POLICY, PROBLEMS AND RESEARCH ISSUES FOR OWNED MULTIFAMILY HOUSING

by James D. Vernor

Demographic and economic changes will make the condominium a more prevalent—although not problem-free—lifestyle for many households in the future. This paper attempts to identify various of these problems and issues and to assemble ideas for research opportunites in this important area of housing. While the label "condominium" is used for convenience, it should be understood that the interest is more broadly focused on all forms of owned multifamily housing—including cooperatives, fee-simple townhouses, zero-lot line houses, *de minimis* planned unit developments and other variants.

A growing demand for owned multifamily housing can be expected from the continuation of current trends. Increasing land and building costs, and historically high interest carrying charges combine to push traditional single-family detached housing beyond the budget capacity of many households. For some of them, the condominium house represents an inferior good—one to be traded down to a period of reduced real purchasing power. For many others, however, the condominium represents a more suitable set of trade-offs: Exterior building and grounds maintenance responsibilities are delegated to others and the economics of scale-purchasing allow amenity packages such as swimming pools and tennis courts. A trend toward smaller households, including singles, combined with an inflation-induced preference for ownership makes condominium-style housing preferable and attractive.

Given the body of experience with condominium-style housing to date and recognizing the increased significance of this lifestyle in the future, it would seem desirable to identify and begin a study of the associated problems from the perspective of the various participants in the housing process: the public sector in the form of local and state governments; the producer as converter or builder; the collective consumer, identified as the condominium community association; the individual consumer; and the urban land economist as he focuses on longer-term considerations of land use patterns and processes.

Problems For Public Policy

During the past decade the benefits of apartment ownership became evident to many renters. The deductibility of interest expense for taxable income purposes combined with the appreciation potential for a levered ownership interest attracted and convinced many buyers for individual rental apartments. Simultaneously and perhaps consequently, gross rent levels failed to grow at the same rate as operating and ownership expenses. As the operation of rental apartments became less profitable, the conversion of those rental units to ownership status for individual occupants became more profitable and commonplace, especially in larger cities. The conversion of rental units into for-sale units raised concerns for those tenants who can't afford to purchase their units and are thus displaced. Housing policy interest grew concerned over the personal disruption and the loss of rental housing stock, and forecasted inadequate rental housing stock. This concern manifested itself in ordinances, laws and statutes at the local and state levels. Various kinds of protections were sought for renters, for buyers, for rental housing and for the low income housing stock.

An interesting policy issue in this area is how to establish a balance between a) the rights of tenants and the interest of the low income rental housing stock and b) the rights of condominium unit purchasers. One possible interpretation of the initiatives to date is that renters have higher rights than buyers. To what extent is it desirable to subordinate the rights of the apartment owner to convert? If

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This article originally was presented to Dr. Richard B. Andrews to commemorate his retirement from the University of Wisconsin.

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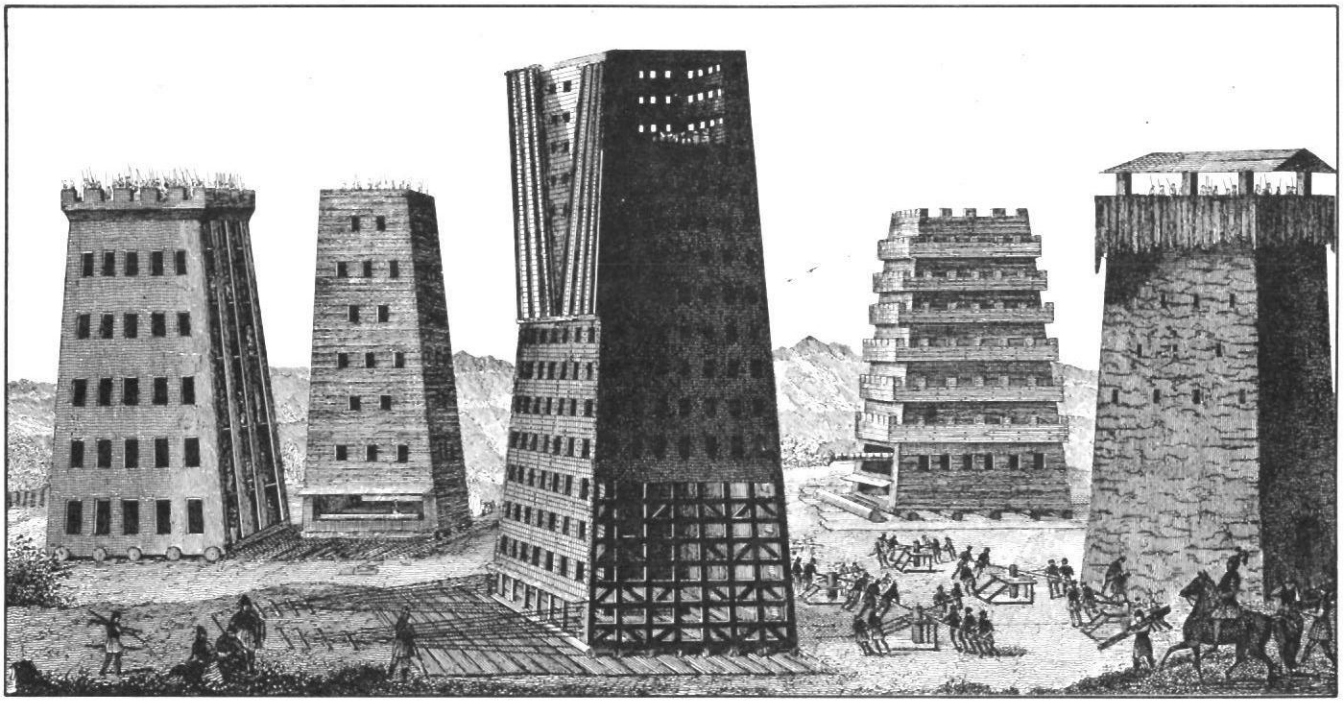

there is a looming shortage of rental housing, as some suggested, what is the disincentive effect on the apartment house builder if public policy closes off one possible escape route from an unprofitable rental situation? Should policymakers recognize that conversion prohibitions might operate like rent control ordinances to alienate capital investors and aggravate a rental housing shortage? Is a conversion limitation another subtle form of rent control in that it might reduce the probability of a satisfactory return on invested capital?

What is the impact of conversion on the level of municipal services demanded and the public budget? Are owners of individual apartment units likely to take a keener interest in the quantity and quality of public infrastructure? If a building is converted, is this a realization of higher property value in ownership? Will conversion generally lead to higher property value, tax assessments and tax revenues? Will the changes in service level demands, as balanced against tax revenue changes, produce tax profits or tax deficits from the condominium conversion process?

The public sector might be interested in the impact of apartment conversion on other neighborhoods where apartments are not being converted. It has been asserted that condominium conversion occurs at the higher end of the price range for apartments and that lower and middle quality apartments are not suitable for conversion. Does this mean that a tenant who is displaced from a high quality apartment and chooses to continue renting will then be relocated to a neighborhood or structure of lesser quality apartments? Might this tenant then contribute to an upgrading of his new neighborhood? What sort of a housing filtering process in chain reaction might be expected from this phenomenon, and what is the overall impact on urban services, budget, and quality of life?

Those in positions of policy responsibility might want to evaluate the adequacy of data for supporting their decisions. In debate about proposed ordinances in Chicago, there was a lack of available information on quantity, quality, and location of condominium conversions. Not only had neighborhood interests who were opposing condominium conversions seriously overestimated their extent, but so had real estate industry proponents; and when they finally were accurately counted, it was determined that the largest share of condominiums (converted from apartments) was in a small number of high-rent level structures and that the impact on the low rental stock has been seriously overestimated. Government officials might need to commence development of systems to gather sufficient data to evaluate the impact of condominium conversion on some protected housing submarkets.

Problems From The Producer's Perspective

The producers of condominium housing include builders of new condominiums, converters of apartments, and mortage lenders who advance interim financing during the construction or conversion period, as well as permanent loans to purchasers. Private and governmental mortgage insurers and secondary mortgage market investors also could be considered.

An initial problem of the condominium builder is the general community resistance accorded all multifamily housing developers: concerns over increased automobile traffic, neighborhood school crowding, other public service overloading, and a general neighborhood fear of

adverse property value impacts. The condominium developer's relationship with the community will be improved if evidence is shown that apartment unit ownership has favorable sociological and economic effects on the community.

The condominium converter seeks ways to defuse opposition to conversion. One interesting possibility for preserving a portion of the rental stock is to sell only 80 percent of the apartments in a structure. The other 20 percent will be saved for rent to tenants and could be owned as community property by all of the owners who have purchased the 80 percent. In one actual situation of this type, it was expected that the rental income to the community association would replace the necessity for monthly maintenance fees. This has some interesting subtle effects. It might well be expected that the developer would seek to achieve his yield and profit objective by including a prorated share of the value of each rental unit in the sales price of each apartment sold. This means the condominium buyer has paid a higher price, reflecting his share of the units rented out, and has probably financed the majority of this purchase price with a higher mortgage. A higher interest payment on that mortgage may be qualified as a deduction for federal income tax purposes. So the buyer of a unit in this project has traded away a monthly maintenance fee to the homeowners association, which is not an allowable federal income tax deduction, for a higher interest expense on the rented units. There will, additionally, be the possibility of a share of a capital gain on the successful resale of these investment units. There will be problems for the tax accountant in establishing prorated shares of basis, and the local property tax assessors may initially have some difficulty in properly assigning these taxable values.

It is to be hoped that the condominium building and converting industry records the lesson learned during its brief history to date. In the early 1970s condominium developers failed to recognize and design a product to meet the needs of their market. Builders with previous experience in offering units for rent shifted into the for-sale market without any modification to their product. Condominium units were constructed and offered for sale in some markets that failed to provide the better quality features and workmanship that were demanded by a more sophisticated purchaser. Some early condominium builders failed to understand the central strategy of the condominium concept as making dense use of expensive land in good locations. Projects were located on marginal and undistinguished sites without significant linkages.

The resulting misfit of product to demand resulted in numerous metropolitan markets with oversupplies of condominiums. The public came to regard the concept as somehow faulty instead of recognizing the errors in its execution. As more is learned about who purchases condominiums, why and how they do it, builders must be ever alert to ascertaining the changing needs of the markets and designing a product to meet them. Since condominium community facilities are so intensely shared, the long-term costs of a poorly designed condominium can exceed the diseconomies and social problems of an unsuccessful single family home development. Greater sophistication in the marketplace today enables the developer to eliminate the swimming pool from a community designed for empty-nester residents who have no desire to attract children; many contemporary buyers realize that the primary function of an ornate clubhouse is to serve as a display and marketing facility for the developer.

A desire for property ownership and the need to economize on construction costs are currently leading to many technological innovations. The condominium concept is frequently being applied to retail and office and medical complexes. A project in Roswell, Georgia offers attached condominium residences and businesses. Some large, old single-family houses are being recycled into small multi-unit ownership. Creative rehabilitation is causing the conversion of old industrial loft buildings to residential condominiums.

Primary lenders, mortgage insurers, and the secondary market are also part of the production process. From their perspective, the prospect of financing individual units in a community carries a whole new dimension of default risk. There is the chance that the closely shared lifestyle will become disagreeable, that the limited pool of community political leadership will prove inadequate, or that the condominium community budget will be mismanaged to the detriment of any capacity to make capital replacements.

Few lenders have been willing to lend in this atmosphere of uncertainty. In general there seems to be a need to educate the financial community so that it is more willing to underwrite these risks. At this time it might be useful to simply begin to develop the questions that the lenders should be asking: What constitutes an adequate level of capital replacement reserves in a condominium community association? How does one simply examine the declaration and bylaws to evaluate the adequacy of the community association authority and governing procedures? How does an outsider quickly evaluate the rules and regulations for their adequacy, fairness, and whether or not they are being enforced? How can the mortgage lender evaluate the human quality—present and future—in the way a commercial banker evaluates the management of a corporate borrower?

A special cog in the financing mechanism is the real estate appraiser. Several special problems attend the application of traditional appraisal methodology in a condominium community. For example, the three hallowed approaches to forecasting market value include the replacement or reproduction cost approach; but this fails to work in a condominium community because of the unavailability of benchmark sales of comparable individual sites. Appraisers are frequently confused in their attempt to define a set from which to draw comparable sales and then to infer probable selling prices. Lacking confidence in their procedures and market familiarity, they might prefer to extrapolate recent sales activity strictly within the condominium community instead of attempting to

make comparisons with other condominium communities nearby that might appeal as alternatives to the most probable buyer.

Another problem is the lack of available information on the sales that do occur within a condominium community. When specialized mortgage lenders like savings and loan associations appraise properties in conjunction with extending mortgage loans, they customarily submit this information to an information pool. There, it is available to be shared by other savings and loans and staff appraisers in the same market. If these savings and loans choose not to make loans on condominiums, there will be fewer comparisons available in the pool; transactions will have to be financed to a greater extent by sellers, but it is unlikely that any record of the transaction terms will be available for subsequent appraisal. Condominium associations can react to a limited extent by requiring notice of sales and related data for the purpose of maintaining their own information pool, but there is no way they can be assured of getting this information to the decision makers in the mortgage lending institutions. Perhaps this suggests an area of possible service for state membership groups of condominium associations—such as the several local and state chapters of the Community Association Institute. These organizations might be in the best position to teach individual condominium associations the importance of gathering market information and establishing formats for such a data survey, and further assuring the delivery of that market information to all the appropriate mortgage lenders and appraisers in the area.

Individual And Collective Consumer Perspectives

The condominium community streets, green planted areas, swimming pools, clubhouses, and building exteriors are concurrently owned in undivided fractional interest as tenants in common by all of the individual unit owners. While other ownership arrangements might be used by cooperatives, zero-lot line houses and fee-simple townhouses, there is usually a custodial and management responsibility assigned to the board of directors of a community owners association. These groups are mandatory membership organizations and are a civil democracy in microcosm. The members of the board of directors and the elected corporate officers serve without pay and are frequently called upon to discharge responsibilities for which they have little training, experience, or inclination.

Although conceptually the same as the elected board of aldermen for an incorporated municipality, the condominium association must rely for its leadership on a much smaller group of citizens. Therefore it runs a higher risk of exhausting the supply of leadership potential. Although numerous professional firms offer specialized services in law, accounting, and property management, there is little exposure of the decision-making process to public scrutiny and a greater potential for malperformance by officers and directors. Many condominium unit owners draw on their experience as apartment tenants and treat their volunteer community leadership more like hired professional property managers. Earnest and well-intentioned officers of the association have little training and taste for abrasive interpersonal relationships and suffer "burn-out" early. With a rapid turnover in its leadership, the community has a short institutional memory, may reinvent solutions to problems, and executes policy in an inconsistent manner, contributing to the general disaffection of some community residents and to a suboptimal financial administration. Community associations must learn to tolerate and ameliorate these people problems.

Condominium community associations have special problems in their long-term financial self-preservation. While the municipal corporation can borrow against future growth, the condominium has usually attained its full size. The sale of public bonds is unfeasible. Unsecured and unguaranteed bank borrowings are impractical, and most state enabling statutes do not permit the collateralizing of community property. Hence the community association must accumulate a sinking fund for the occasional large capital replacement, or levy special assessments when the replacement becomes a necessity.

In most communities it is likely that an extraordinary effort will be required to determine the necessary periodic set-aside for the future replacement of roofs, pavings, etc. At that, a vocal portion of the condominium association membership will prefer to avoid an accumulation program in favor of passing future costs to future residents. The danger in this is that the necessary special assessments in the future might be beyond the means of numerous owners at that time. If they refuse or are unable to pay, the association board then faces a potentially difficult collection process. The heavy special assessment could force a surplus of properties offered for sale, thus depressing property values.

Because the whole condominium concept is so new, there has been little experience with communities needing to repave streets and undertake other major capital replacements during a period of reserve insufficiency. But adequate evidence indicates that this is a factor that looms large in the perspective of lenders. There is some opinion that lenders prefer financing new condominiums to resales in existing communities because the individual loans have a greater chance to season before any reserve insufficiency develops. Developers of new communities and converters of older buildings frequently are sweetening their product-offering by delivering large dollar reserve accounts at the time of grand opening. In the event a community association is unable to finance its capital replacement needs in any manner, there would be an acceleration of the economic life and an obvious and damaging deterioration of the public facilities.

Another problem relating to the financing of condominium communities involves the equity of property taxing systems. Condominium associations have already made progress in convincing tax assessors not to assess common area improvements; assessors seem to agree that prorated shares of the value of clubhouse and other amenity improvements are reflected on a prorated basis in the individual unit market values and assessments.

Condominium interests are a remaining problem, however, in that the condominium unit owners are taxed at the same mil rate as other residential owners but might receive a lower level of services. They argue in particular that they must maintain their own streets, street lights, sewer pipes, park areas, and security services. For their part, the municipalities argue that these are elective services chosen for the benefit of private property. Perhaps this debate will continue without resolution. As condominium purchasers become more sophisticated, they might demand that initial street and sewer system construction be done to the standard and under the inspection of the local governing authority to facilitate their dedication.

While many of the services hired by condominium associations do in fact parallel similar services provided publicly (street lighting and maintenance, security, park area upkeep, recreational services and facilities), the maintenance fee collected by the homeowners association is not recognized as a property tax. So the same services on a private basis cost more on an "after-income tax" basis than if they were provided by a municipality. The condominium association may be able to convert its monthly maintenance fee into a property tax that is deductible for income tax purposes by municipal incorporation of the entire condominium community. This would convert most, but not all, of the costs of these on-site services to property tax supported. Other services not normally within the province of the community association might be purchased from existing government sources such as fire and school services. But in many other ways the community association is already functioning much like an elected municipal government. This would probably be more feasible for larger communities where the increased costs of administration could be spread over a bigger base.

Other advantages to municipal incorporation might exist. Municipalities probably have a superior borrowing power with financial institutions. Certainly the exemption of municipal interest from federal income taxation would enable the municipality to borrow at a lower cost than that available to a condominium association. There are few instances in the record of municipal incorporation for condominiums. One well-known case in Pennsylvania occurred as a defensive measure to prevent annexation to a nearby municipality and a resulting duplication of sewer facilities.

Condominium communities may discover and invent other advantages to the unification of a large number of individual ownership interests in a residential community. A generation ago regional shopping centers discovered that by uniting and organizing diverse retailing interests in a single shopping center, they could standardize shopping hours and undertake concerted actions for improving and publicizing the center as well as present a unified architectural style. Condominium communities would be taking advantage of their unity, for example, in converting into a small city or village. A condominium community in Minneapolis that occupied an entire city block was able to make use of a tax increment financing plan and secure below-market interest rate financing for purchasers. (A tax increment financing scheme facilitates construction or improvements financed with borrowed money where that borrowed money would be repaid out of the additional tax revenues resulting from the improvements).

Another possibility might be for a group of condominium communities to found a credit union. The credit union might appeal for savings accounts to the loyalties of condominium residents and, in turn, concentrate its investments in loans for community improvements, temporary assistance to distressed unit owners for regular and special assessments, and perhaps even for mortgage loans to purchasers.

Perhaps one of the most pressing problems currently facing condominium communities is the misunderstanding on the part of many buyers of the sharing and tolerance involved in these communities. Most community leaders can report examples of occupants who thoughtlessly engage in activities that disturb their neighbors. At the same time many neighbors are insufficiently tolerant of the normal transgressions of those living nearby. While these same problems occur in any living environment, they are frequently aggravated by the greater density of multifamily properties. Just as housing policymakers identified a need to counsel subsidized homebuyers on their new responsibilities, a need might be recognized to counsel prospective condominium occupants on the trade-offs in a shared multifamily housing lifestyle. It seems unlikely that this type of information would be conveyed by any of the present parties to the transaction—lender, broker, or seller.

Future Concerns And Conclusions

As the condominium type of community achieves maturity and perhaps a stage of decline in a life cycle, it may be noticed that it behaves differently from a neighborhood of single-family detached homes under diverse ownership or a high-density multifamily housing project under the single ownership of an investor. What can be expected to happen when the units achieve the end of their physical and economic life expectancies? Since they were all built at the same time, is it reasonable to expect them all to become deteriorated at the same time? How do individual owners rehabilitate and renew their units, if the majority of the community has neither the will nor the means for a private renewal? In what way might units in a condominium community experience the filtering process that hands down housing units to lower socioeconomic occupants? Is such a land use succession likely to occur without serious difficulty, or will the older residents vigorously resist change because of the greater intimacy of their shared lifestyle?

Exactly how might filtering in the condominium neighborhood be complicated by factors not found in single-family detached neighborhoods: common ownership of land and facilities; the association for governance; and the internalizing of the abuse of common and unrelated

property? Will there be an advantage in the control of externalities such as the physical condition of surrounding units and services? What long-term advantages might be associated with the homogeneous nature of condominium neighborhoods? What special qualities might uniquely suit condominium communities as urban in-fill development? Might there be a legitimate long-term need for the association to use inducements to affect tenure choice within its community?

While the many advantages to condominium living—the economies of development scale, the sharing of amenities, the transfer of the maintenance responsibilities and the economies of smaller scale living—are likely to contribute to the increasing popularity of this living style in the future, problems already exist and more are likely to be uncovered. This paper has endeavored to identify some of the opportunities and problem areas that would lend themselves to further study and discussion.