

Guide to Capital Improvement Policies



What We Will Cover Today

*Don't worry about taking notes –
I'll share a PDF of the slides.*



Introduction



Goals of Program Design



Issues and Options in Designing a Capital
Improvements Policy



Related Issues: Maintenance + Multifamily
Housing



Case Study of Homestead Community Land Trust

This Is the “Third Face” of Stewardship”

- Unlike a resale formula – or a ground lease – capital improvement policies are not a mandatory element of the CLT model in the US.
- However, many, if not most, of the established CLTs in the US have considered or implemented a capital improvement policy.
- For new CLTs just trying to get established, this is one of those things that usually goes into the bin labeled “stuff to do later on”.
- *But it is indeed the “third face” of stewardship – taking good care of buildings – and therefore is important to know about.*

A decorative graphic on the left side of the slide shows two white paper houses with red roofs, placed on a wooden surface. The houses are simple, geometric shapes. The background of the slide is white.

Single Family Homeownership

- Today we will be focusing primarily on single family owner-occupied housing.
- But we will talk about multifamily housing issues at the end of this presentation – which are indeed quite different than for single family dwellings.



But First – a Short Story

How I First Encountered Capital Improvements

Madison Area Community Land Trust

- We repurchased all homes until 2007 – fixing up what needed to be fixed – and selling them in good shape.
- Then – the Great Recession – we couldn't do that anymore – and we couldn't buy them all back when they came up for resale.
- So – we only repurchased the ones that needed work.
- So – the homeowners who took the worst care of their homes got the best deal 😞

There's Got to Be a Better Way!

- How could we incentivize good maintenance – when the resale formula gives no credit for it?
- How could we reward people who improved the utility of their homes?
- And how do we maintain affordability going forward?
- **We heard about a “capital improvements policy”** – and how the really smart CLTs had them – but we had no template to follow – no guide to help us.
- It therefore went into the bin labeled “important stuff to do someday” – while I focused on more urgent matters.



And Now — There is Finally a Guide!

- *Believe it or not, there has not previously been a “how-to” guide to help CLTs design their own capital improvement policies.*
- It builds upon the earlier work of Kirby White in chapter 12 of the 2011 *CLT Technical Manual*.
- It also builds on the work of John Emmeus Davis, in particular Chapter 3 of his 2006 publication *Shared Equity Homeownership*.
- *And this is the first time we’ve ever done a presentation on it 😊*

What Is a Capital Improvement?

Definition. It is generally defined as an addition or change that increases a building's value, increases its useful life, or adapts it to new uses.



The Challenge of Capital Improvements in a CLT Context

- In the **conventional housing market**, the unrestricted resale price of a home reflects much of the value added by a homeowner through the addition of improvements.
- But for **resale price-restricted CLT** homes, resale price restrictions *do not* automatically recognize such investments.
- *Therefore, additional policies are necessary if a CLT wants to recognize the monetary contributions of homeowners who add utility enhancing improvements.*

Questions to Address in Crafting These Policies

HOW DO YOU

- Distinguish between **replacements or repairs** and **capital improvements**?
- Distinguish between improvements that increase **utility** and those that are **luxuries**?
- Place a **monetary value for credits on improvements**?
- Negotiate the **process for approving and valuing improvements**?
- Design an improvements policy that is **neither intrusive on the homeowner nor burdensome for the CLT** that administers it?

Goals of Program Design



MAINTAIN
AFFORDABILITY



MAINTAIN
QUALITY



IMPROVE UTILITY



PROMOTE
TRANSPARENCY



REDUCE
ADMINISTRATION

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Maintain Affordability

Incentivizing utility-enhancing improvements cannot come at the expense of maintaining affordability for subsequent homebuyers.

Recommendation: Consider placing an upper limit on the amount of credit provided to the seller in order to protect affordability for the next homebuyer.

Maintain Quality

- Maintaining the quality of the structure is an essential element of a successful stewardship regime.
- CLTs have an interest in seeing that any post-purchase improvements are constructed in a “professional manner.”
- Some CLTs incorporate selected high-cost maintenance items (such as roofs and furnaces) into their capital improvements policies.

Measures to Improve Utility

- **Improving building performance:** replacement of mechanical systems, insulation, window replacement, addition of renewable energy systems.
- **Increasing flexibility of use:** adding a bedroom, adding a first-floor bathroom, or making modifications to create wheelchair accessibility.
- **Improving health outcomes:** air filtration systems, soil remediation, noise mitigation measures.
- **Improving durability of the home:** improvements to the building envelope (such as siding and roof replacement) as well as modifications to improve structural integrity.

Promote Transparency

- *A capital improvements policy should be clearly understandable to homeowners, as costs associated with making capital improvements involve a substantial investment of household finances.*
- **Recommendation:** Transparency as to eligible improvements and likely return on investment is essential. Transparency also reduces the likelihood of conflict between the homeowner and the CLT.

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Reduce Administration

Capital improvement policies can be very burdensome to CLT staff!

- Smaller CLTs can implement schedule-based approaches that provide clarity upfront as to what improvements are allowed and what percentage of costs will be credited.
- Larger CLTs may have the in-house capacity to do case-by-case reviews and can successfully implement more individualized approaches.

Core Issues and Options in Policy Design



What constitutes an “improvement” (as opposed to a repair or replacement)?



How should proposed improvements be reviewed/approved?



Which improvements should be rewarded?



How are improvements valued?



How is compliance monitored and enforced?

What Constitutes a Post-Purchase Improvement?

Challenges and Design Considerations

- **Challenges.** Some high-cost items – such as roof and furnace replacements -- can be difficult to categorize.
- **Considerations in Design.** It is therefore important to set out a clear definition of capital improvements.
 - *It is generally a good practice to provide a list of eligible improvements, to provide clarity as to what is -- and isn't -- covered by the policy.*

How Should Proposed Improvements Be Reviewed and Approved?

Why Is This Important?

- A CLT has an interest in reviewing proposed improvements to make sure that they will be done in a quality manner, in full compliance with applicable laws and regulations.
- Additionally, the CLT has an interest in determining which projects will either (a) be permitted in the first place (does it add utility or is it a luxury?), and (b) whether value (and how much) should be added to the allowable resale price?

Options for Approving and Valuing

- ***Option 1 - Approval not required, value not added.*** Homeowners are free to make modifications, subject to local building and zoning codes, but no credit is given.
- ***Option 2 - Approval not required, value is added.*** Homeowners are free to make any improvements that are on the CLT's pre-approved list.
- ***Option 3 - Approval is required, value is not added.*** CLT has approval rights over selected improvements to ensure that the structural integrity and marketability of the building are maintained
- ***Option 4 - Approval is required, value is added.*** The most common approach, where the homeowner submits building plans to the CLT for approval prior to constructing improvements.

Considerations in Design

- The more detailed the review and approval process, the greater the administrative burden.
- Schedule-based approaches which specify eligible improvements can reduce staff time and also provide clarity to homeowners in deciding which improvements they may want to construct.
- Where no credit is to be provided, CLTs should be mindful of minimizing the compliance burden on homeowners.
- It is important to provide clear criteria for circumstances where proposed improvements are denied by the CLT.

Which Improvements Should Be Incentivized?

Which Improvements Should Be Incentivized?

- **Why Is This Important:** Without incentives, resale price restrictions would discourage homeowners from making any major improvements, since it is likely that little, if any, of their investment would be returned to them at the time of resale.
 - *Incentives signal to homeowners which improvements the CLT believes will benefit the building across generations of homeowners, as well as enhance the physical accessibility of the home.*
- **Model Ground Lease.** It provides four variations on a resale price formula (appraisal-based, indexed, and fixed-rate formulas), none of which provide specific financial incentives for improvements to be constructed.

Improvements Increasing Utility.

- Measures to improve a building's **energy efficiency**.
- **Accessibility modifications** expand opportunities for purchasers with disabilities, and also enable homeowners to more successfully age in.
- **Adding a bedroom** expands opportunities for families with children and intergenerational households.
- **Air filtration systems** which benefit persons with respiratory illnesses.
- Improvements that improve the **structural integrity of the home and protect the building envelope** – helping to ensure that the home will be able to house multiple generations of homeowners.

How Should Improvements Be Valued?

Why Is This Important?

- It is no simple manner to place a value on an incentivized improvement in a resale-restricted home.
 - For example, should a homeowner receive the same amount of credit for an improvement constructed 2 years ago versus one done 20 years in the past?
 - And should all improvements be valued the same, relative to the cost of construction?
- *The greater the percentage of costs recouped at resale via the improvements credit, the greater will be the incentive for constructing the improvement.*

Options for Valuation

- ***Schedule-based (or list-based) approaches*** associate a percentage of costs to be credited for each listed improvement, along with an associated depreciation factor. This provides a very high degree of predictability as to return on investment.
 - However, it does penalize do-it-yourself efforts, where only actual out-of-pocket costs are recognized.
- ***Appraisal-based approaches*** focus on the increase in market value resulting from the improvement. These offer a low level of predictability as to return on investment, with valuation occurring only after work is completed.

Protecting Affordability

- A homeowner who implements all improvements for which a credit is authorized could push the resale price far beyond the means of income-eligible buyers.
- *An upper cap that keeps the home affordable to low-to-moderate income buyers is therefore an essential component of a capital improvements policy.*
- **Recommendation:** All capital improvement policies should consider including a “safety valve” feature to protect the affordability of the home at the time of resale.

How Should Compliance Be Monitored and Enforced?

Considerations in Design

- Once an improvement has been approved, it is still in the interest of the CLT to ensure that it was constructed properly, in compliance with all applicable laws and regulations.
- It is also be good practice for the CLT to conduct a walk-through inspection at the time of resale, to confirm that the improvements were indeed constructed as per plan, in a professional manner, and have been well-maintained.
- In the event that improvements were not constructed and maintained properly, the CLT could require the homeowner to address all needed issues prior to resale, or in the alternative reduce the resale price by the amount necessary to correct the issues.

Related Issues



**MEASURES TO ENSURE
PROPER MAINTENANCE**



**MULTIFAMILY HOUSING
CONSIDERATIONS**

Maintenance

Measures to Ensure Proper Maintenance

- **Incentive-based approaches:** This incorporates a list-based (schedule) approach, where selected maintenance, repair and replacement items are incorporated alongside incentivized improvements.
- **Good repair bonus:** Some CLTs provide a bonus at the time of resale where homes are kept in good repair.
- **Penalty-based approaches:** At the time of resale, the CLT inspects the property and identifies items in need of repair. The CLT can choose to require that the seller makes the required repairs prior to resale, or in the alternative, that the cost of repairs is deducted from the resale price in order to allow the new purchaser to cover the cost of needed repairs.
- **Hybrid approaches:** This would incorporate a list-based approach for certain items (such as roof replacements), along with a final inspection prior to resale, where a penalty may be invoked if the home is not in good repair.

Multifamily Housing Considerations

Condominiums

- The repair and maintenance of all areas outside of the individual condo unit is the responsibility of the condo association, with the unit owner responsible only for what lies within their individual living space.
- Improvements to the “common areas” are approved and financed by the condominium association itself. This covers many of the items included in a capital improvements policy for single family homes.
- Improvements to the individual’s condo unit generally do not require approval from the condominium association as long as (a) they do not involve structural modifications, and (b) do not impinge upon common elements of the building.
- Obligations to the CLT may differ based on whether the land is master leased to the association, or if there are individual ground leases for each condo unit.

Improvements to the Condo Unit

- Most typically, condominium unit owners focus on improvements relating to kitchens, bathrooms, and accessibility modifications -- as well as replacements of mechanical systems that are specific to the individual unit.
 - Window replacement may or may not be the responsibility of the unit owner, depending on how the condominium documents are drafted.
- *The question for the CLT is whether these types of measures are in need of incentives.*
- **Recommendation:** Improvements that focus on accessibility measures and energy efficiency may be a good place to start in crafting a policy for condominiums.

Housing Cooperatives

- **Caveat:** *Other folks know way more about housing cooperatives than I do.*
- A few observations:
 - Because CLT cooperatives are zero-equity or limited-equity in their structure, valuation of capital improvement credits to be added to the share price is subject to an upper limit that keeps it affordable to the next share holder. In practice, this may make credits quite minimal.
 - Incentives for measures that increase utility could be provided by other means, such as no-interest or low-interest loans from the housing cooperative (or the CLT), which could be assumable for the next share holder.



Case Study

Homestead Community Land Trust