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The Future of Limited Equity Cooperatives

Kristin Perkins
University of California, Berkeley

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Abstract

Limited Equity Cooperatives (LECs) are a form of cooperative housing that is price restricted, often created initially through government construction or mortgage interest subsidies. Affordability is maintained in perpetuity by capping the transfer value of cooperative shares to limit the equity that owners can extract from their units. As a type of collective ownership, LECs enable homeownership without the risk of debt financing or the responsibility of maintenance. Cooperative members receive the same tax advantages as traditional homeowners, assessed on shares of the cooperative rather than a single unit. The restriction on share resale values keeps LECs affordable to multiple generations of purchasers and enables renters to become homeowners without having to qualify for traditional financing. LECs provide these benefits while spreading the risk and cost of homeownership across many shareholders (Saegert and Benitez 2003). Nearly 16 million U.S. households are severely cost burdened (spending more than 50 percent of their income on housing), a number that increased by two million between 2001 and 2004 (Joint Center for Housing Studies 2006). Neither the federal government nor the private sector has implemented an effective solution to the affordability crisis. By incorporating LECs into federal housing policy, an opportunity exists to ease the cost-burden of homeownership for low- and moderate-income households, promote mixed-income housing, and increase community engagement and civic capacity. LECs offer an alternative to market rate and subsidized housing, but are not appropriate for every population or every location.

Keywords

Cornell, real estates, nontraditional homeownership, low income housing

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By Kristin Perkins

Limited Equity Cooperatives (LECs) are a form of cooperative housing that is price restricted, often created initially through government construction or mortgage interest subsidies. Affordability is maintained in perpetuity by capping the transfer value of cooperative shares to limit the equity that owners can extract from their units. As a type of collective ownership, LECs enable homeownership without the risk of debt financing or the responsibility of maintenance. Cooperative members receive the same tax advantages as traditional homeowners, assessed on shares of the cooperative rather than a single unit. The restriction on share resale values keeps LECs affordable to multiple generations of purchasers and enables renters to become homeowners without having to qualify for traditional financing. LECs provide these benefits while spreading the risk and cost of homeownership across many shareholders (Saegert and Benitez 2003).

Nearly 16 million U.S. households are severely cost burdened (spending more than 50 percent of their income on housing), a number that increased by two million between 2001 and 2004 (Joint Center for Housing Studies 2006). Neither the federal government nor the private sector has implemented an effective solution to the affordability crisis. By incorporating LECs into federal housing policy, an opportunity exists to ease the cost-burden of homeownership for low- and moderate-income households, promote mixed-income housing, and increase community engagement and civic capacity. LECs offer an alternative to market rate and subsidized housing, but are not appropriate for every population or every location.

author

Kristin L. Perkins is a Master's student in the Department of City and Regional Planning at the University of California, Berkeley. Her interests include affordable housing policy and programs and she is currently a researcher at UC Berkeley's Center for Cities & Schools. After completing her undergraduate degree in urban studies at Cornell University, she worked as an assistant project manager for Telesis Corporation, a national developer of affordable and mixed-income housing, in Washington, D.C. At Telesis, she supervised construction of a community center in southeast D.C. and facilitated community outreach for a neighborhood revitalization project in Baltimore.

Easing Homeowner Cost Burdens

Nearly 18 million U.S. homeowners are cost-burdened, spending more than 30 percent of their incomes on housing. Moderate income homeowners experience housing cost burdens at higher rates than do renters of similar income (Schwartz 2006). The disproportionate cost burdens of moderate-income homeowners reflect their reliance on high financing costs and, in some cases, the extra costs associated with subprime lending. Low and moderate income homeowners do not accrue the same benefits from homeownership as do higher income households. The reliance of low-income homeowners on high-cost mortgages results in thin equity cushions, undermining the benefits of homeownership. Since they typically have smaller mortgages, low-income households have smaller tax deductions than do homeowners with higher incomes and are at greater risk of foreclosure (Saegert and Benitez 2003). LECs provide the same tax advantages granted to fee simple homeowners in addition to many of the other economic and social benefits of homeownership without the risk associated with high-cost mortgages and subprime lending.

Many community revitalization efforts focus on housing and often promote homeownership. Traditional homeownership, however, may not be the best option for those with moderate incomes if it encourages households to assume more debt than they can handle. Community pressure, stemming from the 1977 Community Reinvestment Act, made banks revise their lending standards to enable marginal borrowers to receive loans. Nontraditional forms of homeownership, such as LECs, promote homeownership in disadvantaged communities, but do so while providing security to low and moderate income households. For LECs to provide a viable alternative, they will also have to overcome the private lending industry's reluctance to finance nontraditional homeownership (Dreier 2003).

Critics of LECs say that encouraging low and moderate income households to buy shares in an LEC instead of opting for a more traditional form of homeownership diminishes their potential equity accrual and limit asset building. While LEC shareholders do not typically earn the same return on their investment as do traditional homeowners, it is a more cautious way of investing in real estate, especially for those with low and moderate incomes. Buying a share in an LEC enables low and moderate income households to become homeowners before they can afford the debt required for traditional homeownership. Cooperatives can, in effect, be a dress rehearsal for homeownership by providing affordable housing that assists individuals in building equity.

Mixed-Income Housing

LECs and mixed-income housing have complementary features and thrive under the same community conditions. This makes LECs an appropriate method to implement mixed-income housing. For example, including moderate-income as well as low-income residents in an LEC makes it more likely that the cooperative will be able to cover operating costs and accumulate significant reserves, preventing bankruptcy should vacancy rates rise or major capital investment become necessary.

Mixed-income housing works best in strong housing markets and when it has desirable development characteristics, such as location, cost, design, size, condition, amenities, and resident demographics (Schwartz and Tajbakhsh 1997). LECs also work best in locales where there is a strong market defined by low vacancy rates, and where moderate-income households are unable to find suitable rental housing. Mixed-income developments are easier to manage, and experience less tension among residents, when there is a continuum of incomes rather than a strict dichotomy between subsidized and market rate tenants (Brophy and Smith 1997).

One successful example of a mixed-income LEC is the Townhomes on Capitol Hill (Townhomes), in Southeast Washington, D.C. The Townhomes's development team demolished public housing buildings and replaced them with rowhouses in character with the surrounding Capitol Hill neighborhood. These 92 buildings, which include 134 units of varying size and layout, are now home to a diverse group of residents whose incomes range from 10 percent to over 100 percent of area median income (AMI). This income mix was achieved by including shareholders in three different income bands: 25 percent of the units are available to households with incomes less than 25 percent of AMI; 25 percent are available to households with incomes between 25 and 50 percent of AMI; the other half of the units are available to households with incomes between 50 and 80 percent of AMI, though up to 20 of these 67 units can be occupied by households with incomes between 80 and 115 percent of AMI.

Once a household moves into a unit, it cannot be forced to leave if its income increases beyond 115 percent of AMI, although it might have to pay a higher monthly carrying charge if its income crosses bands. Cooperative members' monthly carrying charges depend on their income; members pay based on 30 percent of the median income of each band. The carrying charges from the highest income band cross-subsidize those from the lowest, enabling the Townhomes to operate without any external subsidy. As a result of this cross-subsidization, the Townhomes have reserves of nearly $900,000. Though the three income bands ensure a mix of incomes, the property also includes 13 fee simple townhomes developed at a later stage. These units were sold at market rates of between $300,000 and $500,000, further adding to the income diversity of the community.

Although the Townhomes demonstrate that LECs can stimulate mixed-income communities, some housing policy theorists question the use of public funds to subsidize what is essentially middle-class homeownership. In any LEC development, but especially in those whose goal it is to stimulate mixed-income communities, it is important to clearly define the share value formula and

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determine how much equity households will earn as residents and how much will remain in the cooperative, allowing the shares to remain affordable to low and moderate income households.

Furthermore, if the goal is to increase affordable options for all low-income households, it is imprudent to convert public housing to mixed-income LECs. Long waiting lists for publicly subsidized housing make it better to build new cooperative units than to renovate public housing; this adds more affordable units and it is more efficient to construct units as cooperatives rather than rehabilitate and retrofit older stock (Rohe 1995).

Community Building

A third benefit of LECs is their ability to stimulate community involvement and organization. Community engagement and participation are natural extensions of the cooperative, resident-managed approach of LECs. Cooperatives own and manage economic capital and can use this resource to build social capital.

Although Miceli, Sazama and Sirmans (1994) suggest that limited returns on their investment means that LEC members may not act any differently than if they were renting their units, Saegert (2006) found that, compared to buildings owned by private, community-based, or public entities, cooperative buildings demonstrate higher levels of social capital and are associated with better building conditions, lower crime, and increased resident participation in community organizing. Collective ownership promotes civic capacity through leadership development by giving owners a stake in public decisions and policies. Homeownership gives people a reason to be involved in their communities and most homeowners seek investment in their communities to increase their property values as well as their quality of life. With cooperative shareowners realizing many of the benefits of homeowners, it is likely that they behave in similar ways (Saegert 2006).

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Although LEC residents do not own their units, research shows that they still experience many of the positive externalities associated with traditional homeownership, such as higher residential satisfaction, greater involvement in community organizations, and better educational and occupational outcomes, especially for their children (Bratt 1989; Rohe 1995). LEC members say that, as homeowners, they have a better sense of belonging to a community than they would as renters. They participate in more neighborhood organizations and have a greater desire to stay in the neighborhood. These characteristics promote collective organization, leading to lower crime rates and residential neighborhood improvement (Rohe 1995; Saegert and Benitez 2003). While the economic benefits are attractive to residents, research shows that the non-monetary benefits, security, control, and sociability, are even more important to residents and potential residents in determining residential satisfaction (Sazama and Willcox 1995).

With any new development in disadvantaged communities, some long time residents may fear an influx of outsiders and become concerned about the possibility of gentrification. LECs stimulate community organization and activity in depressed neighborhoods, but do not themselves lead to gentrification (Saegert and Benitez 2003). Even if gentrification occurs, LECs offer existing residents of a gentrifying neighborhood continued access to affordable housing. With shareholders unable to capitalize on skyrocketing property values, it is unlikely that LECs will attract residents interested in speculative housing.

The Future of LECs

Limited Equity Cooperatives are an underutilized tool in U.S. housing policy, which has long supported single-family homeownership and other market-driven alternatives. LECs offer nearly all of the benefits of traditional homeownership with less risk and can effectively provide homeownership opportunities to low and moderate income families. As such, LECs should be used in addressing the nation’s housing affordability crisis.

To be successful LECs will need cooperation from public and private institutions to become established as an alternative form of homeownership. Though touted as a non-market, non-government substitute for traditional forms of housing, LECs will, initially at least, need government subsidies for construction and development and support from private financial institutions, which has traditionally been nonexistent. One way in which the federal government could support LECs is to make them eligible for development funding under its Low Income Housing Tax Credit (LIHTC) program (Sazama 2000). Though currently available only for more traditional rental developments, the LIHTC program is the federal government's most successful subsidized housing program and its structure could easily be adapted to include an LEC-type of development. Its provisions for mixed-income housing, requiring that a minimum number of units be affordable but allowing resident incomes to increase to 140 percent of AMI, would work well in developing a mixed-income LEC. Private lending institutions should look to the historical success of LECs, their resilience in economic depressions and low foreclosure rate, as reason to support them as a housing alternative in the future. Once LECs are established as a viable alternative and have successfully attracted households with a range of incomes, they will be less reliant on preferential treatment from both the public and private sectors.

To have the greatest chance at financial viability, LECs should be mixed-income, funding both operating costs and maintenance reserves through cross-subsidization. LECs and mixed-income housing are most successful in strong housing markets where moderate-income households have few alternatives; Boston, Washington, D.C., and many California cities fit these specifications well. LECs should seek to serve low- to moderate-income households wanting to become homeowners but facing significant difficulty entering the private homeownership market.

LECs can become a desirable alternative to homeownership for many Americans and an effective tool in addressing the affordability crisis now evident across the country. Though they will never fully replace other forms of subsidized and market rate housing, and are not an ideal form of housing for all populations, LECs can provide homeownership opportunities to many low- and moderate-income households that are currently underserved by the public and private market.

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