



Memorandum

**TO: HONORABLE MAYOR &
CITY COUNCIL**

FROM: Vice Mayor Rose Herrera
Councilmember Johnny Khamis
Councilmember Manh Nguyen

SUBJECT: Apartment Rent Ordinance (ARO)

DATE: April 14, 2016

Approved

Date

[Handwritten signatures and date]
Rose Herrera^{DD} 4/14/16

RECOMMENDATION

1. Direct staff to return with an ordinance amending the City's Apartment Rent Ordinance (ARO) to reflect the following changes:
 - a. *Annual Allowable Rent Increase*
 - Establish a maximum annual rent increase as follows
 - Rental owners may increase rents by not more than 6% in a 12-month period.
 - Owners may increase rents by not more than 8% in a 12-month period subject to the Limited Capital Improvement Pass Through, as outlined in this memo.
 - Rental owners shall have the ability to "bank" unused portions of the 6% annual increase.
 - Rather than implement a unit registry, if an owner seeks to bank portions of an unused increase, the owner is required to notify the tenant(s), in writing, that they are "banking" all, or a portion of, an increase when serving a rent increase notice. They must also inform the tenant of the maximum possible increase they could receive in 12 months (i.e. at the next rent increase), when adding the 6% allowable increase to the full value of the bank. Failure to notify a tenant, in writing, of the amount "banked" will forfeit the owner's right to apply the banked increase in a future year.
 - Provided an owner has properly notified the tenant of the banked increases, the use of any banked portion, when added to the annual allowable increase of 6%, shall not exceed 10% in any 12-month period.
 - The "bank" will reset to zero upon a change in tenancy that would allow the owner to raise rent to the market rate.

- The new standards for the maximum allowable increase will apply to all rent increases issued on or after the effective date of the ordinance.
- b. *Debt Service Pass Through*
- Make the following changes to the Debt Service Pass Through:
 - Eliminate the ability of rental property owners to refinance a property and pass on the cost of increased debt to the tenants.
 - Reduce the maximum Loan-to-Value ratio to 65%.
 - Require that any Debt Service Pass Through must be in connection with the acquisition of an ARO building and the debt must be incurred within 12 months of acquiring ownership.
 - Limit a rent increase related to debt service to not more than 20%.
 - Use of the Debt Service Pass Through will eliminate any “banked” rent increases and the bank for that unit will reset to zero.
 - Direct the City Auditor to analyze the Debt Service Pass Through and determine what, if any, economic consequences may exist to the City by reducing or eliminating this element of the ARO
- c. *Capital Improvement Pass Through*
- Make no changes to the current Capital Improvement Pass Through and maintain the current formula for improvements that would be outside of the Limited CIP Incentive Program outlined below.
- d. *Limited CIP Incentive Program*
- Direct staff to develop a seamless, efficient, and streamlined process that allows rental owners to pass on the costs of specific capital improvements and exempt those increases from challenges provided the total rent increase does not exceed 8%.
 - The use of the Limited CIP Incentive Program will not affect any banked portion of an unused increase from prior years.
- e. *Revised Notification for Notices to Terminate*
- Adopt the original draft staff recommendation to make no changes to the current process for terminating tenancies without cause.
 - Establish a vacancy factor of 4% as the trigger for declaring a “tight rental market”
- f. *Good Cause Eviction Ordinance*
- Direct staff not to pursue a Just Cause Eviction Ordinance. They are instead directed to identify the best ways to ensure that the provisions of California Civil Code Section 1942.5, that protects renters from retaliatory evictions or action by a rental housing provider, are properly enforced.

- Staff is also directed to work with key stakeholders to develop specific provisions of a local Anti-Retaliation & Protection Ordinance (ARPO) as a possible tool to address issues surrounding tenants' fears of retaliation for surfacing code violations or other issues and present a workplan for stakeholder engagement, outreach, and ordinance development to the Rules Committee by June 2016.
- Staff is further directed to continue to ensure that the Multiple Housing Inspection Program is targeting the properties in most need of inspection.

g. Monitoring & Enforcement of the ARO

- The City Auditor is directed to audit the current policies and procedures of the Housing Department's Rental Rights and Referrals Program and the proposed modifications to identify better ways to enforce the provisions surrounding Notices to Terminate and return with a modest staffing plan for City Council consideration, in conjunction with the amended ARO.
- In lieu of a comprehensive rent registry, staff should contract with other data sources such as Co Star that provide data on buildings with as few as five units, and explore the development of an annual custom rent survey for San Jose. As part of the City Auditor's evaluation, the Auditor should help identify cost-effective ways for staff to obtain rent trend data that is not overly intrusive or burdensome on housing providers, staff, or renters.
- A rent registry should not be needed to implement the banking provision outlined in Recommendation 1(a), above, however, the City Auditor should review options and best practices for monitoring and enforcement and provide an analysis on the most cost-effective and efficient program possible that also maintains privacy for renters and is easy to administer for rental housing providers and the City.

h. Evaluation of Staffing Levels

- Consistent with the Smart City Initiative, direct staff to identify technology-based solutions that allow rental property owners to submit information and required notices via the Internet or other electronic applications.
- Direct the City Auditor to work with the Housing Department to review any proposed programs, policies, and procedures to ensure the most effective and efficient monitoring and enforcement program is developed.

2. Adopt recommendation 1.c. from Councilmember Jones' memorandum dated April 8, 2016, to address historically low rents with the modification of the rent reduction from 5% to 6%, as follows:

- a. Establish a special allowance for rent reductions that are equal to, or greater than, 6% in a year.
 - The previous rent, i.e., before the reduction, becomes the base year.

- Allow an owner to increase rent back to the base year amount after a minimum of 12 months. This increase would be the maximum allowed increase in that year, (i.e. the owner could not bank: or utilize the usual 6% annual allowed increase).
 - Reset the bank upon returning to the base year rent.
 - Require tenant notification when an owner reduces rent under this allowance that includes the newly establish base year amount.
3. Do not move forward with the following:
- a. An Ellis Act ordinance
 - b. Review of the City's demolition provisions
 - c. Review of condominium conversion provisions
 - d. An urgency ordinance to limit rent increases
4. Education and Assistance:
- a. Direct staff to assess the current resources devoted to landlord and tenant rights education and assistance in San Jose. Working with community partners (California Apartment Association, Santa Clara County Association of REALTORS, Project Sentinel, Law Foundation of Silicon Valley), develop a work plan, timeline, and budget for a Landlord and Tenant Information and Referral Program that includes metrics for evaluating the success of the program.
 - b. Direct the City Manager to work with stakeholders to bring back the former Project Blossom program beginning in the first quarter of FY 2016-17 and develop a program to recognize owners who have completed the program. This program was extremely successful in the past and served as a model for the City's engagement and education of housing providers.

DISCUSSION

Our current housing crisis is driven by a lack of overall housing supply. It is a community wide issue that effects every resident of San Jose. We understand the desire to alleviate the struggle of individuals and families who are trying to keep up with the rapidly-rising cost of market-rate rental housing. However, we strongly caution against drastic actions that will put pressure on already-rent-controlled apartments while not adding a single new unit of affordable housing.

ARO housing providers (owners of rental buildings built in 1979 or before who come under our rent control ordinance) supply approximately 43,000 units of affordable rental housing. By enacting more restrictive rent control laws, we run the risk of losing these units. Owners may seek to sell them to a market rate developer or remove them from the market. As a result, we will deprive our city of affordable housing stock and cause the displacement of thousands of residents. Our foremost concern must be maintaining and enhancing these housing units--not enacting requirements that by their onerous nature would put small property owners out of business and deny our community the affordable housing it needs.

San Francisco, where stringent rent controls similar to the recommendations put forth by our Housing Department are in place, has experienced a dramatic decrease in the supply of affordable, rent-controlled units. When small investors could no longer afford the upkeep on their properties or earn a reasonable return on their investments, many sold their properties to large-scale developers or kept them vacant.

Rent control has shortcomings and is certainly no panacea for the housing crisis. San Jose's current ordinance may have landed on a 'sweet spot' that protects renters, preserves naturally affordable older housing stock while not driving out the local "mom and pop" owners. San Jose's rental housing providers are local people who have invested in their community and are providing a needed service. These are hard-working people who have invested their savings, their retirements, and funds for their children's college education into our community. They depend on the income derived from their rental investments. For many families, their triplex is their pension. If they cannot realize a reasonable profit many of them will be forced to choose not to continue to provide the service.

The staff proposal to tie rental increases to CPI-U is completely untethered from the realities faced by small providers of rental housing. CPI-U captures costs – like gas prices – that are almost completely irrelevant when it comes to owning rental property. Rental properties are affected mainly by the costs of a mortgage, utilities, and repairs and maintenance, not by the price of gas and groceries. Let's look at the numbers: Property taxes increase about 2.0% each year, garbage rates increased 5.0% each of the past two years, sewer rates increased 16.9% in 2015, and water rates increased as much as 29.0% last year. The owner is typically responsible for these costs — not the renter. Also, maintenance costs for these older buildings subject to ARO are higher because they require more extensive and more costly maintenance work than newer buildings, and in a booming economy these costs typically accelerate much faster than a general measure of cost increases, such as CPI-U.

Further, the figures provided in the consultant's report that discussed the operating costs for rental properties were broad averages that failed to take into consideration the specifics of the mom-and-pop owned and managed properties that the ARO affects. The net operating income figures upon which the Housing Department is basing its recommendations are fatally flawed since they are based upon broad averages that are completely unrelated to the realities of operating smaller, older rental properties. Every example that has been shared with us from small-scale rental providers shows very slim profit margins on these units, due to high maintenance costs, low rental rates, and the fact that they have few units over which to spread any fixed management or administrative costs.

Reducing the 8% allowable rent increase to CPI-U and making the Capital Improvement Pass Through process a cumbersome, challenging one is counterproductive. The real losers in this situation will be the renters. They will suffer because investment in their units may be curtailed as owners face a drawn-out, costly bureaucratic process to have their expenses approved. They will also suffer because there is little, if any, reliability, predictability, and stability in such a process.

To find a balance between the needs of the rental owners and the goal of stability for renters, we recommend reducing the maximum allowable rent increase to 6% with a banking provision.

This is much more realistic and reflective of the actual cost pressures that a property owner faces, especially when the economy is strong. In addition this offers the reliability, predictability, and stability that both sides seek.

Reducing the maximum increase should not impact one's ability to maintain their unit. It is our vision that by filling out a basic worksheet and providing simple documentation of capital expenses, the additional 2% would be deemed approved and an owner would be able to, without being subject to a dispute hearing, issue an 8% increase for limited capital improvements. An efficient, predictable system benefits both renters and rental providers.

Regarding our proposed changes to the Debt Service Pass Through, we believe that excluding re-financings by existing rental property owners addresses a key renter concern--owners who would take advantage of property appreciation to pass on more costs to renters. It accomplishes this while at the same time not acting as an impediment to the purchase and sale of properties in the marketplace. The staff's proposal could have a profoundly negative affect on the value of rental properties subject to the ARO within San Jose and have the unintended, but predictable, consequence of lowering the City's property tax revenues or forcing owners into the position of selling to large-scale developers or corporate rental-property owners.

By limiting value of older housing stock and further depressing the value of housing stock by tying rent increases to CPI-U and eliminating any Debt Service Pass Through we may well be forcing the hard working "mom and pop" owner out of San Jose or discouraging them from buying more property in our City. If we adopt the risky, San Francisco-style proposals offered by the Housing Department, no one will win.

While we need more housing throughout Silicon Valley, the Housing Department's proposal is neither the tool nor the mean to achieve that end. In fact, their proposals would ultimately result in the elimination of many of the affordable units within San Jose, just as we have seen happen in other cities that have imposed the sort of rent control provisions that City staff has brought forward.

We strongly believe that the City should be educating rental housing providers and renters about their rights and responsibilities and giving them the tools they need to understand and exercise the rights afforded to them under state and local laws. While the APRO is well intentioned, it needs further vetting and stakeholder outreach before coming back to the City Council for consideration.

Finally, the City Council's direction to study possible amendments to the ARO did not include the consideration of new ordinances especially when there has been no documented need in San Jose for an Ellis Act Ordinance, Anti-Demolition Ordinance, or Condominium Conversion Ordinance. If these are items we wish to consider, they should be explored in light of current resources and workload and vetted through the Council Priority Setting Process if they are to be considered.

While some are concerned about the possibility of rent increases between April 19 and the adoption of an updated ARO, enacting a "moratorium" on rent increases sends the wrong signal

to the hard working property owners and investors in San Jose. It says that we do not trust them and cannot work cooperatively with them.

CONCLUSION

We commend the Housing Department's efforts over the past seven months to respond to the City Council's direction to study possible amendments to the ARO. The work of the Advisory Committee, stakeholders, staff, and the public has been valuable and must be recognized.

Our Housing Department states the ARO's goals are to "prevent excessive rent increases, alleviate undue hardship to tenants, and to provide a fair and reasonable return to landlords." There is a saying among engineers that if it "ain't broke don't fix it". By any reasonable standard the rents charged by the ARO housing providers are not excessive. According to the City's own Consultant Report on the ARO, the average rent for a rent-controlled unit is \$1306/month compared to an average of \$1,502/month on non-rent-controlled units. These rental rates are far below the rents staff used in September 2015 - and below even the rates cited in the Draft Report - to justify the need to study amendments to the ARO. When comparing the Fourth Quarter 2015 "market" rate rents between a 2bedroom/2bathroom ARO and non-ARO, ARO units are, on average, \$541/month less expensive than non-ARO units.

The lack of complaints prove that this ordinance is not broken. There have been relatively few complaints about excessive rent increases in ARO units, very few pass-through cost requests, and the number of notices to terminate a tenancy filed with the Housing Department appear low.

ARO units are our City's natural, affordable housing. We should not enact regulations that punish and push out the very housing providers who are offering the most affordable housing in San Jose and by extension cause dislocation of renters. Instead we must do more to ensure protection for renters and rental housing providers while increasing the supply of housing by investing real in affordable housing programs and developments.

Alleviating hardships to tenants will be difficult if we force these businesses to stop renting to their tenants and using CPI-U with a 2% floor for allowable rent increases will not provide a fair and reasonable return to landlords. We are being asked to break something that is working.

San Jose's ARO program is 37 years old and it is working. We don't throw the "baby out with the bathwater" in San Jose and "we don't fix what isn't broken". Our community will be stronger and can withstand the modifications we have suggested without jeopardizing the very housing supply we are trying to protect.