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DRAFT MEMORANDUM

To:	Honorable Mayor and Council, City of Beverly Hills
From:	HR&A Advisors, Inc.
Date:	July 26, 2018
Re:	Evaluation of "Banking" Unused Annual Allowable Adjustments Under Rent Stabilization

The City of Beverly Hills (the "City" or "Beverly Hills") retained HR&A Advisors, Inc. ("HR&A") to provide independent research and analysis about seven policy issues related to recently enacted changes to the City's Rent Stabilization Ordinance (the "RSO").[1] This Issue Paper addresses the issue of whether the City Council should consider amending the RSO to allow housing providers to "bank," or reserve, percentages of unused annual allowable rent adjustment, to a further degree than the RSO allows currently only for Chapter 5 units under limited circumstances, as discussed below.

Other elements of allowable annual rent increases, such as certain surcharges that may be "passed through" by housing providers to tenants in the form of rent increases, or the formula for establishing the allowable percentage and/or dollar amount by which rents may be increased annually, and housing provider ability to charge market rents for voluntarily vacated units, are subjects of a separate HR&A Issue Paper on the "Maximum Annual Rent Increase Policies in the Beverly Hills Rent Stabilization Context."

This Issue Paper begins with a general statement about the issue, notes some of the positions about it that have been mentioned in public discussions about the RSO, and summarizes how this issue is addressed by 13 other California cities with rent regulation, based on a review of their ordinances and regulations and through discussions with city representatives. Based on the information provided on this topic, the Issue Paper concludes with a set of plausible general policy options for City Council, City staff, and public consideration.

Statement of the Issue

Under the RSO, housing providers can currently "bank" a portion of the allowable annual rent increase only for Chapter 5 Tenants, and only for those tenants with leases longer than one year that cap rent increases at an amount that is less than allowed by the RSO. The unused increases may be banked only for three years or less.[2] This provision is very limited in practical application, because: (a) Chapter 5 Tenants account for

[1] Ordinance Number 17-O-2729, adopted in April of 2017 (the "RSO Amendments"). The City's Rent Stabilization Ordinance (the "RSO") regulations are included in Beverly Hills Municipal Code ("BHMC") Title 4, Chapter 5 ("Chapter 5") and Chapter 6 ("Chapter 6"). Tenants residing in RSO units subject to regulation under Chapter 5 are hereinafter referred to as "Chapter 5 Tenants;" and Tenants residing in RSO units subject to regulation under Chapter 6 are hereinafter referred to as "Chapter 6 Tenants."

[2] Pursuant to Beverly Hills Municipal Code Section 4-5-310, which also allows housing providers to increase rents upon the expiration of leases longer than one year for Chapter 5 Tenants for capital expenditures and/or certain utility surcharges incurred by the housing provider over the term of a respective lease, provided that the lease contract did not allow for rent increases.

only four percent of all RSO units;[3] and (b) multi-year leases are a relatively rare apartment leasing practice.

One of the key changes in the April 2017 RSO amendments was to limit the ability for housing providers to increase annual rents for Chapter 6 Tenants by the greater of the annual percent change in the Consumer Price Index ("CPI") for the Los Angeles-Riverside-Orange County area or three percent, as compared with the 10 percent annual rent increase previously allowed by the original 1978 RSO.

During a series of professionally-facilitated dialogue sessions between Beverly Hills housing providers and tenants living in buildings subject to the RSO following adoption of the 2017 RSO amendments, housing providers raised the possibility of including a provision in the RSO to allow them to "bank" unused annual rent increases in a given year and add them on top of allowable rent increases in future years. Absent such a provision, a "use it or lose it" perception could prompt housing providers to more frequently increase rents to the maximum percentage allowed each year, rather than prior practice in which rent setting was governed more often by real estate market conditions and tenant retention strategies.

For example, under this approach, if a housing provider is allowed the maximum annual increase of the greater of three percent or the annual percentage change in the CPI under the current RSO Amendments, but raised rent for a unit by only two percent in a given year, banking the unused one percent would allow the housing provider to raise rent for that unit by up to four percent (maximum annual allowable three percent plus the previously unused one percent) in a future year. This could enable housing providers with more flexibility to manage year-to-year variation in market conditions and annual operating expenses. On the other hand, banking could introduce less predictability about annual rent increases for tenants.

Comparison to Other California Cities with Rent Regulation

In addition to Beverly Hills, 13 other California cities currently have residential rent regulation programs. As shown in Table 1, 10 cities (71%), including Beverly Hills, have some form of rent banking provision as a component of their rent regulation programs. However, most cities also limit the application of rent banking, including the total percentage with any banked percentage by which rent can be increased annually, how long unused increases may be held, and tenant categories that may be subject to banked increases based on their tenure, among others.

[3] Per City of Beverly Hills RSO Registry data provided to HR&A on March 21, 2018.

Table 1 – Summary of California Cities with Rent Banking Provisions as Part of Rent Stabilization Programs, 2018

	Cities with Rent Banking Provisions	Cities without Rent Banking Provisions
Total Number of Cities	10	4
Percentage of Cities	71%	29%
Cities	Beverly Hills (Chapter 5)[1] Berkeley East Palo Alto Hayward Los Gatos Mountain View Oakland San Francisco Santa Monica West Hollywood	Los Angeles Palm Springs Richmond San Jose

[1] Beverly Hills Municipal Code Section 4-5-310.

Source: HR&A Advisors, Inc. and the individual cities

As shown in Table 2, cities generally limit the maximum amount that banked rents can be increased annually, commonly set at 10 percent, to prevent tenants from facing unexpected sharp rent increases. However, both Berkeley and San Francisco allow rent increases with no maximum specified percentage with banking. Beverly Hills also does not have an established percentage limit for banked increases, but potential increases are effectively limited by the provision's narrow application to Chapter 5 Tenants with leases longer than one year for which unused increases may only be banked for up to three years. In Santa Monica and West Hollywood, banked rent increase limits are not based on unused percentage changes, but instead are determined by the Maximum Allowable Rent ("MAR") resulting from per-unit cumulative annual rent increases allowed by each city's decisionmakers, based on data for each unit registered with the two cities. This approach effectively allows a housing provider to "catch up" to currently allowable maximum rents. For example, if a housing provider currently charges $800 per month for a unit and the MAR for that unit is $900 per month, the housing provider may increase the rent for that unit by $100 per month (+12.5%). Also shown in Table 2, most cities with banking provisions, other than Berkeley and Hayward, impose other limitations beyond rent increase maximums. There are no other uniformly applied limitations among the cities.

Table 2: Banking Provision Detail by Applicable City, 2018

	Allowable General Rent Adjustment	Banking Provisions	
		Maximum Increase with Banking	Other Limitations
Beverly Hills - Chapter 5	Lesser of 8% or CPI	No limit	Only applies to Chapter 5 apartment units with leases > 1 year and lease restricts the amount of the rent below the amount allowed by the RSO and capped at three years of unused increases
Berkeley	65% x CPI, but not more than 7%	No limit	None
East Palo Alto	80% x CPI	10%	Cannot bank more than three unused annual general adjustments during a tenant's occupancy
Hayward	5%	10%	None
Los Gatos	Greater of 70% x CPI or 5% x existing monthly rent	10%	Unused increases one year can only be applied in the following year
Mountain View	100% x CPI, but not less than 2% or more than 5%	10%	Ability to accumulate does not carry over to next property owner
Oakland	100% x CPI	10%	May not be more than three times the annual adjustment in the year it's applied, and banked increases not used within 10 years expire
San Francisco	60% x CPI, but not more than 7%	No limit	Only increases after 1982 can accumulate
Santa Monica	75% x CPI	Based on Maximum Allowable Rent	None
West Hollywood	75% x CPI	Based on Maximum Allowable Rent	Only uncharged increases between 1985 and 1996 can be charged to a tenant whose tenancy started before 1996

Source: HR&A Advisors, Inc. and the individual cities

Some studies for cities with existing or considering new rent regulations that included a review of the banking issue, including East Palo Alto,[4] Richmond,[5] and San Jose[6], cite the potential administrative challenges posed by the regulatory complexity and costs associated with tracking, maintaining, and enforcing banking provisions. However, HR&A discussed this issue with an official at the City of Santa Monica's Rent Control

[4] https://www.ci.east-palo-alto.ca.us/DocumentCenter/View/2049

[5] https://www.ci.richmond.ca.us/DocumentCenter/View/45357

[6] https://www.bizjournals.com/sanjose/news/2017/02/01/san-jose-places-5-percent-limit-on-some.html

Board who stated that they do not face any added administrative encumbrance due to the allowance of banking. The official explained that this is because the City has a regularly updated rent registry system that calculates the MAR for each registered unit, allowing City staff to expeditiously check the differences between the actual rents a housing provider has charged for any given unit in comparison with the MAR for that same unit. Even so, were Beverly Hills to permit banking, some degree of additional City staff time and registration system data management cost would be required to track and administer the details of a banking system for individual units in each building subject to the RSO on an annual basis.

Other issues that may need to be considered if a banking provision were to be added to the RSO include whether to impose a percentage cap, as most cities with a banking system do; whether subsequent owners could assume any remaining banked rent increase authority at the time of sale; and whether the number of such banking increases should be limited during a continuing tenancy.

Policy Options

Based on the foregoing information and data, HR&A suggests that there are at least four plausible policy options the City Council, City staff, and the public could consider, individually or in combination, when determining whether to allow RSO housing providers to bank unused annual general adjustments in future years:

1) **No Policy Changes:** In this case, the City would continue to allow the narrow ability for housing providers to bank rent increases for Chapter 5 Tenants with leases that are longer than one year,but exclude the ability for housing providers to bank unused rent increases for Chapter 6 Tenants.
    - **Advantages to housing providers:** Chapter 5 housing providers only would maintain the ability to bank unused increases for tenants with leases longer than one year, and no additional administrative effort would be required to implement banking procedures for Chapter 6 Tenants.
    - **Disadvantages to housing providers:** Chapter 6 housing providers could not apply any portion of the unused maximum annual adjustments in future years, limiting the ability to pay for future year operating expenses that might exceed expenses in the year during which the maximum allowable increase was not utilized, or respond to improved real estate market conditions, and could limit the ability to implement a tenant retention strategy based on maintaining lower-than-allowable rents.
    - **Advantages to tenants:** Tenants would benefit from more predictable annual rent increases currently allowed by Chapter 5 and Chapter 6, and would avoid potential unexpected rent increases which could vary from year to year when banked increases might be imposed on top of annual allowable increases.
    - **Disadvantages to tenants:** With the recent RSO change reducing the maximum allowable rent increase, Chapter 6 housing providers may be more inclined to apply the full allowable rent increase each year as a hedge against year-to-year variation in operating expenses.

Administrative Considerations: Due to limited applicability of the current RSO banking policy, there would not be any change in current City costs to administer the RSO.

2) **Remove the Current Multi-Year Lease Term Restriction on Use of Banking for Chapter 5 Tenants:** In this case, the City would allow housing providers to bank unused allowable rent increases for

Chapter 5 Tenants regardless of the lease term, but would still limit the cumulative banking provision to three years.

- **Advantages to housing providers:** Chapter 5 housing providers would be able to more flexibly utilize unused allowable rent increases and this ability would not be constrained to only tenancies of more than one year.
- **Disadvantages to housing providers:** Chapter 6 housing providers would still not be able to bank unused allowable rent increases, and Chapter 5 housing providers may be encumbered by unit-by-unit record keeping and reporting.
- **Advantages to tenants:** Chapter 6 Tenants would not be subject to possibly unexpected banked rent increases. Chapter 5 Tenants would still likely experience only generally limited rent increases, due to other Chapter 5 limitations, which would limit additional annual rent increases from banking. Chapter 5 Tenants may not experience maximum allowable rent increases because housing providers would have the ability to bank unused increases.
- **Disadvantages to tenants:** Chapter 5 Tenants with one-year or less lease terms could be subject to unexpected banked rent increases to which they are not currently subject, while Chapter 6 Tenants could experience somewhat higher annual rent increases if housing providers decide to apply the full allowable rent increase each year in in the absence of any ability to bank unused allowable rent increases.

Administrative Considerations: This policy option would significantly increase City administrative costs as the City would need to administer a survey to Chapter 5 housing providers and Tenants to determine if any of those units are subject to a lease with a term that is longer than a year. A survey of this kind would be time-consuming for the City to administer and may not yield complete results.

3) **Adopt a Banking Provision for Both Chapter 5 and Chapter 6 Tenants without Limitations:** In this case, the City would allow housing providers the greatest flexibility regarding banked rent increases.
    - **Advantages to housing providers:** Provides housing providers the ability to carry over unused maximum rent increases from year to year for both Chapter 5 and Chapter 6 Tenants, and charge rents more closely aligned with changes in market rent and operating expense trends, and greater flexibility in using lower rents as a tenant retention strategy.
    - **Disadvantages to housing providers:** Little to no disadvantage, other than required unit-by-unit record keeping and reporting.
    - **Advantages to tenants:** Only the possibility that some housing providers (other than recent buyers with presumably higher mortgage costs) may be less inclined to impose the maximum annual rent increase each year, because they retain the flexibility to bank any differences between actual rent and maximum allowable rent to use as needed in a future year.
    - **Disadvantages to tenants:** Tenants could face sharp, unpredictable increases in rents when housing providers apply one or more banked increases at the same time.

Administrative Considerations: This policy option would require significant additional costs for the City to develop a new data system (or augment the new RSO Registry) to monitor current and historic rent amounts by each tenancy subject to the RSO, and the durations of each tenancy to adequately determine whether a proposed banked rent increase is permissible. In addition to ongoing updating and maintenance of the rent and tenancy tracking system, this would require additional staff time to review and process proposed banked rent increases, and any disputes about them.

4) **Adopt a Banking Provision, but Limit the Total Amount that Rent May be Increased Annually and/or Apply Other Limitations:** In this case, the City would allow unused rent increases to be banked for use in future years for both Chapter 5 and Chapter 6 Tenants, but would limit the total amount that rent could be increased in a given year. The City could also add other limitations, such as how long unused increases could be banked, how many times a housing provider may bank rent increases, limit any carryover banking accruing to subsequent owners and/or limit the application of banking based on tenant tenure.
   - **Advantages to housing providers:** Provides the ability to charge rents more closely in line with market trends – i.e. charging rents below allowable levels in years when the market is weak or operating expenses are stable, and using that unused amount to capitalize on stronger markets or higher operating expenses in future years, and use lower rents as part of a tenant retention strategy.
   - **Disadvantages to housing providers:** Program limitations may prove cumbersome to administer and/or hinder the extent to which unused rent increases can be recaptured.
   - **Advantages to tenants:** An upper limit on annual increases in a given year with banking would provide some degree of certainty as to the total amount by which rents could potentially increase. Other limitations would reduce the extent to which tenants could be subject to banked increases.
   - **Disadvantages to tenants:** Tenants could face unexpected and unpredictable rent increases when housing providers apply one or more banked increases.

Administrative Considerations: Like Policy Option #3, this option would require significant additional City costs for data management, monitoring and other administrative tasks, but somewhat more cost than Policy Option #3, to track and monitor the additional specified banking limitations.