



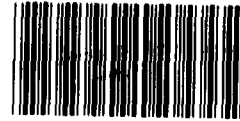
UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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PROGRAM ANALYSIS
DIVISION

March 5, 1981

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The Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

Subject: Influence of Speculation on the Price
of Converted Condominium Units (PAD-81-62)

This report addresses your concerns regarding the effects of investor speculation on the price of converted condominiums. As we understand it, you are concerned that rapid turnover in sales of converted condominium units by investors has caused the price of these units to increase more rapidly than general housing prices. In this response, we discuss the complex interactions that determine the prices at which transactions take place in the housing market. Then a means of isolating the influence of investor speculation on the prices of converted condominium units is discussed. However, because of limited available information at this time, the test we propose cannot be performed in time for your immediate needs.

THE OVERALL APPROACH

The price of a converted condominium cannot be assessed in isolation from the prices of other converted condominiums or the prices and rentals of alternative housing units. In general, prices for housing depend on three broad sets of factors:

- the demand for housing of all types;
- the supply of housing of all types; and
- the debt service burden associated with the purchase of most housing which, in turn, is dependent largely on mortgage interest rates.

Any buyer of a converted condominium unit weighs several factors when purchasing the unit. First, given his tastes, he compares the purchase price on that unit with the purchase

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prices on alternative units that suit his needs. Second, in view of mortgage market conditions, he must decide whether the downpayment and monthly debt service burden imposed on him is affordable.

The supply or availability of converted condominium units depends on the costs of conversion, the costs of development of alternative housing units, and a myriad of factors influencing the availability of resale property. Logically, developers would only convert rental units into condominiums if the expected rate of return exceeds the rate of return from construction of new condominium units or other types of housing. The interaction of demand, supply and mortgage markets limits the prices obtainable from sale of converted condominiums. Converted condominium prices must be within the bounds set by the prices of substitute housing purchases.

The determinants of the demand and supply of converted condominiums and the state of the mortgage market are numerous. Figure I represents a taxonomy of these determinants.

DEMAND FACTORS AFFECTING
THE PRICE A BUYER WILL PAY

A major determinant of condominium purchases are the prices of converted condominiums relative to all other housing prices. Given the quality of the converted units, their price must compare favorably with the rest of the housing market. The recent interest in condominiums partially reflects this fact. Many potential purchasers of townhouses or detached dwellings now face an escalation in their prices and in the terms of mortgage loans. Many of these potential homeowners have turned to the condominium market. As new purchasers move into the condominium market, prices for condominiums increase compared to other housing units.

The important point here is that new condominiums, new detached dwellings, old detached dwellings, new and old townhouses and rentals are all compared in the market. Even if a particular buyer does not compare all units simultaneously, other buyers are making comparisons and affecting the prices. We are all aware that housing is an active market. No one seller can keep his price out of line with the rest of the market, nor can a single buyer significantly affect the price. The price paid for any given converted unit, in short, depends on the prices, quality and quantity of all types of alternative housing.

FIGURE ITHE DETERMINANTS OF THE PRICE
OF CONVERTED CONDOMINIUM UNITS

- | | |
|---|--|
| <p>1. <u>Factors affecting the price the buyer will pay (demand)</u></p> <p>a. Prices of converted condominiums</p> <p>b. Prices of new condominiums</p> <p>c. Rents on comparable units</p> <p>d. Prices of other types of housing</p> <p>e. Related housing costs</p> <p style="padding-left: 20px;">--Heat</p> <p style="padding-left: 20px;">--Transportation expense</p> <p>f. Inflation</p> <p style="padding-left: 20px;">--Tax bracket creep</p> <p style="padding-left: 20px;">--Housing as an investment</p> <p>g. Family income</p> <p>h. Family life style</p> <p style="padding-left: 20px;">--Age of family</p> <p style="padding-left: 20px;">--Job location</p> <p style="padding-left: 20px;">--Recreational/shopping pattern</p> <p>i. Attractiveness of various neighborhoods</p> <p>j. Government policies</p> <p style="padding-left: 20px;">--Location of transit systems</p> <p style="padding-left: 20px;">--Land costs and EPA</p> <p style="padding-left: 20px;">--Local services</p> | <p>2. <u>Factors affecting the price that a developer will charge (supply)</u></p> <p>a. The number of rental units that can be converted</p> <p>b. Conversion costs of condominiums, including acquisition</p> <p>c. Prices of new condominiums</p> <p>d. Prices of other new housing</p> <p>e. Renovation cost of other old housing</p> <p>f. Attractiveness of various neighborhoods</p> <p>g. Construction and financing costs</p> <p>h. Political/governmental impacts</p> <p style="padding-left: 20px;">--Current/potential rent controls</p> <p style="padding-left: 20px;">--Current/potential conversion moratoria</p> <p style="padding-left: 20px;">--EPA mandated costs</p> |
|---|--|
3. Factors affecting buyers in the mortgage market
- The interest rate
- The term to maturity
- The size of the downpayment

However, one should not conclude that all housing units in a given metropolitan area of a given size and configuration will sell at identical prices. The purchase of a house is a joint purchase along with the neighborhood. That is, the house and its location are evaluated simultaneously. To the extent that a location is more desirable, the price of any given unit will be higher relative to similar units in less desirable locations. Neighborhood attributes, such as quality of local education or extent of adjacent parkland are important. Condominiums in the heart of a depressed or physically dangerous area should not be expected to command the same prices as units in attractive, safe areas. On the other hand, if enough people believe these less desirable locations will become prestigious areas in the future, prices could be bid up prior to revitalization in anticipation of future neighborhood conditions. Examples of this phenomenon include: Brownstowns in NYC, Capital Hill in Washington, D.C., or Dorchester in Boston.

In addition to the relative price of a unit and its neighborhood attributes, family income and life style also influence the composition of demand. Changes in the composition of the population family life style, and increases in the number of two wage-earner families have all served to increase demand for urban condominiums. Specifically, increases in the numbers of two income couples without children, unattached adults, and older adults, all of whom tend to prefer more urban locations, have led to increases in the demand for housing in urban areas where, in general, new housing cannot be built.

The relative increase in urban housing prices is also influenced by increasing energy costs. Those costs affect the overall costs of home ownership. Increasing energy costs mean higher heating bills and increased commuting costs. This increases the demand for more energy efficient, non-detached dwellings in closer proximity to urban areas such as urban condominiums.

It is important to emphasize that the pressures on the prices of urban housing do not only represent inflation. Rather, they are also relative price changes that reflect changes in preferences and the scarcity values of this sort of housing.

Inflation is the increase in the general level of prices. It is not an increase in any particular price. Increases and decreases in particular prices are a necessary and vital component of a market economy. Without changes in relative prices producers would not know what to produce and consumers would not know what to consume or avoid. If all prices maintained a constant relative relationship, the economy would have no way to signal and adjust to changes in real costs

and consumers demands. Clearly, there is a significant amount of inflation in our economy, and a significant part of the increase in condominium prices comes from this underlying trend. However, even if we were to discover that converted condominium prices have increased more quickly than other prices, the above discussion of factors affecting demand indicates that speculation is not likely to be the sole contributing factor.

The above, notwithstanding, inflation does influence the demand for housing. During inflationary periods there is an incentive to hold wealth in the form of tangible assets of all kinds. This ensures that real wealth is, at worst, not eroded by price increases and, at best, may increase. Housing is a particularly desirable asset to hold during inflationary periods because of the highly leveraged position that the current mortgage arrangements allow homebuyers to take. A small investment confers control over a large and increasingly valuable tangible asset.

Finally, there are two general types of government policies that influence the demand for housing. First, because of tax writeoffs of interest expenses and property taxes, the real costs of homeownership are reduced. Also because of inflation, the advantage conferred by these tax writeoffs increases because of the progressive nature of the tax system. In addition, capital gains that result from inflation and other factors may allow one to avoid taxation indefinitely, further increasing the desirability of housing relative to other financial and nonfinancial assets.

SUPPLY - THE DETERMINANTS OF THE
PRICE CHARGED BY A DEVELOPER FOR
A CONVERTED CONDOMINIUM

Many of the factors listed in the taxonomy as supply considerations are self-explanatory.

The price charged by a developer is determined by his costs (conversion costs and acquisition costs of the building), and is constrained by the prices of competing units. The developer must be aware of his construction costs and the consumer demand for various type units, which were discussed in the previous subsection.

One important supply side area is the impact of governmental policies on condominium prices. If the rental income of a building is constrained by rent controls, the value of

the building is reduced relative to its value in an unconstrained rental environment. This creates the incentive for the existing landlord or a developer to convert the unit into a condominium, thus increasing the supply of these types of units. On the other hand, if this type of activity is constrained by conversion moratoria, then the value of the stock of existing condominium units is increased because of their relative scarcity. Thus both of these types of government intervention in housing markets have the tendency to either reduce the stock of rental housing and/or increase the value of converted condominiums.

THE FACTORS IN THE MORTGAGE MARKET THAT AFFECT BUYERS

The cost and demand pressures of the marketplace determine the relative price of condominium units in relation to other types of housing. But, the consumer's ability to pay determines the overall demand in the market. Income is a very important determinant of the consumer's ability to pay. But, in addition, mortgage terms play an important role. The impact of a mortgage on the consumer's ability to pay is determined by three factors:

- the mortgage interest rate;
- the size of the downpayment; and
- the term to maturity.

Because these factors affect demand for housing, they also affect the demand for converted condominiums. As terms become stricter many individuals are rationed out of the market for more expensive housing. Consequently, the demand for smaller and usually less expensive units, including converted condominiums, increases.

A TEST OF RELATIVE PRICE INCREASES

Price changes in converted condominiums are attributable to a large number of factors--one of which may be speculation. Because of the interaction of the numerous forces influencing the supply and demand for converted condominiums and their prices, any methodology to test for the influence of speculation on converted condominium prices must control on, or hold constant, the influence of all other factors.

There are two fundamental ways to test for evidence that speculation has caused inordinately rapid increases in prices received for converted condominium units. The first would be to compare transactions prices on converted condominium units

with prices on all other types of housing adjusted for the supply and demand influences we have just discussed. A methodology would need to be developed that could, for example, compare condominium prices with prices on similar housing in more distant locations. Condominium prices also need to be adjusted for the premium conferred by lower heating and transportation costs, income and debt burden constraints and the like. Such a model in all likelihood would be intractable.

The second way to approach the problem is through use of a filter or screening mechanism which selects a housing sample which, to the maximum extent possible, has precisely the same attributes as converted condominium units. This latter approach, if only because of its simplicity, is preferable.

A test of relative price changes on converted condominium units should compare first and subsequent resale prices for converted condominium units with similar data for new condominium units. Both the new and converted units should be located in the near suburbs and price data should be gathered for the years 1973 through 1980.

Nineteen seventy-three is a good starting point because the condominium market became very active beginning in that year. Several cities where condominium markets have been active should be studied to see if a consistent pattern emerges. The study of relative price increases should only be performed in the near suburbs for several basic reasons. First, when comparing new and converted condominium prices, locational and life style factors affecting their relative prices must be standardized. Thus, we must study an area where new and converted condominium sales are likely to occur. This eliminates from consideration the far suburbs, since apartment-type construction (let alone conversions) is not likely. It also leaves out the inner-city, where most condominiums are conversions. If, because less new condominiums are built in urban locations, one compared urban condominium conversion appreciation rates to suburban new condominium appreciation rates, the comparison would be clouded by locational and life style influences. Comparison of rates of appreciation between 1973 and 1980 would include several housing business cycles. As demand and supply shifts over time, the relative rates of appreciation can shift. Comparison of rates over the period proposed allows one to reach more sound conclusions regarding long-term trends and eliminates the probability of reaching conclusions because of a quirk which may have existed during a shorter period of time. Price changes should be calculated on an annual basis. Only similar types of condominium units should be compared. Townhouse condominiums and efficiency condominiums are not the same housing type.

The definition of a near suburb must be city specific. For example, in Washington, it would be all areas within the beltway but outside the District of Columbia. In other cities, it may differ.

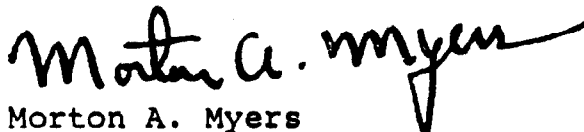
Finally, it is important to use the first resale price as the starting point for the data analysis. The reason for this is that in converted condominiums, first sales are often made to existing tenants at a discount from sales prices to non-tenants. This discount alleviates pressure on some of the tenants to relocate because it puts the purchase price within their range of affordability and also reduces, to some extent, the undesirable social costs associated with relocations. Also because immediate sale to tenants reduces marketing and construction/renovation and loan costs, the developer's financial burden is eased. This is passed through in the form of a discounted price. Thus, a comparison of first sales prices with first resale prices on new and converted condominiums would tend to indicate differences arising from the tenant discount rather than other forces.

The data sources must be actual transaction prices. Local Multiple Listing Services or metropolitan real estate boards may be able to suggest or provide sources of data.

The results emerging from the study design we propose would not be totally conclusive. The greater the extent to which factors influencing housing prices are controlled, the more confidence one will have that any differences observed in rates of price change are not due to extraneous forces. It is exceedingly important to point out that if, after implementing the study design we have proposed, converted condominium unit rates of price appreciation exceed new condominium unit rates of appreciation, the case for speculation in converted condominium units will be strengthened, but not proven. If, on the other hand, these results do not emerge, then the case for speculation cannot be made.

As arranged with your office, copies of this report will be available to others upon request. We hope that this information will be useful to you. Let us know if we can be of further assistance.

Sincerely yours,



Morton A. Myers
Director