

Additionally, in some cases, owners will take units out of circulation when a longstanding tenant moves out. The apartment's rent might be too low to justify the amount of work necessary to bring the unit back to rentable condition. All these scenarios lead to the reduction of the type of stock

affordable to middle-income households that legislators are trying to increase.

The law does not apply to new construction, but new apartments in New York City are almost entirely aimed at the luxury segment, with market-rate rents averaging more than $4,000 per month. The pipeline of new supply may not be severely affected, but it is possible that developers might decide not to build in the city in the event that rent control laws are tightened in the future. Some 30,000 multifamily units are currently under construction in New York City (as of December 2019), according to Matrix.

Losing Propositions

The New York state law is designed in a way that makes it likely that expense growth will outstrip income growth. Many owners face a situation in which expenses—utilities, wages, property taxes, capital improvements—will rise more than the allowable 1% to 2% annual rent increases. That was true before, but until now owners could make up for any losses with rent increases on units that had new residents or were otherwise deregulated.

Transaction activity has ground to a near halt as the market digests the impact of the new law. Market participants say that the values of properties with stabilized units dropped anywhere from

20% to 40% overnight. Owners with highly leveraged properties or those that are thinly capitalized will feel the most pain, and those that suddenly find themselves underwater might decide to hand over the keys to the lenders. The composition of the buyer base is also likely to change, as some owners exit the market, while more opportunistic capital sources and those that left when acquisition yields fell to 3-4% in recent years will come back looking for bargains or distressed assets.

Another concern is the possibility of increased loan defaults. A study of 125 CMBS pools by BlackRock Solutions found that two-thirds of New York City apartments that back more than $5 billion of collateral will be negatively affected by the new rent control law. "We expect the performance of regulated buildings will worsen," said the report, which was released in August.

KBRA reported that two loans on New York multifamily properties in the LNCR 2018-CRE1 transaction—Two West 107th Street (the second-largest loan, accounting for 9.0% of the loan collateral balance) and 471-476 Central Park West—were 30-plus days delinquent during the August 2019 remittance period. Although the agency did not specifically attribute the delinquency to the new rent control law, its report on the delinquency made note of the law. New York City apartment owners will, at the least, take the reduced prospects into account when deciding how to handle a problem loan.

Needed: Smart Housing Policy

It's possible to overstate the impact of rent control on the institutional CRE market. Multifamily remains the most in-favor property type in an in-favor asset class. Equity and debt investors of all types and regions are eager to add multifamily assets to their portfolios. Household growth, demographics and lifestyle trends make it likely that demand will continue to increase steadily in the coming decade. Occupancy rates are at or near historical highs in many metros, and multifamily loan defaults are practically non-existent.

That said, rent control laws are at best a shortsighted solution to the affordable housing crisis. Limiting rents on residents that stay in place increases the cost burden on those who move or enter the market for the first time. It limits the amount of new development, which exacerbates affordability by decreasing the amount of stock. And by limiting what owners are willing to spend on renovations, it likely means the deterioration of apartment stock.

The U.S. faces many barriers to a smart affordable housing policy. One problem is the cost of construction, which makes it challenging to build apartments that low- and middle-income families can afford. Nearly 90% of the 1.3 million-plus apartments completed in the U.S. since 2016 are luxury units (according to Yardi Matrix). Land, materials and labor costs have steadily risen faster than inflation during this market cycle. There is a major shortage of skilled construction workers, which is being exacerbated by the tightening of immigration standards.

Government is yet another inhibitor. Fees and regulations add 32% to the cost of housing, according to NMHC, and the entitlement process can delay projects for years. Exclusionary zoning makes it more difficult to build affordable housing (or any at all) in many jurisdictions.

Solutions to the affordability crisis include:

- Building more units, which requires streamlining the entitlement process.
- Allowing higher density to make projects more viable, often in conjunction with improved infrastructure and public transportation.
- Increasing the amount of government subsidized housing to households that pay a significant portion of income on rent.

Finding the political will to implement these solutions, some of which encompass government spending, will be difficult. What's more, underlying all these issues is the fact that those with the knowledge and/or means to implement real solutions are rarely in a position to act. Zoning law in most states is controlled by municipal authorities that do not have interests at stake larger than winning their next election, and being anti-development offers a popular campaign slogan in many municipal races.

None of these problems will be easily overcome, as California illustrates. Gov. Gavin Newsom has set a goal of building 3.5 million housing units by 2025, but the effort is bogging down as legislators representing some cities object to height limits, increased density, environmental impacts and other issues. The lack of affordable housing is holding back California's economy, as residents and employers leave for less expensive destinations.

Alleviating the affordable housing issue in the U.S. will take commitment and cooperation from builders, municipalities and other stakeholders. The depth of the crisis has spurred action, but the fact that rent control remains the first response for some states is a sign that finding solutions is likely to be an arduous process riddled with bumps.

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