Small Property Owners Association
287 Huron Avenue
Cambridge MA 02138
Tel.354-5533

The Honorable Joseph P. Connarton,
Clerk of the Cambridge City Council
City Hall, Cambridge MA 02139

August 18, 1991

Re. Communication to the City Council.

Dear Mr. Connarton;

Please find attached a copy of a letter from our association to the Executive Director of the Cambridge Rent Control Board. In said letter we formally request hearings on how the Fair Net Operating Income of rent controlled properties is calculated and on the need to include financing costs in the rent formula.

We hope that you will make said letter part of the official record of the City Council, and that you will distribute copies of it to each and every councillor as is customarily done with communications to the Council.

Sincerely;

Salim E. Kabawat,
Co-Chair, SPOA of Cambridge.

cc. Mr. Robert Healy, the City Manager
The Cambridge Chronicle
The Tab

Small Property Owners Association
287 Huron Avenue
Cambridge MA 02138
Tel.354-5533

Mr. Terry Morris
Executive Director
Cambridge Rent Control Board
Cambridge MA 02139

August 15, 1991

Dear Mr. Morris;

This letter is to formally request that the Rent Control Board opens hearings on the General Adjustment (GA) proceedings in order to modify the rent formula to allow for cost of financing. We ask that the hearings be held as soon as possible so that the results would be incorporated in this year's GA.

The current rent formula which is applied by the Board to determine the maximum allowable rent divides the rent into three components: 1-fair net operating income(FNOI), 2-fair net operating expenses and 3-cost of capital improvements which is amortized over the period of a predetermined number of years. Nowhere in the formula is there an allowance for cost of financing of the original investment in the property. In contrast, cost of financing of capital improvements has been rightfully passed into the rent although capped at 15% for owners of small properties. Several attempts made in the past to include interest payments in the fair net operating expenses have been aborted by the Board.

The Board based its decision on a narrow interpretation by the Board's counsel of a court decision from the mid 70s which related to a speculative purchase by a condominium converter who financed 100% of his purchase price (Zusman v/s Brookline). This case does not relate to the current rent control act in Cambridge. Our letter concerns conventional borrowing practices to finance a mortgage upon purchase of a property. These practices which are sanctioned by Fannie Mae, HUD and other federal agencies are the common way by which members of our organization have purchased their properties. Unusual financing schemes and plots are of no concern to our organization.

By reviewing the rent formula it is obvious that the portion of the rent which is meant to cover the cost of purchase of a property and thus, determines its value is indeed the fair net operating income.This is the portion which is considered by banks as the true income which is derived from the property after substraction of the operating expenses and after recovery of capital improvements from the net collectible rental income. In fact a common banking practice is to allow only for 75% of the net income to provide for the funds which are necessary to cover the cost of interest and principal payments. It is thus obvious that, speculation aside, the actual value of a rental property (an asset) is directly related to the amount of fair net operating income (cash flow) it provides. It is also inversely related to interest rate. As interest rate goes up more of the cash flow would go to cover interest payments and less of it toward repaying principal. Thus, an efficient operator given a fixed cash flow would pay less to acquire the same asset (a decrease in value).

Of course, in a free market setting, the seller can always increase the rent (the cash flow) as interest rates go up in order to protect the value of his/her asset. This increase in rent would be only subject to rental market demands. Such a luxury is unfortunately unavailable in the regulated market where the cash flow is fixed by the regulatory agency. The Board should consult with experts in real estate appraising to verify this principle which can also be found in any standard text on the subject (e.g. Ellwood Tables for Real Estate Appraising and Financing, Chicago, American Institute of Real Estate Appraisers, 1970).

To provide the Board with an example and to illustrate the importance of interest rate let us calculate the value of a property based on a fixed yearly cash flow and variable interest rate. The value of the asset can then be estimated by capitalizing the value of the NOI by the amount of first mortgage at a known interest rate as listed in Comprehensive Mortgage Tables.

Let us consider a four family house whose fair net operating income in 1967 was $1500 per year. In 1967 interest rate for a conventional first mortgage was 6.33% (source: HUD Statistical Yearbook, 1967). In 1986 this rate became 10.09% (Source: Statistical abstracts of the U.S, Bureau of Census).

In 1967, $1500 if capitalized at 6.33% indicate a value of $23,697. In 1986, the FNOI from the same property as calculated by the Board using an inflation factor (CPI-U-X1) of 3.02 would have been $4,530. If interest rate remained at 6.33% the capitalized value of this property would have been $71,564 which is exactly its 1967 value multiplied by 3.02. However, since interest rate in 1986 increased to 10.09%, the capitalized value of $4,530 (the FNOI allowed by the Board) is only $44,896, a loss of 37% from the fair $71,564 value. In other words, because the Cambridge Rent Control Board regulations did not adjust for changes in interest rate the capitalized value of rent control property in Cambridge has dropped 37% from 1967 to 1986.

How could the Board have prevented this disaster from occurring? If in calculating the FNOI in 1986 the Board had multiplied the base FNOI not only by the inflation index but also by a supplemental index "fair", where

fair= interest 1986/interest 1967

the resulting FNOI would have been fairer.
In this example "fair"= 10.09/6.33= 1.594

Thus the 1986 FNOI should have been $1500 X 3.02 X 1.594= $7,221

One criticism which is often uttered against our members is that "they have paid too much for their property". This means that there is a correct value to every rent controlled property which must not be exceeded for the investment to remain profitable. However, if the value of rent control property is to be the same as in 1967 in real 1967 dollars, it is obvious from the above analysis that the problem is with the FNOI which has not kept up with increasing interest rate and is thus too low. It is also obvious that this aberration must be corrected promptly.

Our association hereby urges you to open hearings on how the FNOI is calculated. We feel that the introduction of an additional factor "fair" which would correct for interest rates is a matter of extreme urgency. Hearings on the subject should be scheduled within the next few weeks. The "fair" factor should be introduced for the 1991 general adjustment and for all reg.72 adjustments immediately. This is not the first time that we have written to the Board about the need for this adjustment. The Board's continued ignoring of this factor can only mean that it purposefully chooses to provide property owners with less than the fair net operating income mandated by the law. In the absence of this urgently needed correction it is apparent that the Board has artificially devalued rent control properties from their value in the base year. This decrease in value can certainly be considered as an illegal taking.

We would appreciate your prompt attention to this important matter and hope that you will share copies of this letter with members of the Rent Control Board.

Sincerely

Salim Kabawat,
Co-chair, SPOA.

Consent Comm. # 22 S-947

Comm. from Salim E. Kabawat, Co-Chair SPOA of Cambridge, requesting a hearing on how the Fair Net Operating Income of rent contrlled properties is calculated and to include financing costs in the rent formula.

In City Council,

Sept. 16, 1991

Referred to the
Rent Control Committee
Copy sent to Rent Control
Comm. 9/18/91 DE