A review of condominium conversions in Washington

Washington State Department of Commerce

Exploring viability for affordable homeownership opportunities per Chapter 165, Laws of 2022

HOUSING DIVISION

March 8, 2023

Report to the Legislature

Interim Director Kendrick Stewart

V3.2

Acknowledgments

Washington State Department of Commerce
1011 Plum St. SE
P.O. Box 42525
Olympia, WA 98504-2525

www.commerce.wa.gov

For people with disabilities, this report is available on request in other formats. To submit a request, please call 360-725-4000 (TTY 360-586-0772)

Study Project Committee
In addition to representatives from ECONorthwest, BDS Planning, and the Washington State Department of Commerce, the Affordable Housing Advisory Board Condominium Conversion Study Project Committee included:

Paul Trautman, Senior Housing Developer, Community Frameworks Affordable Housing Advisory Board Chair

Ann Campbell, Managing Director Homeownership, Washington State Department of Commerce

Jeanette McKague, Assistant Director of Housing and Community Development, Washington Realtors

Michael Orbino, Managing Broker, Team Foster Building + Developer Services at Compass

Steve Walker, Executive Director, Washington State Housing Finance Director

Patrick Johansen, Chairman of Housing Justice Committee, RiseUpWA

Raelene Schifano, Nonprofit Advocate, HOA Fightclub

Michael Brandt, Real Estate Lawyer, Brandt Law Group

Table of contents

Executive summary

As of 2019, Washington has underproduced more than 140,000 housing units and ranks as the fifth worst state in the nation in terms of underproduction as a share of total housing stock.[1] From 2011 to 2021, only 0.92 units of housing were added for every household formed in Washington, contributing to a lack of housing affordability across the state. One symptom of housing underproduction is that prices are increasing faster than incomes — particularly for households who might struggle to save for a down payment, even if their incomes can support a mortgage. The price of new detached, single-family housing across the state has more than doubled in the past decade, with very limited production of housing units that are affordable to households earning less than 100% of the Area Median Income (AMI). This limits the state's ability to attract new businesses and residents, and it means that current residents and renters are unable to become homeowners if they desire.

Recognizing the lack of affordable homeownership opportunities and the importance of homeownership as a means to stability and wealth generation, the 2022 Washington State Legislature directed the Affordable Housing Advisory Board (AHAB) to study the feasibility of converting apartment buildings into condos as an option to increase affordable homeownership opportunities in Chapter 165, Laws of 2022 (Senate Bill 5758).

AHAB advises the Washington State Department of Commerce on housing and housing-related issues. The following findings will help guide legislators as they continue their efforts to make homeownership more accessible to a wider array of Washington residents, including first-time homebuyers.

Legislative mandate

This report was produced to satisfy the portion of requirements of Section 7(2) of Chapter 165, Laws of 2022 (SSB 5758):

> The board must provide a report on its review to the appropriate standing committees of the legislature by December 1, 2022. In conducting its review, the board shall seek input from ESSB stakeholders with expertise in both the condominium conversion process and in providing tenant relocation programs and assistance.

What are condo conversions?

A condo conversion is a process of converting leased rental apartments into owned condo units. The conversion can create more entry-level housing, but it might displace rental tenants who cannot afford to purchase their current units.

This process is more complex than changing the legal terms of a unit. Converting apartments to condos is expensive and often requires lengthy construction and legal processes, as the requirements for apartments are different than for home ownership. There are numerous financial barriers and considerations when converting a rental apartment into a condo. The process often requires multidisciplinary teams, and the expenses burden both the developer pursuing the conversion and the cost of ownership for the buyer purchasing the unit.

Most buildings are converted by developers because many apartment building owners do not have the skillsets, risk profile, and access to capital required.

[1] ECONorthwest, "Redefining Economic Success in Washington State: 3 Keys to Quality Growth," (2022), https://econw.com/projects-collection/2022/3/8/redefining-economic-success-in-washington-state-3-keys-to-quality-growth

Summary of findings

Conversion incentive programs face a policy tradeoff. Increasing wealth-building opportunities can come at the expense of reducing naturally occurring affordable apartments and increasing displacement risk for existing tenants.

- **The condo market is small.** Although demand for homes of every type has been strong in Washington for the last decade, there has not been a corresponding rise in new condo construction nor an increase in the number of conversions of apartments to condos. According to data from the U.S. Census Bureau ACS 2019 5-year, attached ownership units make up 5.3% of the stock of housing statewide. This is a close proxy for condos but is likely an overestimate because it also includes attached units that are not in legal condo structures (such as fee simple units). Additionally, condos accounted for less than 1% of new unit construction over the last decade. The barriers facing developers and contractors affect their financial returns and risk, such that they almost exclusively produce other types of housing (predominantly multifamily apartments and single-family detached homes).

- **Federal Housing Administration (FHA) program requirements limit scaling affordability in condo ownership.** Condo buyers face an additional barrier because FHA loan underwriting requirements for condo mortgages have greater risk mitigation standards than non-condo loan products. The heightened underwriting standards include criteria related to the financial solvency of the condo owners' association, more stringent financial qualifications for individual buyers, and limitations on the number of insured mortgages in a single condo development. These requirements reduce the pool of potential condo owners to cash buyers and those who can secure non-FHA-secured loans.

- **Legal barriers are a hurdle to conversions.** Condo developers, realtors, and contractors cited the same issue: risk, specifically construction defect liability. Primarily determined by RCW 64.34, the Washington Condo Act (WCA), condo developers are subject to specific warranties not applicable to detached housing or apartment buildings. These laws are also applicable to condo conversion and can add risk and cost via inspection, insurance, loan and presale requirements. Chapter 238, Laws of 2019 (SB 5334) constrained condo defect liability, but many developers are still hesitant to reenter the condo market.

- **Condo conversion is expensive, impacting affordability for renters and buyers**. Providing an opportunity for renters to purchase the apartments they live in could allow more households to build wealth, remain in neighborhoods of choice and maintain cost stability. However, the costs associated with the conversion process increase the income required to afford the same unit that was previously rented, making conversion challenging for low- and moderate-income households. For example, a hypothetical two-bedroom unit renting at 80% of Area Median Income (AMI) in King County is $2,145 per month and would cost $334,620 to purchase in current market conditions, resulting in a $4,060 monthly payment (assuming a 5% down payment), including monthly condo fees, mortgage principal and interest payments, private mortgage insurance, property taxes, and insurance. That means the rental unit — affordable at 80% AMI — is now a condo that would require an income of 140% of AMI to afford the monthly payments.

- **Unregulated condo associations increase risks to homebuyers.** Condos are attractive to many homebuyers due to the limited maintenance and the lower purchase price compared to detached housing. The mechanism for achieving shared caretaking responsibilities is condo associations (also referred to as homeowner associations or HOAs), but these shared responsibilities often create an imbalance of power due to fee structures that can be changed without the approval of a majority of the homeowners. HOA boards also have the power to fee, fine and even place liens on one's property.

- **Displacement risk from condo conversion incentives.** There are many factors that affect the displacement risk for a tenant in a condo conversion project, including their desire to purchase the unit, their access to capital for a down payment, and their ability to afford the monthly payment of the condo. If a new condo conversion incentive was introduced but did not include adequate homeownership assistance for existing residents, it could cause the displacement of existing tenants. Although some cities do require relocation assistance in such situations, it is often insufficient to mitigate any increases in rental or transportation costs associated with the constrained new housing options.

- **Economic conditions have changed rapidly since 2019, with a particular effect on real estate markets.** Market volatility regarding interest rates, the impact of inflation, and changing valuation metrics for apartments (cap rates) make it challenging to forecast condo conversion feasibility in the near term. As current market conditions/volatility change in the future, the affordability impact of conversion could improve, at which point they can be explored as an option to provide affordable homeownership.

In the long term, conversion creates new homeownership opportunities but **does not add to the overall housing supply**. Permanently removing rental apartments from local housing markets can exacerbate shortages of rental housing and play a role in rising housing costs, especially when new housing construction is slow or stagnant. Because condo conversions are more likely to occur in buildings that rent at more affordable rates, conversion has a more acute impact on the supply of affordable rental housing, disproportionately impacting low- and middle-income renters.

Frequently used terms

Area Median Income (AMI) is the primary measure of income used to determine housing affordability. It is determined annually by HUD for individual counties and metro areas across the county. AMI represents the median household income for a family of four and then is adjusted based on the number of people in the household or the number of bedrooms in a housing unit to determine affordability. This is sometimes also referred to as median family income or MFI.

Housing is considered **affordable** when a household spends 30% or less of its gross income on a mortgage, rent, or combined housing cost. If a household is spending more than 30% of its gross income on housing, they are considered cost burdened.

A **first-time home buyer** is an individual or their spouse or domestic partner who have not owned a home during the three-year period prior to purchase of a home. The Washington Center for Real Estate Research, which publishes quarterly housing market summaries with affordability indices, assumes a first-time homebuyer household to have less income (85% of the AMI) than a "typical" homebuyer household to support a mortgage payment or a 20% down payment on a home.

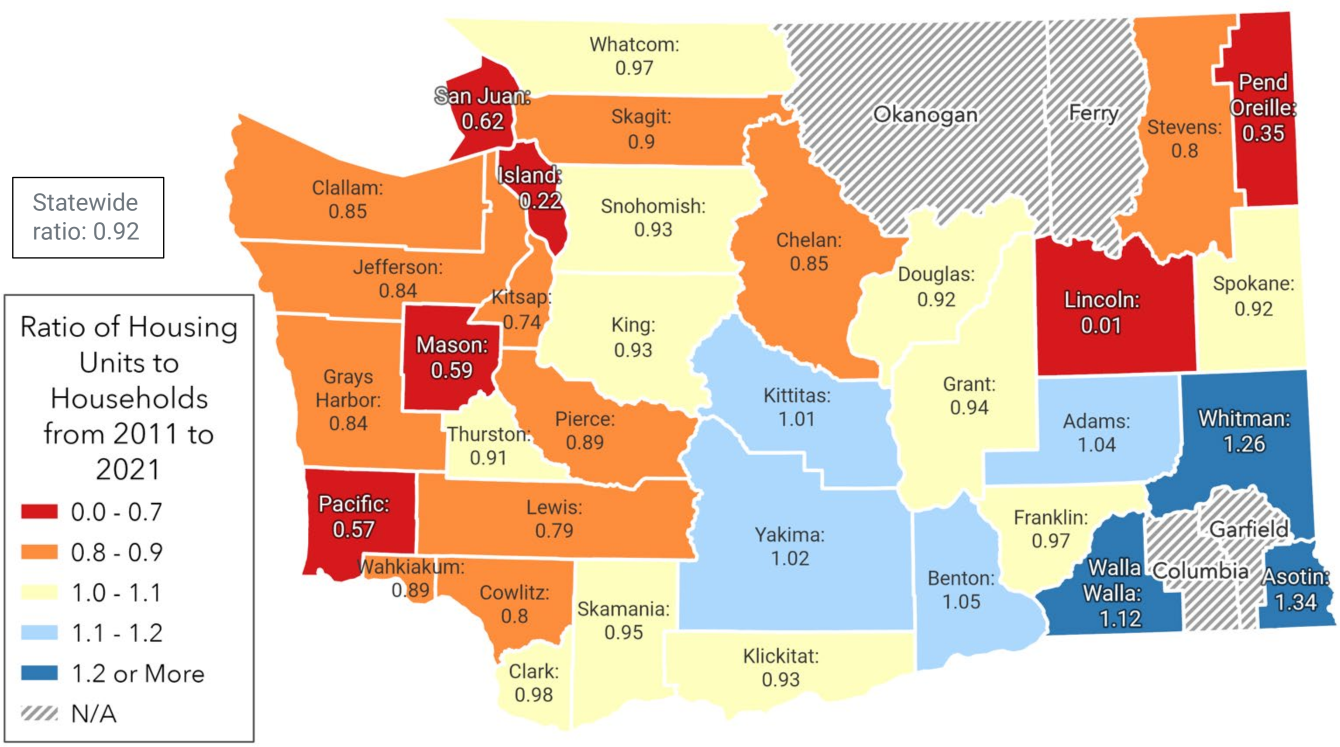
A **low-income household** is a single person, family or unrelated people living together whose adjusted income is less than 80% of the median family income, adjusted for household size, for the county where the project is located.

Introduction

A recent study evaluating business competitiveness in Washington identified the lack of housing as the leading barrier to equitable economic growth in the state.[2] As of 2019, Washington has underproduced more than 140,000 housing units and ranks as the fifth worst state in the nation in terms of underproduction as a share of total housing stock. The state has had one of the strongest economies in recent decades, buoyed by the growing tech industry, but has not produced sufficient housing to meet the growing demand. From 2011 to 2021, only 0.92 units of housing were added for every household formed in Washington, contributing to a lack of housing affordability across the state.

As shown in the map below (Exhibit 1), the ratio of housing units to households from 2011-2021 is below 1.0 in most Washington counties. It is not limited to rural or urban counties, although the most significant disparities do exist in some of Washington's least populated counties.

Exhibit 1: Housing underproduction ratio by county in Washington, 2010 to 2021



Source: OFM, ECONorthwest Calculations

Findings in this report are informed by in-depth analysis, discussions with industry experts and key stakeholder interviews, including project committee members. The scope of this study was broad and focused on the intersection of topics such as condo financing, displacement protections, HOA board dynamics, and transit

[2] Ibid.

corridors, among others. We recognize that the topics of affordable housing, homeownership, and tenants' and homeowners' rights are complex and often include difficult tradeoffs.

This study includes:

- An assessment of the current housing market and affordability of condo conversions, especially for first-time homebuyers
- Statutory, regulatory, financial or other barriers to condo conversions as a viable source of housing supply for first-time home buyers
- Impacts to tenants caused by the conversion of multifamily buildings to condo ownership, and the adequacy of programs and resources for tenant rental relocation and other assistance
- A review of programs in other states that use condo ownership as a first-time homeownership opportunity, including those focused on employer-specific programs for certain public service occupations in high-cost areas
- Specific areas in counties subject to the buildable lands reviews and evaluation program where condo conversion could provide first-time home buyer opportunities close to light rail, express bus service, or other forms of mass transit
- Condo association concerns, including board accountability, fee collection, effective communication, representation regarding covenants, lien and foreclosure fairness, and insurance claim impartiality

Methodology

This study included a series of meetings facilitated by BDS Planning and Urban Design with a Project Committee consisting of Affordable Housing Advisory Board (AHAB) members, housing developers, experts in condo law and homeowner associations, and tenant and homeowner advocates.[3] The Project Committee provided feedback and guidance in the research process, assisted in stakeholder selection, and reviewed findings. Additional targeted interviews were conducted with developers who had previous experience with conversions, as well as experts on condo law and insurance requirements.

Overall, desired outcomes of the study include the following:

- A county-level analysis of the condo homeownership market
- A profile of first-time homebuyers that includes an evaluation of a homeownership-ready approach.
- A financial analysis of the financial feasibility of condo conversion in locations around the state.
- A review of statutory, regulatory, financial, or other barriers to condo conversions.
- A review of impacts to tenants caused by the conversion of multifamily buildings to condo ownership.
- A review of programs in other states using condo ownership as a first-time homeownership opportunity.
- Specific areas in counties where condo conversion could provide first-time homebuyer opportunities in proximity to transit.
- Concerns regarding condo associations.

[3] See Appendix, Study Project Committee for a list of Project Committee members.

Background

Is more condo homeownership an option?

Because condos are generally less expensive than detached single-family homes, Washington has considered incentivizing or reducing barriers to condo development to provide more homeownership opportunities, particularly for first-time homebuyers or downsizing seniors. Homebuyers might use the equity on their condo to purchase their first single-family home. Because condos are about half the size of single-family units, they are generally priced about 30% less, offering one potential avenue for creating more affordable homeownership opportunities.

Potential homeowners have limited financing options to purchase a condo compared to a detached home. The condo mortgage market has declined in the last 15 years compared to the mortgage market in general. Condo mortgages declined from 15% of residential lending in 2007 to 8% in 2019.[4]

Rapidly changing market conditions

Economic conditions have changed rapidly since 2019, with a particular effect on real estate markets. Factors like mortgage interest rates and capitalization rates influence the cost and affordability of converting apartments into condos. At the time of this report, mortgage rates were hovering between 6.5% and 7%, the highest rates in over 20 years, which negatively affects housing affordability.

Capitalization rates, or "cap rates," are the ratio of a building's operating revenue to its purchase price and the market mechanism to value commercial real estate. Lower cap rates increase property values, thereby making conversion more expensive. Cap rates have steadily decreased for the past two decades, which has resulted in valuations of apartment buildings more than doubling in many parts of the state. The economic uncertainty and risk of recession are increasing the likelihood that cap rates will reverse and begin to increase. Any increase in cap rates will improve the affordability of conversion, as the acquisition price of the apartment would decrease.

Homeownership is out of reach

Underproduction + Rising mortgage rates = Decreased affordability

Washington has underproduced needed housing relative to its strong economy and population growth in the past several decades. As of 2021, Washington's housing stock provides 1.08 units of housing per household, below the U.S. average of 1.11 units per household and ranking second to last among all states.[5] The U.S. ratio of 1.11 units per household serves as a good target ratio, allowing for market vacancy, turnover as units are demolished or become obsolete, the presence of second and vacation homes, and the formation of new households.

---

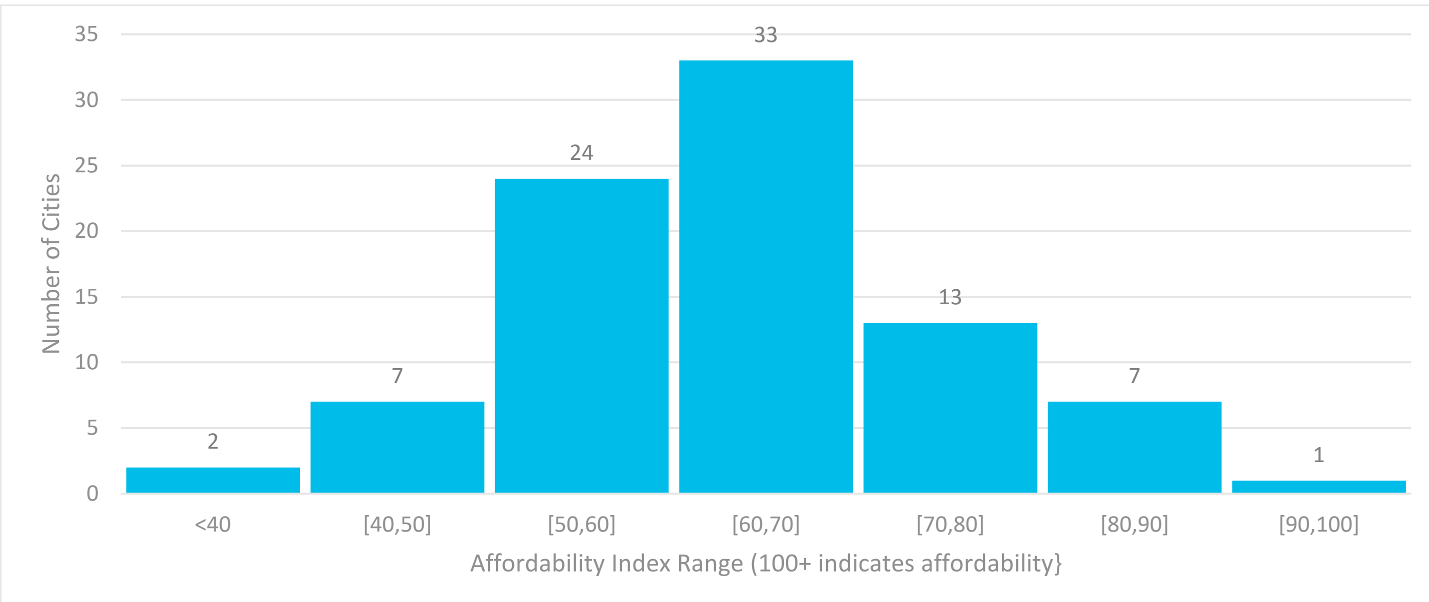
[4] Sumit Agarwal, et al., "The Hidden Peril: The Role of the Condo Loan Market in the Recent Financial Crisis," *Review of Finance* 8, no. 1, (2016): 467–500, https://academic.oup.com/rof/article/20/2/467/2461314;
Jacqueline Doty, "The State of Condominium Lending: U.S. Housing Finance Update 2019," *CoreLogic: The MarketPulse* 8, no. 5, (2019): 6, 8, https://www.corelogic.com/wp-content/uploads/sites/4/downloadable-docs/marketpulse/the-marketpulse-vol-8-issue-5-may-2019-screen-052219.pdf

[5] 2021 U.S. Census ACS, 1 year sample

Without an appropriate structural vacancy factor, a natural consequence of the imbalance in housing demand and supply is a rise in housing prices and rent. The Sightline Institute describes an undersupplied housing market as a game of musical chairs, except rather than racing to a limited seat, the process of attaining housing becomes a bidding war, with those least able to afford a unit being most impacted.[6]

Mortgage interest rates and prices increased statewide from 2012 to 2021, resulting in a higher income needed to purchase the median-priced home. Households must earn more than 100% of AMI to purchase the median home virtually everywhere in Washington, and over 200% of AMI is required for new construction in most parts of the state.[7] A decade ago, new construction was often affordable to households earning less than 100% of AMI.

Exhibit 2: Median income buyer affordability index distribution in Washington cities, 2022



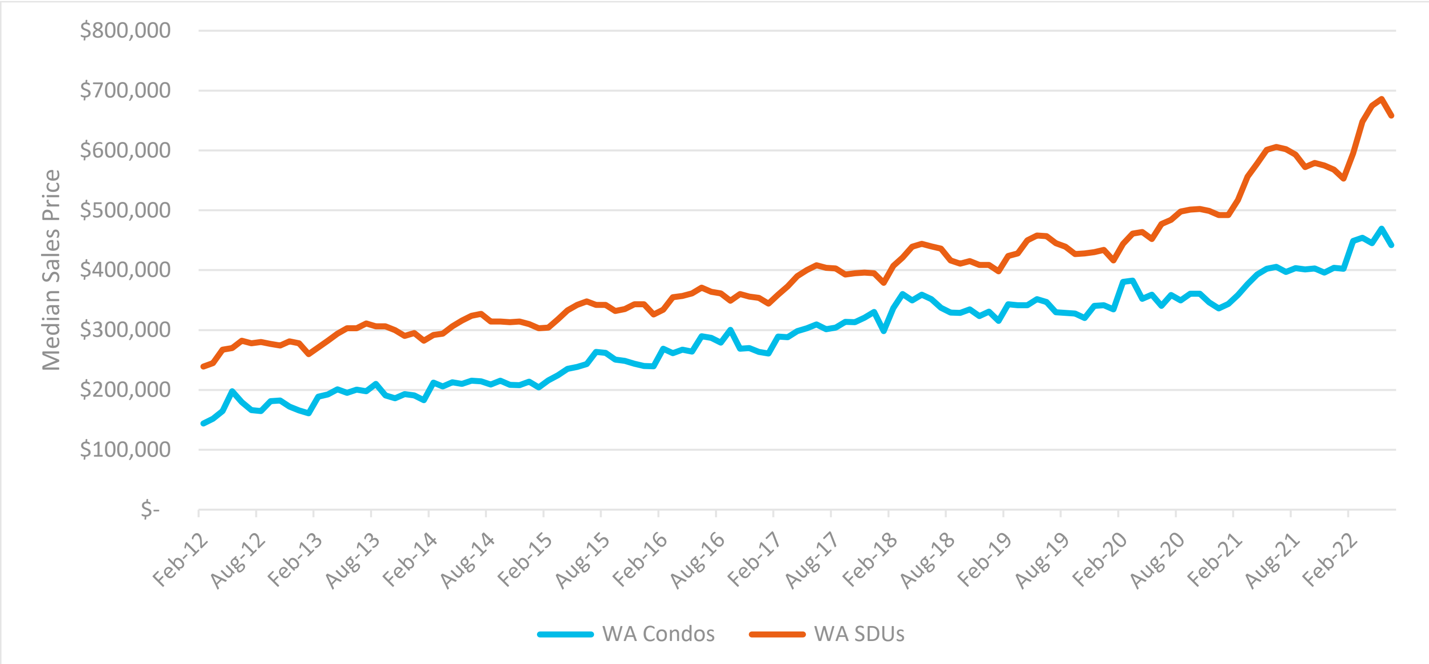
Source: Washington Center for Real Estate Research

[6] The Sightline Institute, "Infographic: The mean musical chairs of rising rent and home prices," (2018), https://www.sightline.org/2018/03/14/infographic-the-mean-musical-chairs-of-rising-rent-and-home-prices/
[7] New construction refers to the building of a structure where none previously existed or a significant addition to an existing structure.

Rising housing costs in Washington

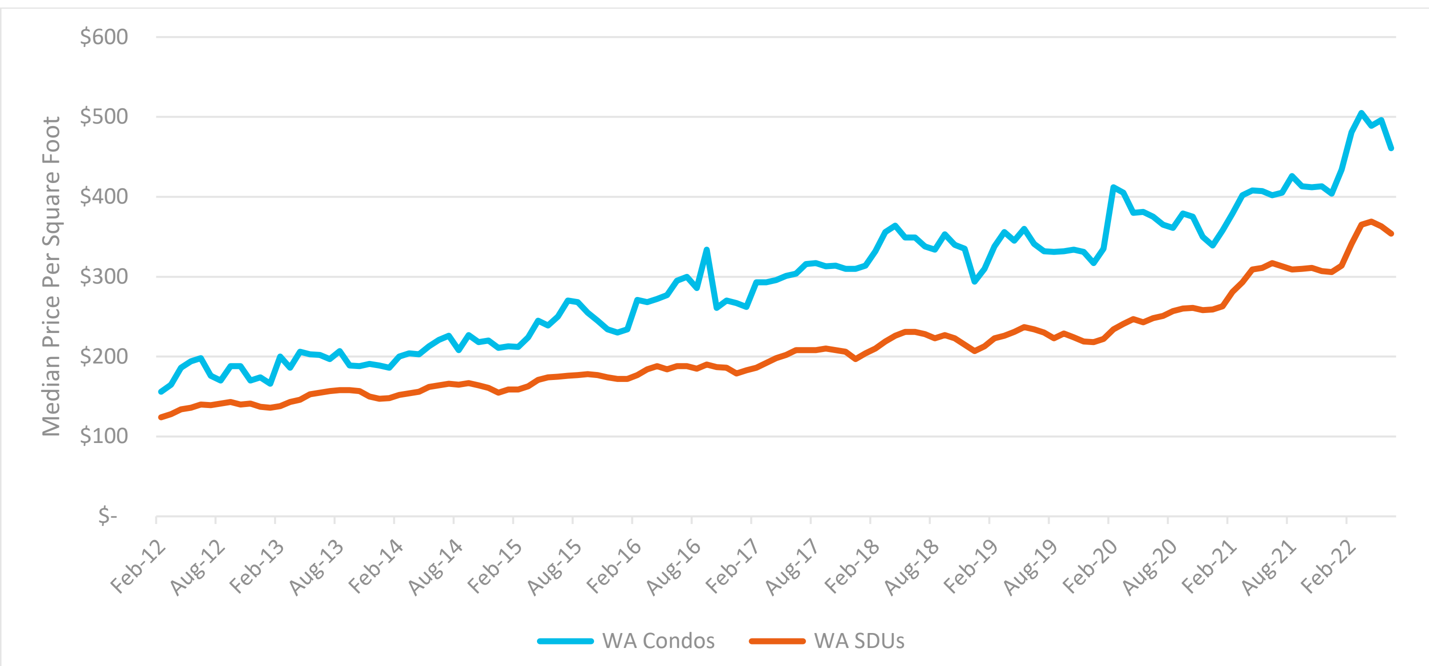
From 2012 to 2022, prices for condos and single detached units more than doubled, with the median cost of condos rising by nearly $300,000 and the median cost of single detached units rising by over $400,000.

Exhibit 3: Median sale prices in Washington, January 2012-September 2022



Source: Redfin Sales Data 2012-2022

Exhibit 4: Median price per square foot in Washington, January 2012-September 2022



Source: Redfin Sales Data 2012-2022

While condos are generally more expensive on a per-square-foot basis, the average sale price is lower because condos are, on average, half the size of detached units in Washington. However, homeowner association (HOA) fees are not reflected in purchase prices and affect the overall affordability of condos over time. For example, a $600/month HOA fee is equivalent to $100,000 of the purchase price when financed using a 30-year mortgage at a 6% interest rate. The difference between the average detached home and a condo statewide is about $216,200, which is equivalent to a $1,300/month HOA fee (which is higher than the median HOA fee in any location in the state) if financed using a 30-year mortgage at a 6% interest rate.

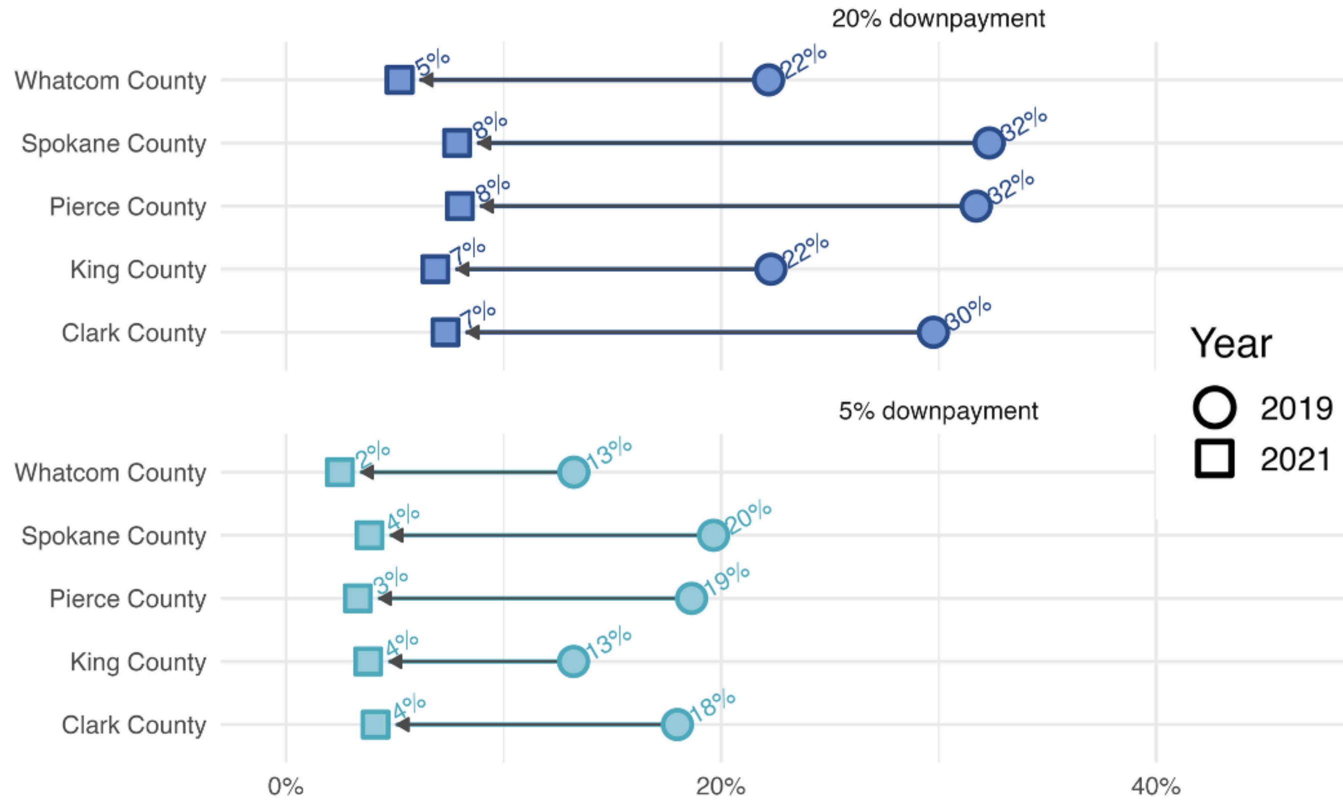
Homeownership attainability decreased in the current market

While this report primarily focuses on homeownership opportunities, would-be homeowners are current renters, and increasing rents limits their ability to save for a down payment and transition into homeowners. The inability to save due to increased rents, combined with high-interest rates and home prices, make homeownership unattainable for many. Exhibit 5 shows the share of renter households who have incomes sufficient to purchase a home in various locations across Washington, broken out by an assumption of a 5% or 20% down payment.

There are two primary factors influencing the decrease in homeownership attainability: increasing prices and increasing interest rates. At the time of publication in December 2022, the households level dataset (PUMS) used for the analysis was only available through 2021. The exhibit below shows the share of renter households with sufficient income to afford the median-priced home in different parts of the state, with both a 5% and 20% down payment assumption. The share of renters who could afford the median-priced home is less than 4% in each of the counties with a 5% down payment assumption. For example, in Pierce County, 3% of renter households could afford the median home in 2021, compared to 19% in 2019.

Since then, mortgage interest rates have risen to their highest level in more than 20 years, further straining the affordability of the housing stock. Prices have since stabilized and, in some areas of the state, have declined. Given the magnitude of the mortgage interest increase during 2022, prices would need to decrease by roughly 25% to offset the increase in interest rates.

Exhibit 5: Share of renters that can afford the median price home, 2019 vs. 2021



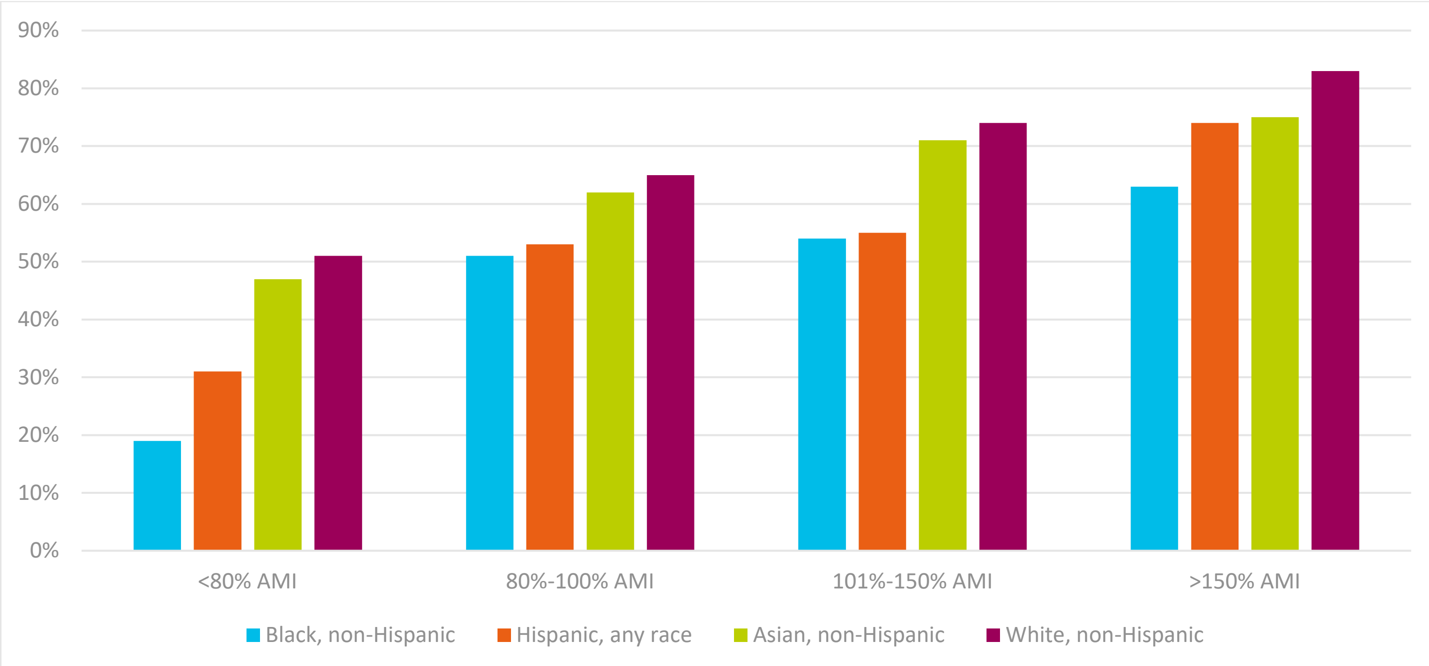
Source: Census PUMS 2021, Freddie Mac, UW Center for Real Estate Research

Homeownership inequities are persistent

Asian, Indigenous, Black, and Hispanic households have lower homeownership rates than non-Hispanic White households across the state. In particular, Black households have a homeownership rate of less than half that of white households. Alarmingly, for some of these groups, these rates are worsening: The Black-white homeownership gap is worse today than it was in the 1960s when racial discrimination in housing was legal. More than 143,000 BIPOC households would need to become homeowners for the BIPOC homeownership rate to equal the non-Hispanic white homeownership rate.[8]

[8] Washington State Department of Commerce, "Improving Homeownership Rates for Black, Indigenous, and People of Color in Washington," (2022), https://www.commerce.wa.gov/wp-content/uploads/2022/09/Homeownership-Disparities-Recommendations-Report-FINAL-Sep2022.pdf

Exhibit 6: Washington homeownership rate by race/ethnicity and income level in 2021



Source: US Census Bureau, ACS 2021 1-year

These disparities in homeownership rates are due to a confluence of current and historical factors, including historically racist zoning practices, racially restrictive covenants, redlining, gentrification and displacement, lack of access to generational wealth, and discriminatory lending practices. In 2022, the Washington State Department of Commerce released the report "Improving Homeownership Rates for Black, Indigenous, and People of Color in Washington," which examined the causes and consequences of disparities in homeownership rates between non-Hispanic white households and Black, Indigenous, and People of Color (BIPOC) households across the state.[9]

[9] Ibid.

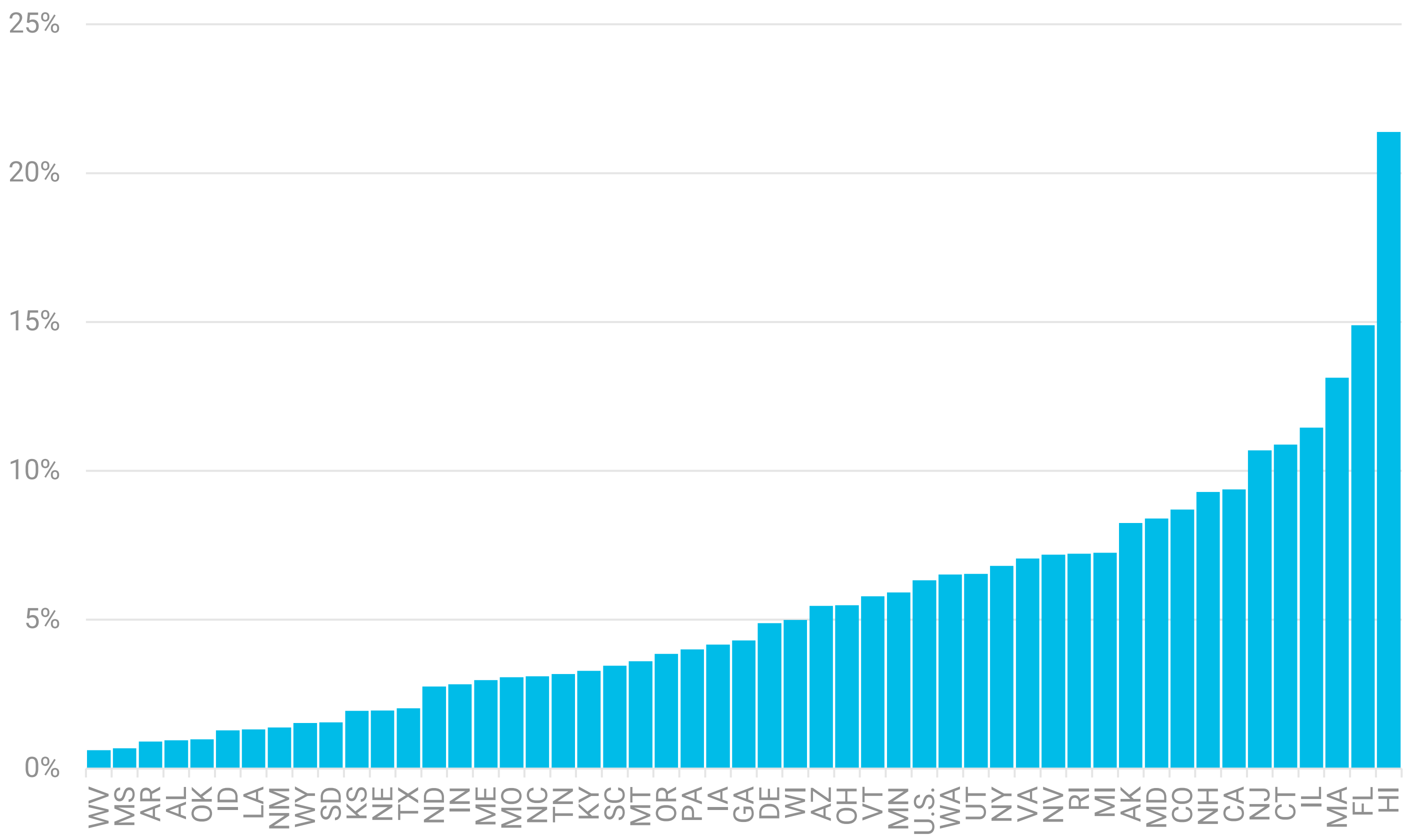
Barriers to condo conversion

The condo market is small and stagnant

Condos represent only 5.3% of the overall housing stock statewide.[10] As seen in Exhibit 8, the condo share of housing stock in Washington is similar to the U.S. average. In addition to the small share of housing, the condo market in Washington has not increased; condos have made up 1% or less of new construction since 2011.

Data availability and reliability are limited at the county level. The map below shows the share of attached ownership units as a share of all housing units. This is a close proxy for condos but is an overestimate because it also includes attached units that are not in a legal condo structure (such as fee simple attached units). No county has more than 10% of its stock of housing as attached ownership units.

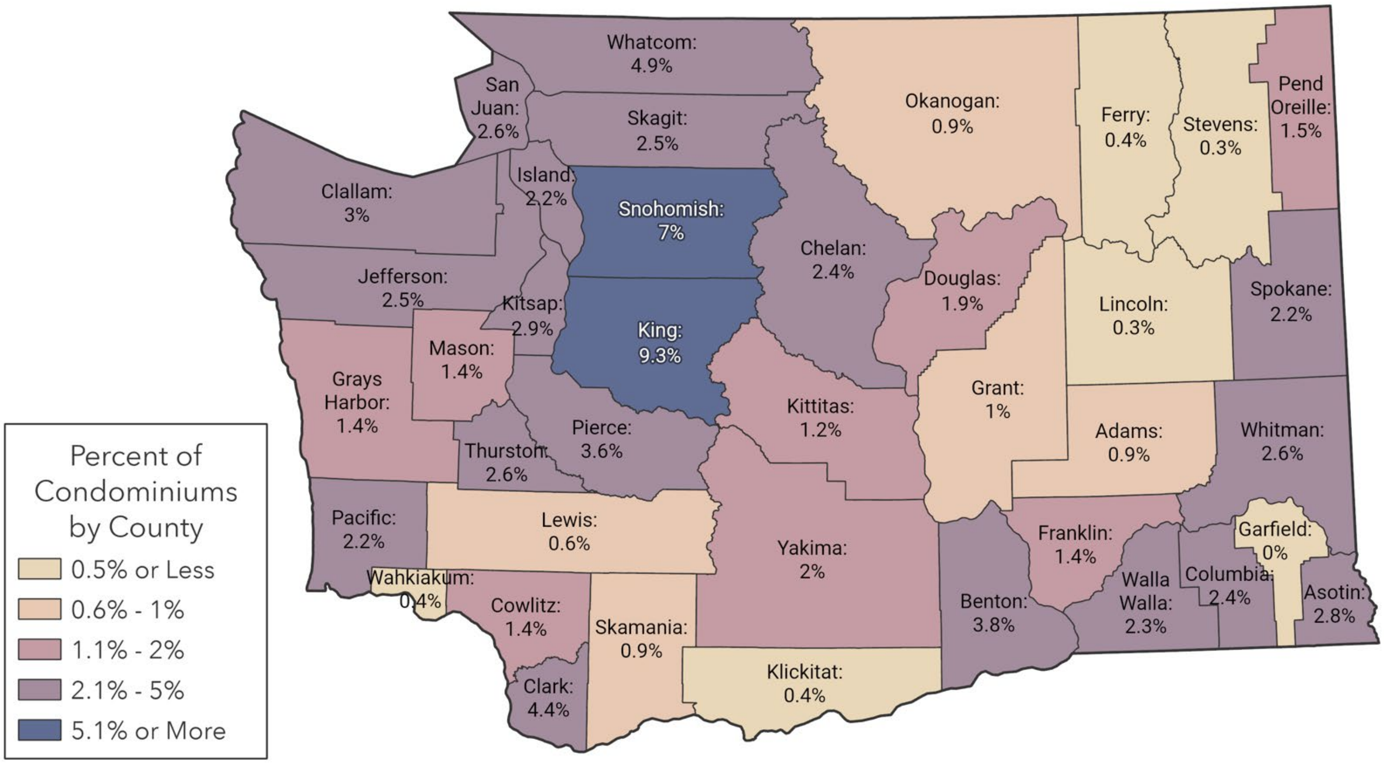
Exhibit 7: Condos as a percentage of housing stock by state



Source: U.S. Census Bureau ACS 2019 5-year

[10] Source: U.S. Census Bureau ACS 2019 5-Year

Exhibit 1: Attached ownership units as a percentage of units in Washington, 2019



Source: U.S. Census Bureau ACS 2019 5-Year

Federal financing standards restrict condo ownership

Condo buyers face additional barriers to homeownership when seeking mortgages. The Federal Housing Administration (FHA) expanded its requirements for condo loans to include criteria on the financial solvency of the owners' association in addition to more stringent qualifications for individual buyers. These policy changes reduced the pool of buyers in favor of those who could secure private loans not backed by the FHA or using cash.[11]

The most significant policy change affecting access to condo homeownership is the cap on the number of insured mortgages allowed in a single condo development:

- In buildings with 10 or fewer units, only two units are eligible
- In buildings with more than 10 units, only 10% of units are eligible

This policy alone makes condo conversions for affordable housing challenging, as 90% of buyers must qualify for a conventional loan or must have another source of subsidy or down payment assistance that is backed by a federally insured product. Other FHA policies make condo developments ineligible if too many units are

[11] U.S. Department of Housing and Urban Development, "Project Approval for Single-Family Condominiums," *Federal Register* 84 FR 41846, (2019), https://www.federalregister.gov/documents/2019/08/15/2019-17213/project-approval-for-single-family-condominiums

owned by one entity or if the owners' association is party to an active lawsuit (such as construction defect liability claims).

During the collapse of the housing market that began in 2006, condos had a higher foreclosure rate compared to single detached homes, likely driven by the larger role of investors/owners in the condo market at the time.[12] In 2019, the FHA updated its lending and Private Mortgage Insurance (PMI) rules for condos with the intention of broadening access to the market for condo mortgages. At the time, only 6.5% of 150,000 condo developments were eligible for FHA-insured loans.[13] These regulatory changes focused on policies related to non-residential space in mixed-use developments, owner-occupancy rates, and whole-building certification for FHA loans.[14]

In February 2022, Fannie Mae and Freddie Mac released additional qualifications related to structural integrity, deferred maintenance, and operating reserves after the collapse of the Champlain Towers South condo in Florida. Compliance with the new disclosure requirements among owners' associations has been uneven, which has complicated or stalled some condo sales.[15] These lending requirements related to deferred maintenance may present less of a barrier for condo conversions because the conversion process would include engineering reviews, necessary renovations for safety and habitability, and the identification of needed reserves for future capital improvements. The costs of these necessary steps contribute to the overall cost of conversion to condo ownership and increase the per-unit sale price.

Litigation risk constrains condo development

Building or renovating condos introduces more requirements applicable to the developer than building detached housing or apartments under RCW 64.34 (the 1989 Washington Condo Act, or WCA). These legal requirements impact condo construction by increasing costs (higher insurance premiums, markups from general contractors, architects, and engineers) as well as the uncertainty that it adds to development timelines and potential litigation years after completion.

State regulations can introduce litigation risk

Primarily determined by the WCA, condos are subject to specific development liabilities intended to "provide protection to condo purchasers in part through the creation of implied warranties of quality construction."[16] This results in a higher construction warranty standard for condos than detached housing or apartment buildings.

[12] Agarwal, et al.
[13] U.S. Department of Housing and Urban Development, “FHA Issues New Condominium Approval Rule,” (April 14, 2019), https://archives.hud.gov/news/2019/pr19-121.cfm
[14] U.S. Department of Housing and Urban Development, “Project Approval for Single-Family Condominiums,” *Federal Register* 84 FR 41846, (2019), https://www.cnn.com/2022/04/02/homes/us-new-condo-rules-freddie-and-fannie/index.html
[15] Anna Bahney, “Why this recent change just made it harder to buy or sell an apartment,” *CNN Business*, (April 2, 2022), https://www.cnn.com/2022/04/02/homes/us-new-condo-rules-freddie-and-fannie/index.html
[16] Leon, David, "Washington Center for Real Estate Research, Incentivizing Condominium Development in Washington State: A Market and Legal Analysis," (July 28, 2016), https://re.be.uw.edu/wp-content/uploads/sites/9/2016/07/CondoReport_v7_FINAL.pdf

Under RCW 64.34.455 and RCW 64.90.670, condos are **subject to the following warranties**:

- There will be no adverse change to the physical condition of the unit, beyond reasonable wear and tear, between the date of sale agreement and the date of conveyance
- The unit and common elements are suitable for the ordinary use of real estate of its type
- Any improvements must be:
    - Free from material defects and constructed in accordance with sound engineering and construction standards
    - Constructed in a workmanlike manner
    - Constructed in compliance with all laws then applicable to such improvements
- The continuation of a residential use of a unit does not violate applicable law

Plaintiffs must show that the alleged breach has or will impair the performance of the construction, materially impairs the operation of a major building system, or unreasonably endangers health or life. Generally, warranties extend for a period of four years after the first sale.

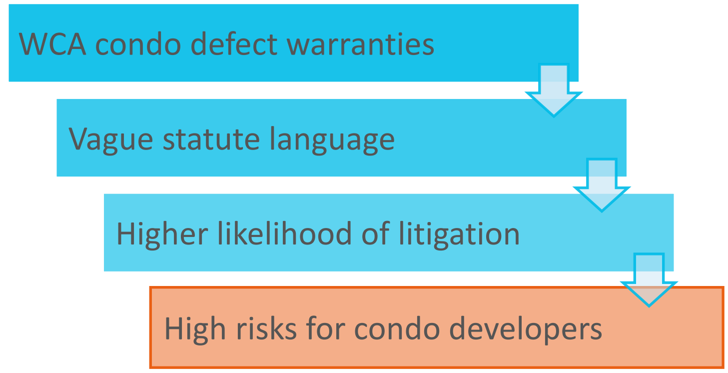
Under 2004 updates to RCA 64.35, condo developers can obtain defect liability insurance for the unit owners and owners' association by providing a "qualified warranty." To be a qualified warranty, the insurance policy must provide coverage for the following:

- **Two-year materials and labor warranty** for noncompliance with building code.
- **Five-year building envelope warranty** provides coverage for defects in the building envelope.
- **Ten-year structural defects warranty** provides coverage for defects that cause structural damage that renders the condo unlivable.

"Warranties run four years from the date of the first unit sale and the plaintiff attorneys show up three and a half years later**. Their success rate is nearly 100%"**
— Seattle Area Real Estate Attorney

However, insurance providers have been unwilling to provide such insurance, and this provision has largely gone unused.

The WCA statute language has been interpreted broadly by attorneys and courts, often leaving developers vulnerable to litigation. Rather than imposing specific construction standards, implied warranties impose product liability standards that require expert testimony. Plaintiff attorneys and HOAs have a limited time period to bring litigation and protect against personal liability, resulting in a higher rate of litigation than other types of housing products. While a 2019 update to the warranty legislation removed shielded individual HOA board members and officers from personal liability, HOA members could still potentially face high repair or maintenance costs in the case of unresolved defects. Prompted by plaintiffs' attorneys (who will typically work on contingency), many HOAs will err on the side of bringing any potentially viable defect lawsuit rather than risk missing any defects during the warranty period.



Given these considerations, the overall risk, costs, and differing standards of condo and non-condo construction for defect litigation reduce the rate of return for condo development statewide compared to apartments and other types of housing.

1989 Washington Condo Act (64.34 RCW) legislative history

Legislative changes to the WCA have both supported and hindered condo development in Washington, with the most recent update in 2019. A timeline of these legislative changes is shown in Exhibit 9.

Exhibit 9: Washington Condo Act timeline, 1989-2019

1989 — RCW 64.34, **Washington Condominium Act** (WCA) passed.

2003–2005 — WCA amended to **provide protections for builders,** supporting a boom in condo development. Legislation allowed builders to cure defects, provided a higher standard of proof for defect claims, and a statutory insurance program.

2005 — Chapter 64.55 passed to provide **protections to homeowners**, extending the statute of limitations for potential defect lawsuits and imposing higher development standards.

2007 — **Condo development peaks** in Washington, with 1,590 units added to the market.

2008 — Following several public defect lawsuits and safety concerns, the WCA was amended to **increase tenant protections** during condo conversions, including tenant relocation assistance, extending the tenant notification period to 120 days, and prohibiting construction until tenants vacated the property.

2009 — WCA amended to provide **protections to homeowners,** incentivizing HOAs to bring litigation to protect officers and board members from future liability. **Condo-related lawsuits swell.**

2011 — Condo production and conversion **slows.** Since 2011, 1% or less of new construction have been condos.

2019 — SB 5334 passed to constrain **condo defect liability and increase condo development.**

Source: ECONorthwest

2019 WCA updates to constrain defect liability and increase development

Following discussions with developers and other stakeholders, the Washington Legislature passed Chapter 238, Laws of 2019, which was intended to increase protections for condo developers, decrease the number of defect liability lawsuits, and increase condo development overall.[17] Major changes included:

- **Updated the implied warranties for condo construction:** Condos must be "constructed in accordance with applicable building codes, generally accepted in the State of Washington at the time of construction."[18] Previously, the language more broadly stated that condos must follow "all laws then applicable to such improvements."[19] By changing the language from "all laws" to "generally accepted," the Legislature hoped to give developers additional cover from frivolous defect allegations.

- **Modified the burden of proof for claims of "breach of warranties of habitability:"** The Legislature increased the burden of proof required to show a breach of warranty. Purchasers are now required to establish that the breach is more than technical, is significant to a reasonable person, has caused or will cause physical damage to the unit or common elements, or presents a safety risk to occupants.[20] By doing so, the Legislature again hoped to give developers additional cover from frivolous defect allegations.

- **Helped shield condo association board members from personal liability:** To limit condo lawsuits, HOA officers and board members are now entitled to certain immunities from liabilities. Previously, these members were at risk of personal fiscal liability if a defect was not cured or financed via litigation, incentivizing HOAs to bring lawsuits over all potential issues. By providing protection to HOA members, the Legislature hoped to disincentivize litigation.

While stakeholders interviewed for this report generally supported these changes, many agreed it was too early to tell if these changes would affect condo development and litigation. Other states, including Colorado, have updated their condo defect legislation in the past five to 10 years; however, their respective condo markets have yet to reflect any potential impacts. Some Washington developers have cautiously begun to build or consider condos, but many still consider the condo market too risky of an investment

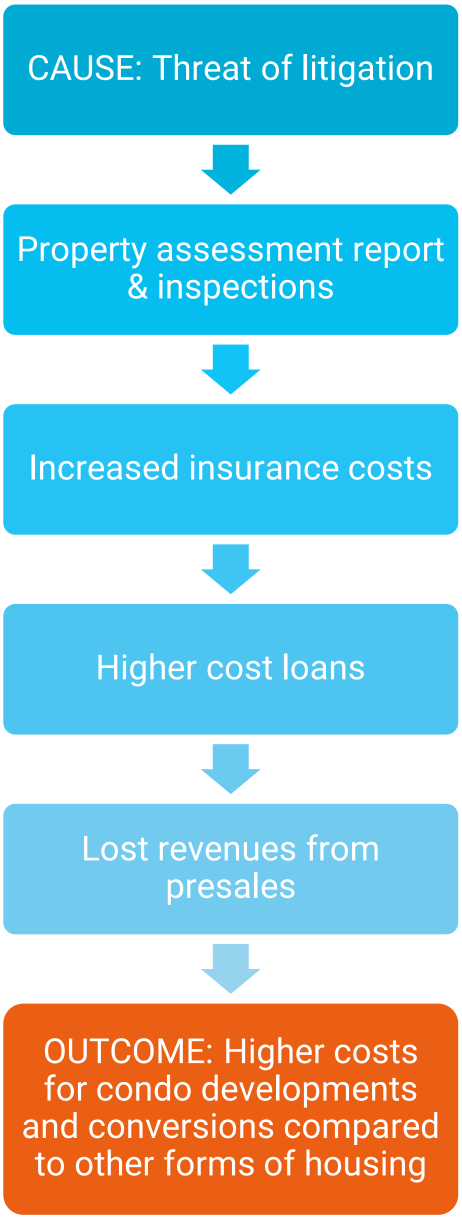
Consequences of litigation risk

Stakeholders **identified the threat of litigation as one of the biggest barriers to condo development** in Washington. Developers and other industry stakeholders interviewed for this report stated that they were not interested in condo development due to increased costs, risks, or previous experience with litigation. Consequences for this increased risk are pervasive throughout the development process. In response, developers often take on additional financial and procedural burdens, such as expensive assessments and inspections, higher insurance and loan rates, and presale requirements that impose further risk. In total,

---

[17] Washington State Legislature, "Chapter 238, Laws of 2021 (SB 5334)," https://apps.leg.wa.gov/billsummary?BillNumber=5334&Initiative=false&Year=2019
[18] Ibid.
[19] Preg O'Donnell & Gillett, "Small Steps Toward Promising Change – Breaking down the 2019 amendments to Washington's Common Interest Ownership Act," (Sept. 27, 2019), https://www.pregodonnell.com/2019/09/small-steps-toward-%E2%80%A8promising-change-breaking-down-the-2019-amendments-to-washingtons-common-interest-ownership-act/
[20] Washington State Legislature, "Chapter 238, Laws of 2021 (SB 5334)," https://apps.leg.wa.gov/billsummary?BillNumber=5334&Initiative=false&Year=2019

stakeholders emphasized there are currently very few incentives to build condos in Washington, particularly in comparison to other types of housing such as single detached or multifamily apartments,



Inspections: Prior to converting, developers must get a property assessment report that documents the condition of the building (this report can cost $10,000-$50,000). Findings in this report can affect insurance rates and are provided to potential buyers, so there is a strong incentive for developers to fix any discovered issues. In addition, developers often hire third-party consultants to conduct independent inspections after project completion as protection against defect litigation.

Insurance: In response to litigation risks, insurers charge higher liability insurance premiums for condo developers and other involved parties. Because contractors and subcontractors are also subject to liability risk, developers must obtain wrap insurance policies that provide comprehensive coverage to all parties involved in condo development projects. However, these policies can be extremely expensive, with stakeholders reporting costs of up to $1 million. Because of the increased cost and complexity not present in liability insurance for other forms of housing (which also have high demand), many developers are deterred from participating in condo development.

Loans: Condo conversions often require conversion-specific loans, which can have shorter timeframes for project completion and be more expensive than traditional loans. Because liability risk extends to lenders and investors, these loans can also be difficult to secure.

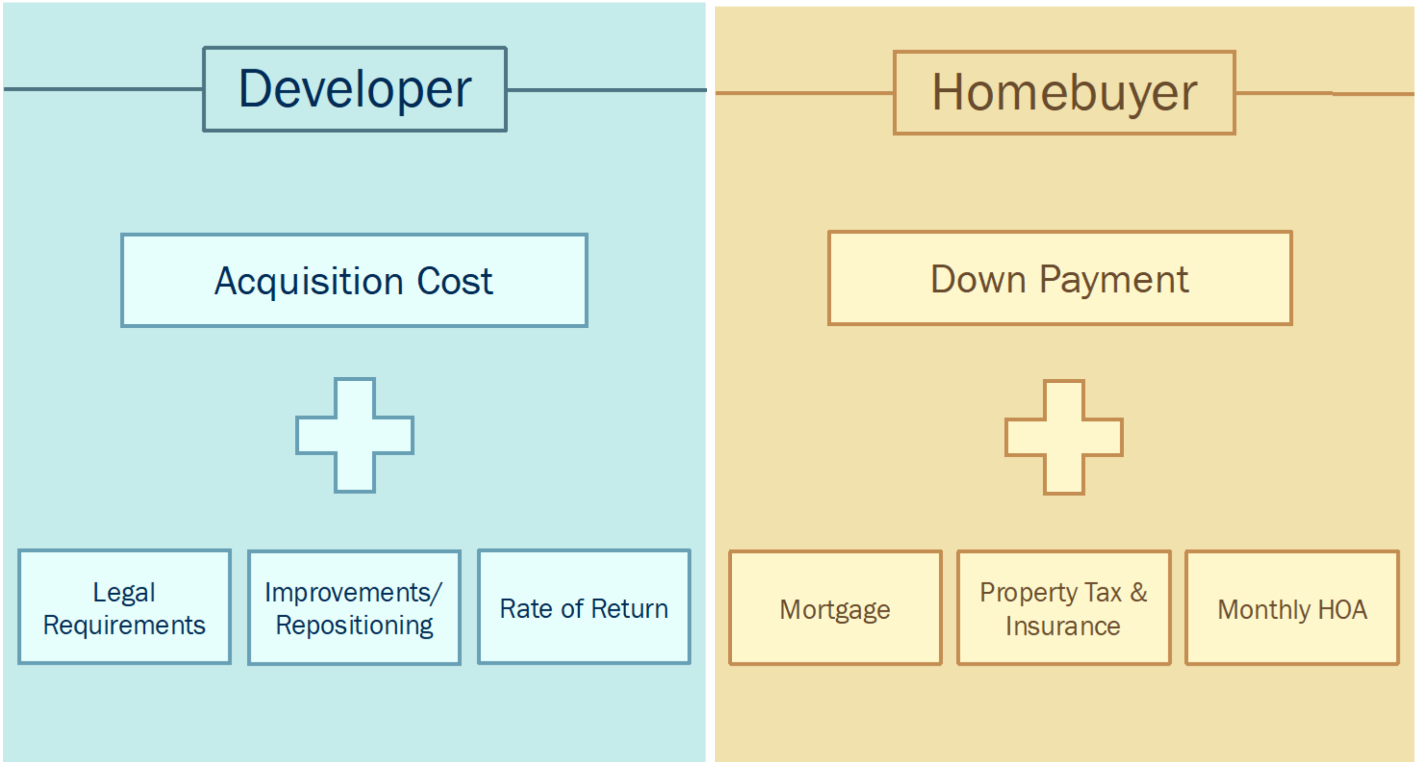
Presales: For new condo developments and conversions, lenders often structure development loans so that funds will not be released until the project pre-sells a certain number of units, delaying construction. For developers, this often means pricing and selling condos that do not yet exist, running the risk of losing months or even years of real estate appreciation before selling the final unit and turning over the building. In fast-growing markets, where home prices continue to surge, the difference in just a matter of months could be significant.

Converting condos is expensive

When developing a rental property, the upfront costs are recouped over decades. With a fee simple condo sale, those costs are expected to be recouped as quickly as possible. The following section details how the conversion of an apartment to a condo can increase the monthly cost of ownership by almost double compared to monthly rent.

Development costs are complex

Getting to the core of the research question in this study, there are numerous financial barriers and considerations when converting a rental apartment into a condo. The process is lengthy and complex, requiring multidisciplinary teams to execute. There are two processes at play impacting affordability; the acquisition cost for the developer pursuing the conversion and the cost of ownership for the homebuyer purchasing the unit.



Developer process to convert apartment to a condo

Acquire a building. First, the developer must locate a suitable building for conversion and determine the acquisition cost. This presents an initial major hurdle because the existing property is generating revenue for the current owner. Buying a performing asset (even if it is underperforming) to convert is more expensive than buying vacant land for new construction.

The acquisition cost of an apartment is determined by the property's net operating income (NOI)[21] and the current market capitalization rate, or cap rate. For the remainder of this section, a hypothetical building located in King County that is currently renting two-bedroom units at 80% of AMI will be used as an example to demonstrate the cost of conversion. In the case of a condo conversion, a developer must secure financing for the cost of acquisition as well as any rehabilitation or repositioning of the property.

[21] NOI equals the building's revenues less expenses and vacancies.

What does it cost to acquire an apartment while renting at 80% of AMI?

Building owners have varying levels of interest in selling existing apartments. The owner determines the conditions under which they are willing to sell: Do they need the influx of cash a sale provides? Do they need to sell the property to balance a portfolio in a Real Estate Investment Trust (REIT)? Is there sentimental value to holding the building?

When a building owner is interested in selling, the offer price needs to be worth as much or more than the value of the building as a rental property.[22] The industry standard is to value a building using its net operating income (revenue after expenses and vacancies) and market cap rates. Currently, the housing market supply is low, and demand is high, which drives rental and sale prices even higher. If a prospective buyer, the developer, is able to offer a price that is equal to or greater than the value of the building as a rental property, then the seller is likely to accept the offer.

What are capitalization rates?

Capitalization rates (cap rates) are the ratio of a building's operating revenue to its purchase price. Cap rates fluctuate with the market and are influenced by the sales of similar buildings in and the willingness of investors to finance a real estate development. Rates of return are compared against other market-based investments, such as stocks and bonds.

Lower cap rates increase property values. Cap rates are currently at an historic low, which increases the value and purchase price necessary to acquire a building. Cap rates have been driven by the relative performance of real estate assets compared to other investment types. In recent decades, investors have flocked to real estate asset ownership. This increased interest in real estate has increased the competition among investors to own properties, thereby driving up purchase prices.

Exhibit 10: Example conversion scenario

Scenario	80% of AMI building
Location	King County
Bedroom type	Two Bedroom
Rent	$2,145 (80% of AMI)
Vacancy	5% of gross income (-$107)
Operating expense	30% of gross income (-$644)
Monthly NOI	$1,394
Annual NOI	$16,728 ($1,394 * 12)
Cap rate	5%

The developer's purchase price of this property would be $334,620 per unit.

Source: ECONorthwest Calculations

[22] Selling a building is not required for a condo conversion. A building owner could do it themselves, but it is not likely to occur as the skillsets, risk profile, and access to capital is a limiting factor to conversion. For this reason, we have assumed the most likely scenario for a conversion is for a developer to purchase an existing apartment, then begin the conversion process to a condo.

Cost of converting an apartment to a condo

Rehab or reposition of the property

Developers must understand the costs required to rehabilitate the property and improve it to a standard at which they can sell it as a condo. This requires an inspection to understand the current conditions (presence of mold, water intrusion, etc.) and the capital needs of the building (costs to repair building systems, envelopes, roofs, etc.). Developers also need to understand the construction cost to improve the units sufficient to interest potential buyers compared to similarly priced units in the area. Because of the extended warranties on the building systems, envelopes and structures, developers face legal risks due to potential construction defects on these building components. In order to mitigate these risks, developers will purchase costly wrap insurance policies.

Transaction costs

In addition to the costs of construction and improvement, other costs associated with the conversion include selling costs, closing costs, and Real Estate Excise Taxes (REET). Delays in permitting, construction or materials acquisition add to the timeline and cost the developer money via carrying costs (the interest payments accruing on the debt financing construction). Developers are also required to produce a reserve study, then fund it, typically with at least two months of HOA payments for all units. In addition to finding a unit and understanding the costs of conversion, the developer needs to understand the legal rights of the existing tenants, including possible notification requirements and relocation assistance. For example, the City of Seattle's SMC 22.903 requires developers to pay low- and middle-income tenants up to three months of rent as relocation assistance.

Expected return

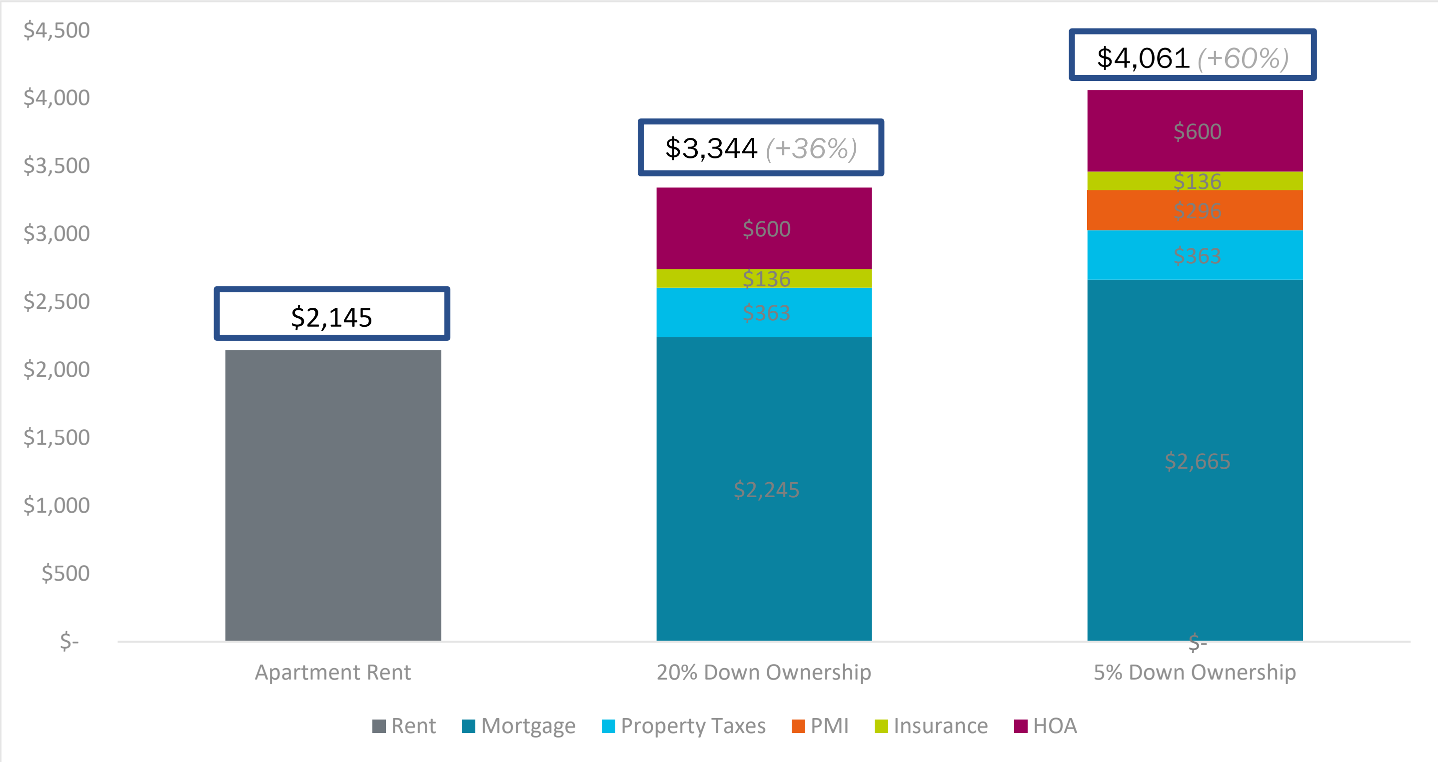
The inherent risk of development, along with staffing and carrying costs, all contribute to the developer's selected rate of return. The rate of return in our model is 15%, which is determined as a premium added to the cost of acquisition and all subsequent costs and fees related to the conversion. This rate of return has been confirmed through local developer and real estate brokerage interviews.

Exhibit 11: Example conversion scenario, rate of return calculations

Conversion costs	
Physical improvements	$25,000 per unit
Legal requirements	$25,000 per unit
Rate of return	22%
Sales transaction cost	7%
Net rate of return	15%
Developer purchase price per unit	$334,620
Required sales price for a 15% rate of return after accounting for 7% in transaction costs	$468,000 per unit (+40%)

Source: ECONorthwest Calculations

Exhibit 12: Monthly housing affordability cost comparison, King County 80% AMI, two-bedroom unit - apartment converted to condo



Source: ECONorthwest Calculations

Factors influencing homeownership affordability

The second aspect of financial considerations comes from the potential homeowner. Homebuying involves numerous costs, including the down payment, mortgage principal and interest, insurance, taxes, and fees (such as closing costs). It also involves numerous processes, from the offer to the inspection, escrow and closing. Most home buyers use a 20% down payment, but depending on the loan, the borrower's income and the purchase price, this can be too expensive for some potential buyers.

A two-bedroom unit currently renting at 80% of the AMI in King County is $2,145 per month and would cost $334,620 to purchase in current market conditions. This same unit would require $4,060 monthly payments after converting to a condo (assuming a 5% down payment), including monthly condo fees, mortgage principal and interest payments, private mortgage insurance, property taxes, and insurance. **This increase would convert this rental unit — affordable at 80% AMI — into a condo that would require an income of 140% of AMI to afford the monthly payments. If the tenant had savings to support a 20% down payment, the tenant's income would need to be 116% of AMI (equivalent to a 36% increase in AMI) to afford the condo payments.**

These estimates assume a down payment of 5% on a standard 30-year amortizing loan and $600 per month in HOA fees. A 5% down payment requires less upfront wealth and equity than a 20% down payment but results in a larger principal loan balance and, therefore, higher monthly payments, which is particularly impactful as mortgage interest rates rise and increase the cost of borrowing money. A 5% down payment also requires private mortgage insurance (0.8% of the total mortgage), an additional expense avoided with a 20% down payment.

Exhibit 13: Example King County conversion scenario, monthly payment calculations

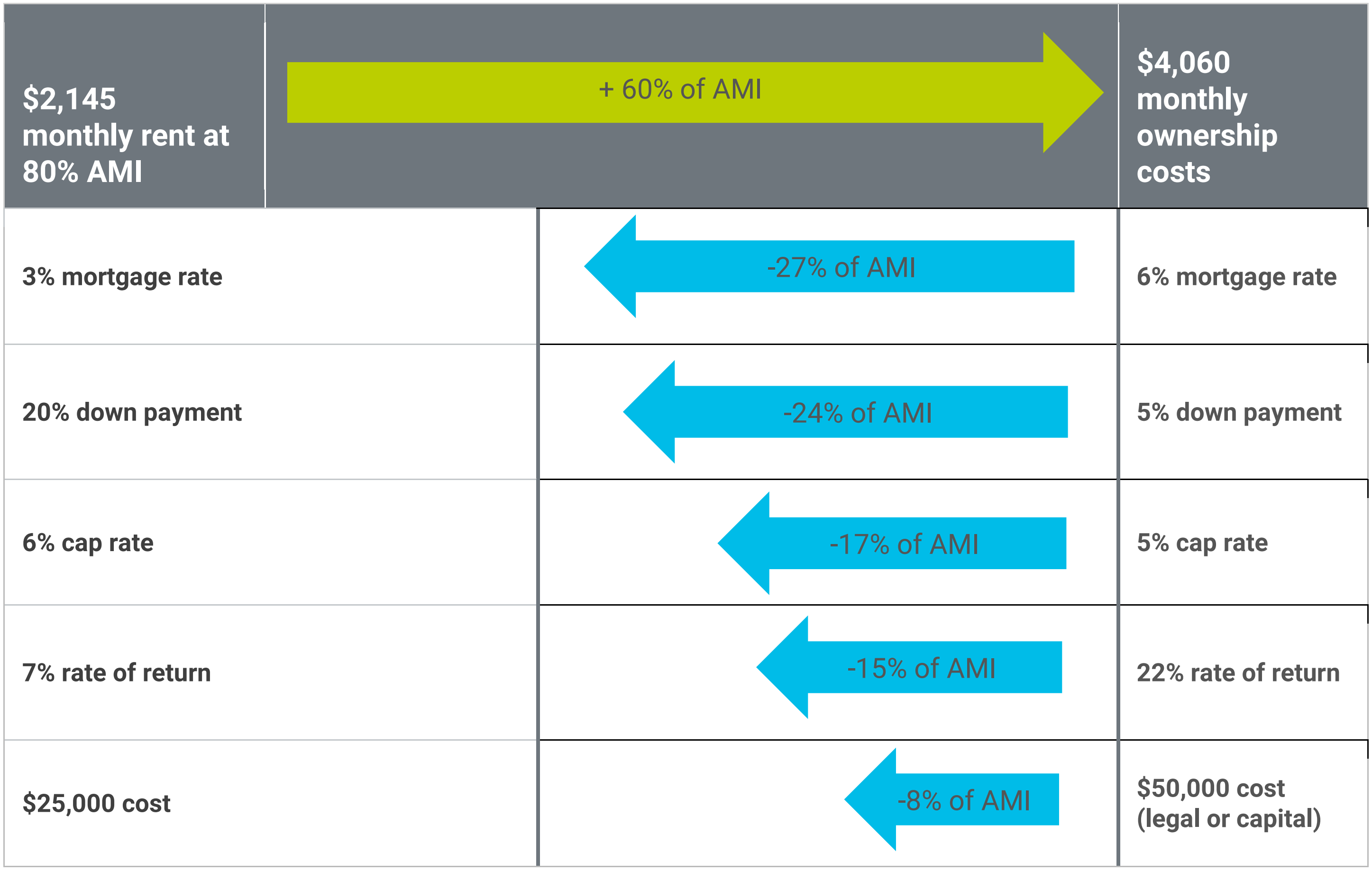
Scenario	80% AMI 2-bedroom
Purchase cost per unit	**$468,000 (5% down)**
Mortgage	30-year amortization
Mortgage rate	6%
Down payment	5%
Monthly mortgage payment	$2,665
Private mortgage insurance	$296
Homeowners' association fees	$600
Property taxes	$363
Insurance	$136
Previous monthly rent	$2,145
Total monthly payment	**$4,060**

Source: ECONorthwest Calculations

What influences the affordability of a condo conversion?

The assumptions and factors that influence the affordability of the conversion process vary by individual circumstances, market conditions, state and local policy, building condition, and developer goals, among others. There is no silver bullet to convert an apartment into an ownership option that is affordable to an equivalent AMI level. The variables described below are the key factors identified that influence the cost of condo conversions. The chart below demonstrates the impact of various key factors on the overall affordability of the example converted unit, presented as a nominal change to the AMI needed to afford the unit. For example, beginning with the increase in required income is equivalent to 60% of AMI, which means a household able to afford a unit at 80% of AMI, would need to earn 140% of AMI (80% + 60%).

Exhibit 2: Impact of cost factors on monthly housing costs



Source: ECONorthwest Calculations

Mortgage rates

Mortgage rates are often the largest contributing factor to the costs of homeownership, particularly for first-time homebuyers who don't have large down payments (equity). Mortgage rates on a 30-year fixed-rate loan were as low as 2.625% in December 2021 and have more than doubled since to near 7% in November 2022; they might be even higher depending on credit scores. Reducing mortgage rates by three percentage points (for example, from 6% to 3%) would lower the cost of conversion affordability by the equivalent of 27% of AMI, which is almost half of the cost increase from a rental unit.

Down payment size

One of the factors that most affect a conversion's affordability is the size of the down payment. We assume a 5% down payment in our analysis because it requires the least amount of individual upfront savings to enter into ownership. Smaller down payments increase the remaining mortgage balance, require private mortgage insurance and result in larger subsequent monthly payments. Increasing the down payment from 5% to 20% lowers the cost of conversion affordability by the equivalent of 24% of AMI. In addition, avoiding private mortgage insurance payments means the totality of the owner's monthly mortgage payments goes towards home equity rather than insuring the lender's risk.

Cap rate

Capitalization rates, or "cap rates," are the ratio of a building's operating revenue to its purchase price and the market mechanism to value commercial real estate. Lower cap rates increase property values, thereby making conversion more expensive. Cap rates have declined for two decades and are at near historic lows, which drives up the value and purchase price necessary to acquire a building. An increase in the cap rate from 5% to 6% would lower the cost of conversion affordability by the equivalent of 17% of AMI.

Rates of return

Typical rates of return for condo conversion are near 22%, which accounts for time, staffing, risk and profit margins. The rate of return a developer targets is used to secure project financing, and these costs are added to the ultimate sale price. Assuming a 7% rate of return as the lowest achievable rate, it would reduce the sale price after conversion. Reducing the rate of return from 22% to 7% would lower the cost of conversion affordability by the equivalent of 15% of AMI.

Legal and capital costs

Legal and capital costs are incurred by the developer during the conversion process. As described earlier in the section on litigation risks, the risk of lawsuits and building warranties is seemingly inevitable and must be budgeted as a cost to conversion. The capital costs for building improvements vary based on building age and condition, building code, and target homebuyers. For example, decreasing these costs from $50,000 to $25,000 per unit could lower the cost of conversion affordability by the equivalent of 8% of AMI.

> In order to maintain affordability for buyers earning 80% of AMI, it would require up to a $175,000 price reduction per unit. This is more than the difference in the developer acquisition price of $334,620 and the resulting renter purchase price of $468,000, largely due to monthly HOA fees, and current mortgage interest rates.

Affordability for first-time homebuyers

Definitions of "first-time homebuyer" vary by agency, jurisdiction, and purpose. Most federal, state and local programs that provide homeownership counseling, down payment assistance, loans, or tax credits define first-time homebuyers **as those who have not had a mortgage for the preceding three years**.

The U.S. Department of Housing and Urban Development defines first-time homebuyers as individuals who meet any of the following criteria:

- Individuals who have not had ownership in a principal residence during the three-year period ending on the date of purchase of the property. This may also include a spouse, so if either meets the above test, they are considered first-time homebuyers.
- Single parents who have only owned a property with a former spouse while married.
- Individuals who are displaced homemakers and have only owned with a spouse.
- Individuals who have only owned a principal residence not permanently affixed to a permanent foundation in accordance with applicable regulations.
- Individuals who have only owned property that was not in compliance with state, local or model building codes and which cannot be brought into compliance for less than the cost of constructing a permanent structure.

The Washington State Department of Commerce defines a first-time home buyer in accordance with [RCW 43.185A.010](https://app.leg.wa.gov/rcw/default.aspx?cite=43.185A.010):

> First-time home buyer" is an individual or their spouse or domestic partner who have not owned a home during the three-year period prior to purchase of a home.

Additionally, the definition of a low-income household is as follows:

> Low-income household" is a single person, family or unrelated people living together whose adjusted income is less than 80% of the median family income, adjusted for household size, for the county where the project is located.

These definitions are often combined to characterize a low-income first-time homebuyer.

Researchers trying to understand long-term housing market trends prefer to define first-time homebuyers as borrowers who have never had a mortgage, but there is no single or complete source of data on this population.[23]

Condo associations add risk to homeowners

Washington state law requires condo developments to be governed by a condo or HOA, to which all owners belong and are governed by a board of owners. The structure, powers, and responsibilities of HOAs are also defined by state law. The responsibility and legal expectations of HOAs provide them with powers to oversee the management of the facility, which can conflict with an individual's desired independence, and results in no ability to control the monthly costs associated with fees and special assessments. They are also granted powers to fine and (if it comes to it) foreclose upon a homeowner who owes fees that are greater than the equivalent of three months of HOA dues.

As it relates to condo conversion, the financial risk is likely to be higher as a developer doesn't have a requirement (or strong incentive) to adequately fund the HOA reserve.

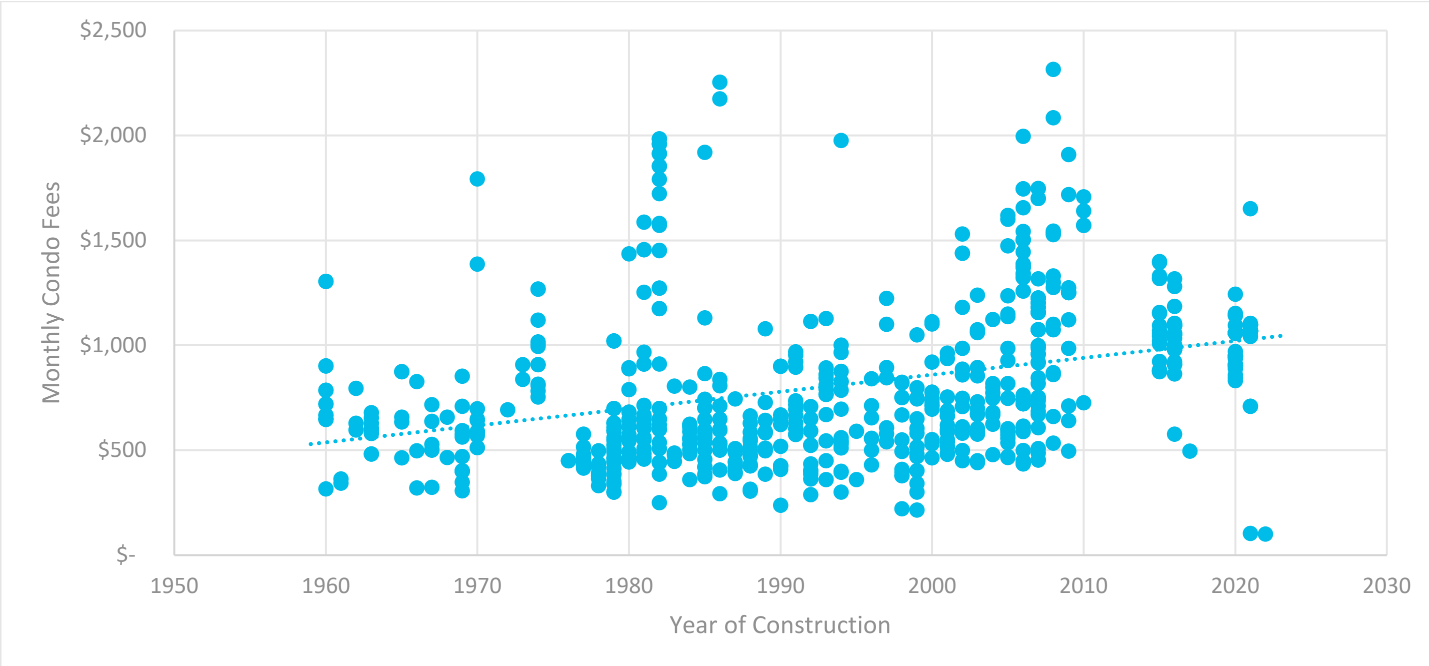
HOA fees can be unpredictable and costly

In addition to the mortgage, a condo owner must pay HOA fees. The funding is to be used for costs covering required maintenance, repair and replacement reserves, and an emergency fund. Special assessments could be added when high-cost, building-wide, or common area items must be repaired or replaced.

As Exhibit 15 shows, monthly condo fees have steadily increased in the City of Seattle based on the year of construction, with an average fee of more than $1,000 per month for units built in 2020 and later.

[23] Arthur Acolin, Paul Calem, Julapa Jagtiani, and Susan Wachter, "First-Time Homebuyers: Toward a New Measure," *Cityscape* 20, no. 1, (2018): 193–204, https://www.huduser.gov/portal/periodicals/cityscpe/vol20num1/article9.html

Exhibit 15: Monthly condo fees by year of construction, City of Seattle, 1950-2022

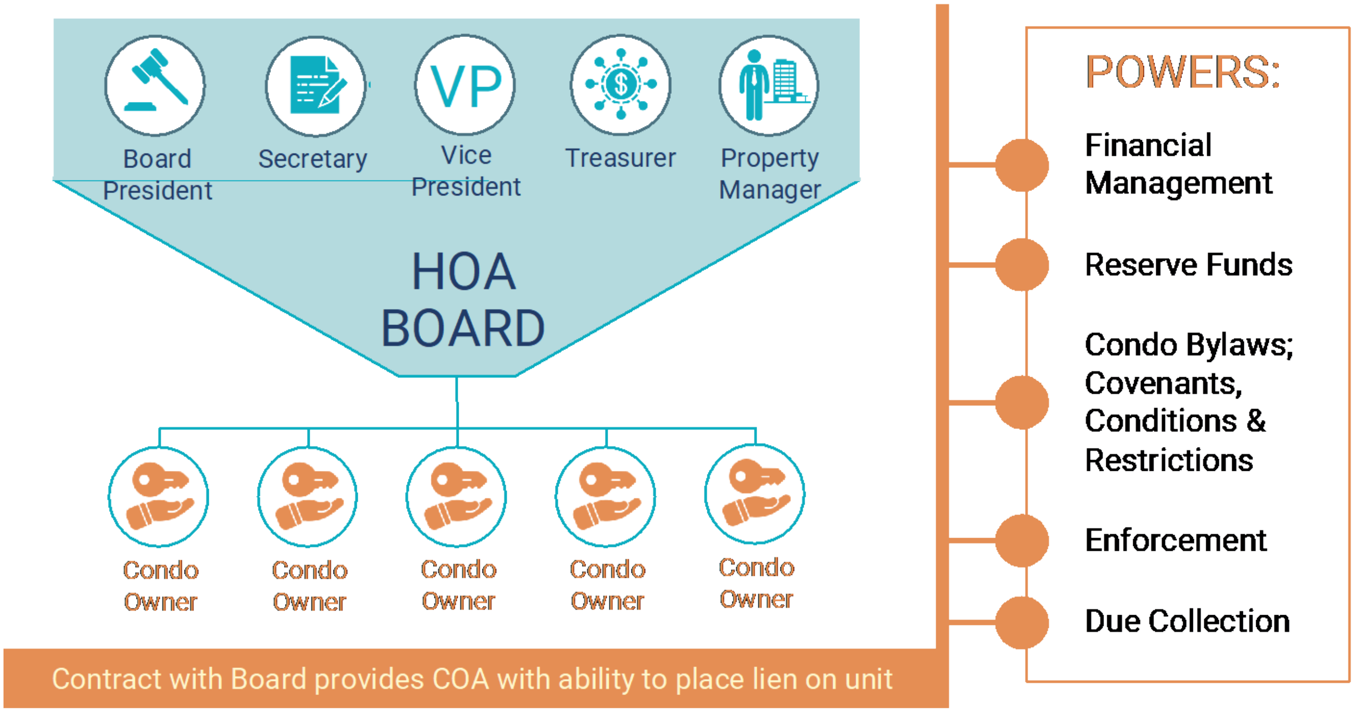


Source: Redfin Sales Data 2021-2022

Washington has recently updated laws pertaining to HOAs

Becoming a homeowner in a common interest property entails different contractual responsibilities and options for resolving disputes than between tenants and landlords or between property owners and local government. In 2018, the Washington Uniform Common Interest Ownership Act (WUCIOA) offered consistent regulations for all types of common interest communities (condo, cooperative, subdivisions, etc.) created after July 1, 2018, and updated key provisions for pre-existing HOAs governed by older laws. Conversions of rental apartments to condos are also now subject to the terms of WUCIOA.

In addition to local, state, and federal law, HOA members are subject to the covenants, conditions, and restrictions (CC&Rs), rules, and bylaws of the HOA. HOA documents are generally long and complex, sometimes hundreds of pages. They are provided to owners before the purchase of a condo and detail owner and board responsibilities and processes.



WUCIOA provisions aim to improve the transparency of many HOA functions and require notice and member communication for amending rules, record keeping, budgets and financial audits, borrowing, and open meetings. There are also standardized rules for the quorum and approval threshold for changes to HOA documents. Aspects of WUCIOA also allow common interest communities more paths for pursuing alternative dispute resolution before seeking remedy through the court system, which can be expensive for homeowners and HOAs.

Conflict between HOAs and homeowners

WUCIOA has elements that seek to protect homeowners and HOAs but does not resolve all the interests between individual owners and the HOA as a corporation. Some of the most divisive issues arise over fines and foreclosures:

	Lender	Local Government	HOA
Condo Owner	Contract/Agreement: Mortgage Time Until Foreclosure: 4 months	Contract/Agreement: Property Tax Time Until Foreclosure: 3 years	Contract/Agreement: Monthly fees, assessments, fines Time Until Foreclosure: 6 months
Homeowner	Contract/Agreement: Mortgage Time Until Foreclosure: 4 months	Contract/Agreement: Property Tax Time Until Foreclosure: 3 years	N/A

- **Fines:** HOAs have the power to levy fines against individual owners for violations of the rules defined in HOA documents. Fines often range from $50-$200 but can be applied repeatedly until a violation is remedied or while an owner disputes the fine. If fines accumulate without repayment or resolution, the HOA may be able to initiate foreclosure against homeowners.

- **Foreclosures:** HOAs have the power to foreclose on homeowners for unpaid assessments, separate from a lender foreclosure for an unpaid mortgage. WUCIOA reformed the HOA foreclosure process in three key ways:

  - Foreclosures can only be filed for delinquent payments equal to three months of common expense assessments
  - HOA boards must vote to approve foreclosure filings
  - Nonjudicial foreclosures are allowed

WUCIOA provisions provide greater security and time for homeowners to address past-due payments and prevent foreclosures for minor unpaid fines. Allowing HOAs to pursue nonjudicial foreclosure offers a faster and less costly process than going to court but requires that homeowners file a lawsuit to dispute foreclosure action.

Balancing the rights and responsibilities of condo owners and volunteer HOA board members can be a challenge. WUCIOA attempts to establish a baseline of accountability for HOA governing boards while protecting board members from individual liability that would discourage board service. These laws also define rules for decision-making that encourage participation from members without paralyzing governance in communities where owner participation is low. Yet advocates for condo owners have concerns about the accountability of HOA board members under existing laws and the ability of low- and moderate-income condo owners to dispute incorrect, unreasonable, or potentially discriminatory HOA actions without litigation. One approach to these issues taken in other states is the creation of a common interest community ombudsperson office within the regulatory or consumer affairs department. At minimum, these offices offer clarification about state laws related to HOAs. In some states, including Florida, Delaware and Nevada, the ombudsperson also has the authority to mediate disputes between associations and members and/or recommend state enforcement of HOA governance laws.[24]

Permanent displacement could result from conversions

Converting occupied rental apartments into ownership units may support wealth generation efforts, but it comes with risk. This shift will cause both short- and long-term impacts on tenants, altering housing supply and affordability.

Permanent displacement and its impacts

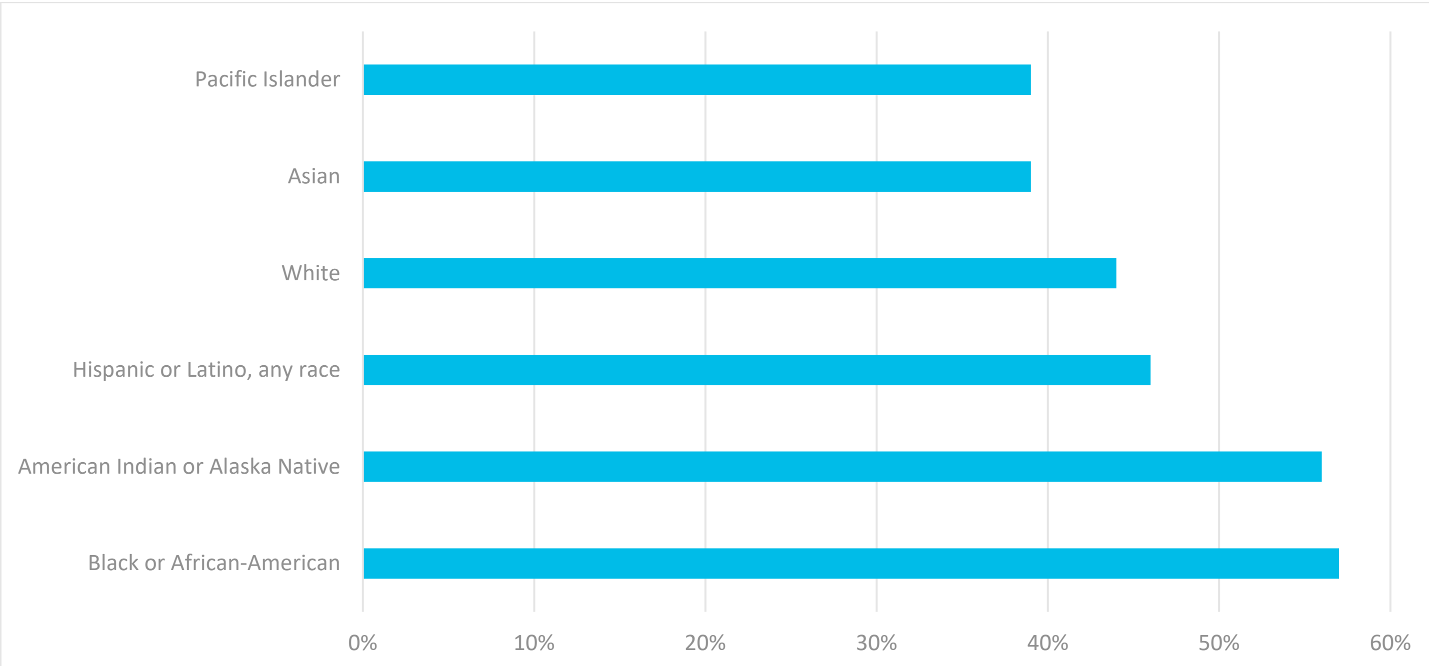
An increase in the number of conversions of occupied apartments to condominiums could result in physical displacement due to economic circumstances. When housing markets are tight, as they have been in Washington in recent years, developers of new (or newly converted) units can take on larger renovation projects. Despite being older properties, as the potential income return exceeds the perception of risk by investors, structures become likely candidates for redevelopment.[25] Seen in various regions throughout the country, gentrification and displacement are more common in areas that have seen ongoing depreciation and

---

[24] Florida Department of Business & Professional Regulation, *Condominium Ombudsman*, http://www.myfloridalicense.com/DBPR/condominiums-and-cooperatives/condominium-ombudsman/;
Delaware Department of Justice, *Office of the Ombudsperson for the Common Interest Community*, https://attorneygeneral.delaware.gov/fraud/cpu/ombudsperson/;
State of Nevada Department of Business & Industry, *Homeowners Association Complaints*, https://business.nv.gov/Homeowner/Homeowners_Association_Complaints/
[25] Smith, Neil. "Gentrification and the Rent Gap," Annals of the Association of American Geographers 77, no. 3, (September 1987): 462–65, https://doi.org/10.1111/j.1467-8306.1987.tb00171.x

physical deterioration of older built structures.[26] These structures are often occupied by lower-income renters. Given longstanding racial wealth disparities in the state, displacement pressures will likely disproportionately affect Black, Hispanic and Indigenous renters at a higher rate than white residents.[27]

Exhibit 16: Share of Seattle renters who are cost-burdened by race



Source: Race and Social Justice Initiative (RSJI), Housing Affordability, City of Seattle, 2017

Despite additional policies and programs that support existing tenants to purchase converted units in their building, conversion projects are likely to displace all or most current residents. Some cities have passed laws that encourage buildings to be sold to current tenants for ownership opportunities. Washington, D.C.'s Tenant Opportunity to Purchase Act (TOPA) passed in 1980 and is the best known of these policies. TOPA specifies the process for notifying current tenants of sale and gives tenants the right of first offer and the right to match third-party offers. Tenant purchase conversions have been most successful when tenants have access to legal assistance and low-cost financing to navigate the conversion and ownership process.

If a developer planning a condo conversion offers converted units to current residents, not all renters will become owners. They might not be interested, or they might be unable to afford the costs and risks of home ownership. **Lower-income tenants will likely be displaced by the conversion process and will have to seek new housing in what could be a highly competitive rental market.**

Washington state law authorizes most cities to create policies to compensate tenants displaced by building sales and condo conversions. Of the cities that have such policies, assistance amounts are relatively small —

[26] National Community Reinvestment Coalition, "Shifting Neighborhoods: Gentrification and cultural displacement in American cities," https://ncrc.org/wp-content/uploads/2019/03/NCRC-Research-Gentrification-FINAL.pdf
[27] 2021: ACS 1-Year Estimates

for example, $2,000 in Tacoma[28] to about $5,000 in Seattle.[29] Most importantly, tenants are often unable to find adequate or affordable housing in their existing neighborhoods. Interviews with city staff who administer tenant relocation assistance in Seattle suggest that current displacement patterns have residents of south and west Seattle neighborhoods relocating primarily to the Burien, Renton and Federal Way suburbs.

In the long term, conversion creates new homeownership opportunities but **does not add to the overall housing supply**. Permanently removing rental apartments from local housing markets can exacerbate shortages of rental housing and play a role in rising housing costs, especially when new housing construction is slow or stagnant. Because condo conversions are more likely to occur in buildings that **rent** at more affordable rates, conversion has a more acute impact on the supply of affordable rental housing, disproportionately impacting low- and middle-income renters.

Feasibility of converting housing stock inside transit corridors

The legislation authorizing this study requested an investigation of the affordability of the rental housing stock within transit corridors located inside Growth Management Act counties. Access to jobs and transportation are important considerations when selecting housing and impact its affordability. As it relates to condo conversion, we focus on transit corridors with rents that would allow for the lowest acquisition cost and, thereby, the best opportunity to provide units that are affordable after conversion.

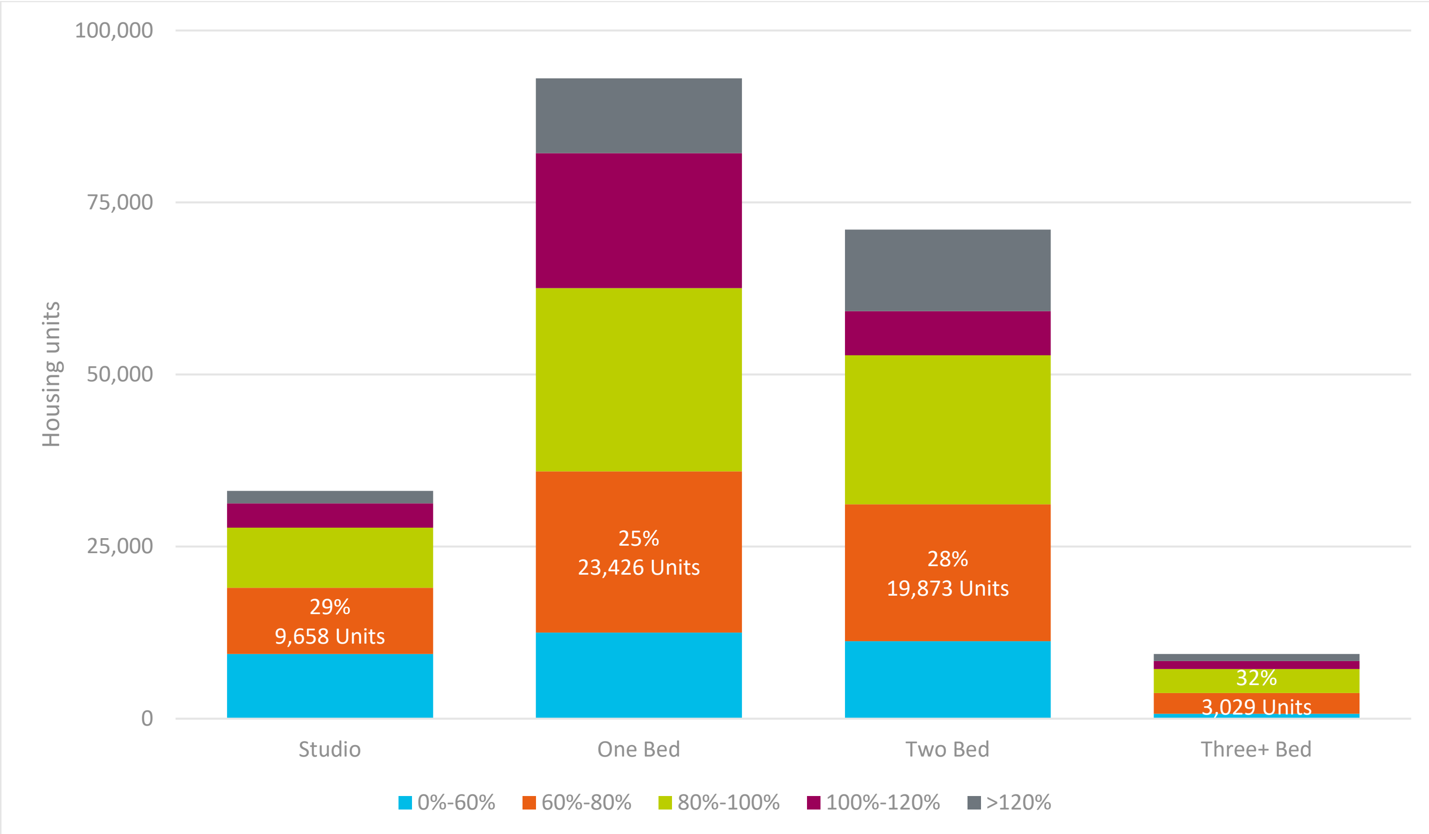
In order to understand the scale of opportunity of units suitable for conversion, we looked at the affordability of apartment rents near frequent-service mass transit lines in the following Washington counties: Clark, King, Kitsap, Pierce, Snohomish, Thurston and Whatcom.[30] We obtained parcel-level apartment rent estimates from CoStar and transit line locations from the Washington State Department of Transportation (WSDOT).

Beyond the data, our results were driven by three assumptions. First, our analysis defined "frequent" transit lines as those with average headways (the time between transit vehicles) of 15 minutes or less during weekday mornings. Second, we defined nearby units as apartments within a half-mile of a transit line. Finally, based on the analysis in this report identifying the incremental cost of conversion in the range of an additional 35% to 60% of AMI, targeting naturally occurring apartment units in the 60% to 80% of AMI make the best candidates if the goal is to deliver converted condos that are affordable.

---

[28] Tacoma Municipal Code 1.95, https://www.cityoftacoma.org/government/city_departments/equity_and_human_rights/rental_housing_code/relocation#:~:text=Under%20Tacoma%20Municipal%20Code%201.95,use%20of%20their%20rented%20residence
[29] Seattle Municipal Code 22.903, https://www.seattle.gov/sdci/codes/codes-we-enforce-(a-z)/condominium-conversions
[30] These are the seven counties subject to the buildable lands review from RCW 36.70A.215.

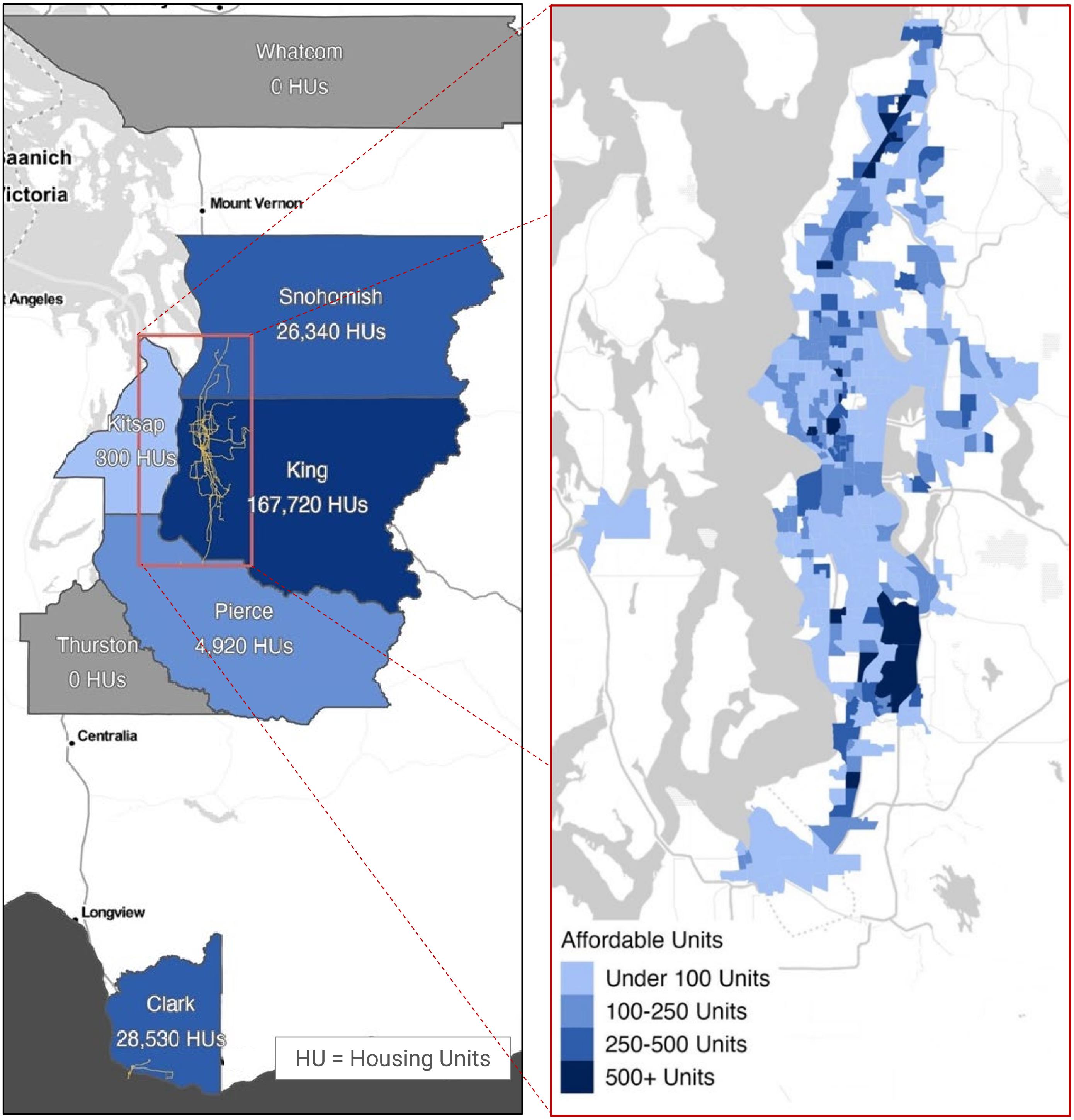
Exhibit 17: Affordability of housing units with proximity to transit



Source: CoStar, HUD, ECONorthwest Calculations

Of the 227,500 apartment units inside the transit corridors, 25% of them (56,000) are affordable to households earning between 60% and 80% of AMI. These units presented limited options for family-sized units, with 59% of the stock of suitable conversion units having fewer than two bedrooms. The exhibit below shows the number of affordable housing units (HUs) in Western Washington counties (left) and the Seattle-Tacoma metro area (right).

Exhibit 18: (Left) Total apartment units within transit corridors in 2022, (right) number of naturally occurring apartments affordable between 60% and 80% of AMI in 2022



Source: CoStar, HUD, ECONorthwest Calculations

Case studies: Policy examples from other states

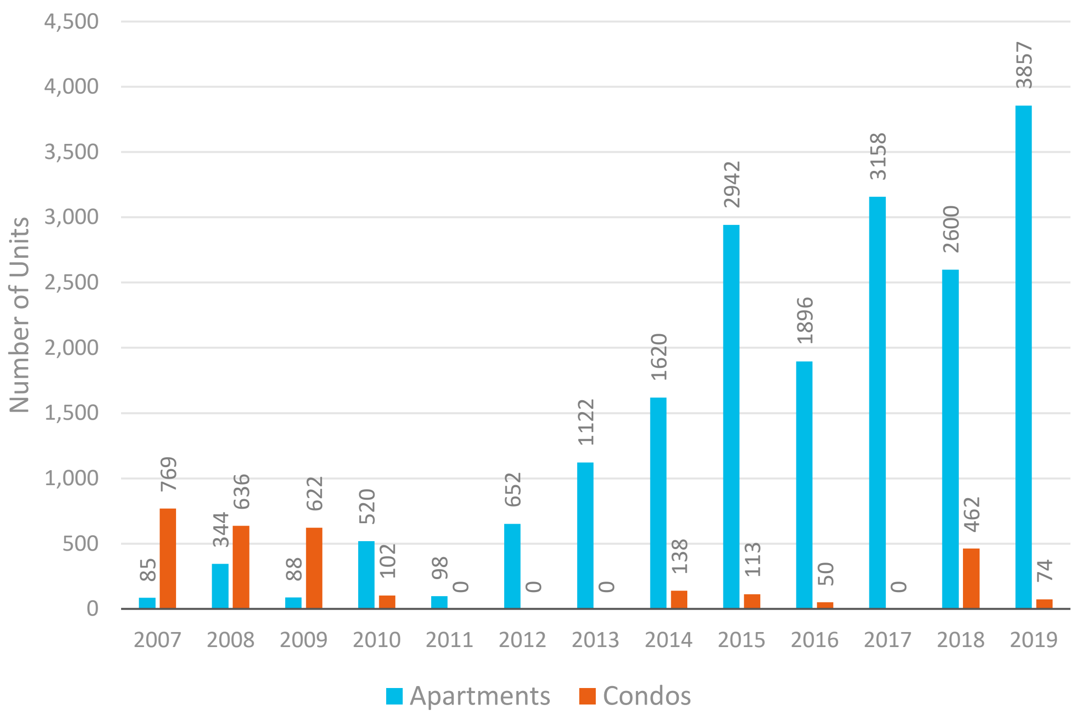
We explored policies in other states that affected condo conversions and development, including Colorado, New York and Florida.

Case study: Colorado

In 2017, Colorado legislators passed HB 1279 to update the **Colorado Construction Defect Action Reform Act (CDARA)** to spur condo development in the state. At the time of the legislation, condos made up only 3% of new development in Colorado. To reduce condo defect liability litigation, HB 1279 implemented a requirement that a majority of condo owners must approve builder defect lawsuits, not just a majority of the homeowners' association board. The developer will also have the opportunity to remedy the defect prior to the HOA vote. Also, in 2017, the Colorado Supreme Court ruled that condo developers could require arbitration in the case of construction defect disputes rather than going directly to litigation as another protection for condo developers and builders.

There is high demand for condos after years of stagnant development, with recent condo developments in Denver selling out quickly. However, condo development — and condo conversion — has not gained traction due to lingering uncertainty and the risk of lawsuits. For conversions, deed restrictions and the cost to convert units remain substantial barriers. Many developers remain cautious and are waiting to see the impact of the legislation before entering the condo market.

Exhibit 19: Units completed annually in Denver, 2007-2019



From 2014 to 2019, Denver added about 33,000 new apartments and 765 condo units, a growth of under 2%.

Source: Rodriquez, James, "GOING VERTICAL: Is Denver-area condo development primed for a rebound? It's complicated." *Denver Business Journal*, (2020), https://www.bizjournals.com/denver/news/2020/02/06/denver-condo-development-rebound.html

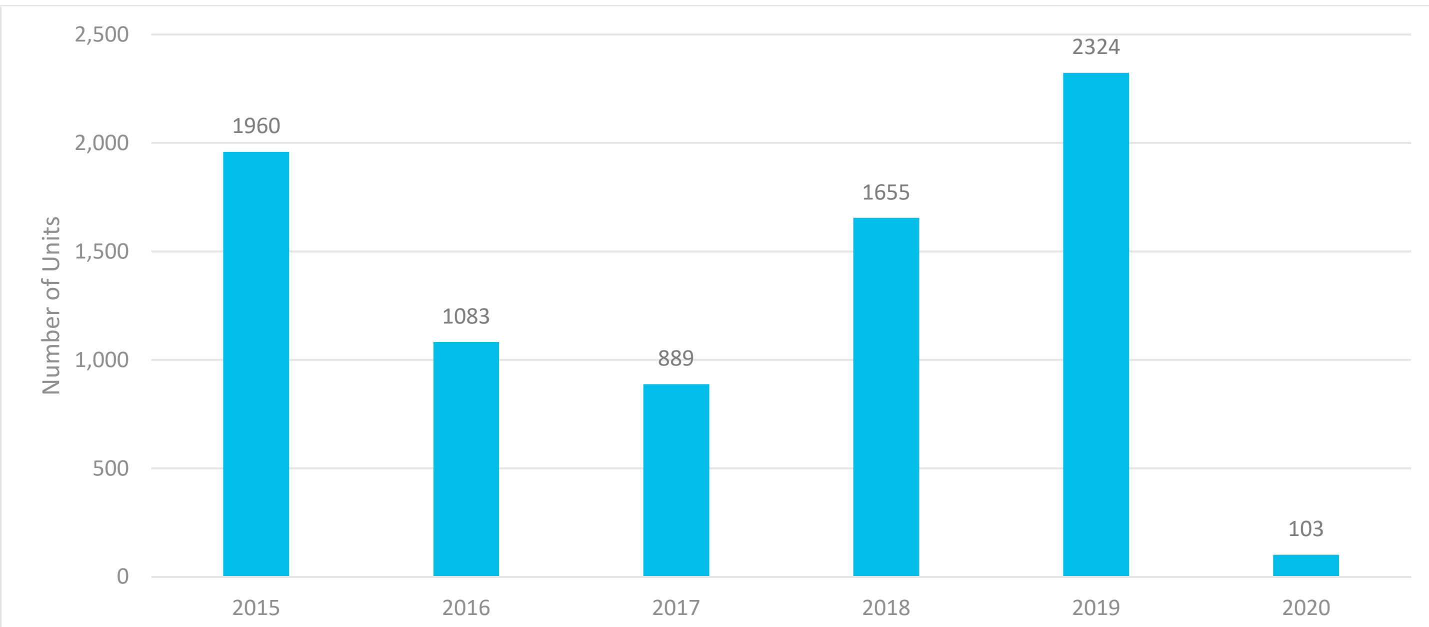
Case study: New York

In 2019, New York City passed the **Housing Stability and Tenant Protection Act** to strengthen tenant protections, requiring that 51% of existing tenants agree to buy their apartments before a building can be converted. Previously, only 15% of existing tenants were required, and the percentage could also include non-tenants who were purchasing the apartment to use as their primary residence. The new 51% requirement includes current tenants only.[31]

According to a report written by the Steven L. Newman Real Estate Institute at Baruch College, this legislation played a major role in slowing condo and co-op conversions in New York City. In the year following this legislation, just five condo conversion plans were submitted, down 75% from the previous year and an all-time low.[32] The total units associated with these projects are shown in the following exhibit. In 2013, the total property value of converted projects was $3.7 billion; in 2019, this value was only $6 million.[33]

The same report also found that in neighborhoods with condo conversion projects, homeownership rates increased by 1.3 percentage points.[34]

Exhibit 20: Total apartment units converted in New York City, 2015-2020



Source: Steven L. Newman Real Estate Institute at Baruch College, "NYC Condominium and Cooperative Conversion: Historical Trends and Impacts of the Law Changes," https://zicklin.baruch.cuny.edu/wp-content/uploads/sites/10/2021/05/5.5.2021_NYC-Condo-Conversion_Impact-of-the-Recent-Law-Change_May-5th-2021.pdf

---

[31] Gadow, Sandy, "What happens when your rental is being converted into a condo?" The Washington Post, (Sept. 29, 2015), https://www.washingtonpost.com/realestate/what-happens-when-your-rental-is-being-converted-into-a-condo/2015/09/28/e5e528fa-5336-11e5-9812-92d5948a40f8_story.html

[32] Hudson, Erin, "Rental-to-condo conversions drop 80% after 2019 rent law: report," *The Real Deal*, (May 13, 2021), https://therealdeal.com/2021/05/13/rental-to-condo-conversions-drop-80-after-2019-rent-law-report/

[33] Steven L. Newman Real Estate Institute Baruch College, the City University of New York, "NYC Condominium and Cooperative Conversion: Historical Trends and Impacts of the Law Changes," https://zicklin.baruch.cuny.edu/wp-content/uploads/sites/10/2021/05/5.5.2021_NYC-Condo-Conversion_Impact-of-the-Recent-Law-Change_May-5th-2021.pdf

[34] Ibid.

Case study: Florida

Following the deadly collapse of the Champlain Towers South in Surfside, Florida, state lawmakers passed the **Building Safety Act** to reform condo regulations.[35] As part of this legislation, condo associations in Florida have until 2025 to complete inspections to determine the scope and cost of any repairs. Condo associations must hold reserves for major repairs, likely costing unit owners high assessment fees. Recertification will be required after 30 years and every 10 years following. Due to the uncertainty of potential costs and risks associated with previously deferred repairs, it is likely that the Florida condo market will slow in the coming years.

In Florida, the **Roth Act** governs condo conversions. It requires a condo conversion report to be prepared by an engineer or architect, with each unit owner and the HOA as third-party beneficiaries of the report. In addition, developers are required to provide one of three types of post-purchase protections to condo buyers:[36]

Example: After updates to Florida Legislation, unit owners of the Florida condo tower Murano at Portofino are facing an assessment of $30 million — or $160,000 per unit. The building is not offering financing, leaving unit owners to come up with costs individually. Many involved in the Florida condo market are expecting a wave of similar fees or HOA due increases for condo owners across the state.

- Establish converter reserve accounts for capital expenditures and deferred maintenance. These funds are used for any required maintenance or repairs, and the amount is based on the age of the building.
- Grant the purchaser of each unit an implied warranty of fitness and merchantability for the purposes or uses intended. The developer agrees to cover the cost of any repairs or replacements for up to a three-year period. However, if a developer chooses to grant these warranties, the time limit on those warranties likely begins when the notice of intent to convert is filed, not when the unit is sold.
- Post a surety bond equal to the total amount of all reserve accounts, which would otherwise be required. This bond will cover the cost of any repairs or replacements of the features it covers.

While the Roth Act was not specifically updated in the Building Safety Act, condos formed via conversions will be subject to the same assessment and inspection requirements as existing condos.

[35] Echikson, Julia, "Colliers Launches Advisory to Help Florida Condos Manage New Assessment Laws," *Commercial Observer*, (Sept. 20, 2022), https://commercialobserver.com/2022/09/champlain-towers-south-colliers/
[36] Sweeney Law, "Transforming Apartment Buildings Into Condominiums In Florida," (Nov. 25, 2019), https://www.sweeneylawpa.com/transforming-apartment-buildings-into-condominiums-in-florida/

Conclusion: Conversions a complicated approach

The prospect of homeownership is getting further out of reach for many people in Washington. This study examined the potential of converting apartment buildings into condos and (if currently occupied) transitioning existing tenants into owners of their units. We identified a series of financial and legal barriers that limit the market from pursuing conversion at scale. The limited amount of conversions is due to a myriad of factors for which there is no clear fix. Two of the main issues are:

1. The construction defect liability of any work undertaken within conversions can lead to protracted and costly lawsuits that drive up the cost, time, and complexity of conversion projects, making it difficult to secure in-demand labor or financing.
2. In recent years, the return on investment for multifamily rental buildings has been strong, mitigating the desire to develop condos. The risk associated with developing or converting a condo is not financially attractive compared to other market options, particularly detached housing or apartments.

On top of the initial costs to convert (financial and material), condo fees and private mortgage insurance will typically push the monthly costs higher than what many middle- or lower-income individuals can afford. The risk of entering the contractual obligations of a homeowners association and its ability to fee, fine and place liens also adds risk.

The goal of expanding homeownership and the ability to build wealth while creating housing stability is challenging for low-income households and first-time homebuyers, as the cost of converting an apartment can almost double the monthly costs of ownership compared to an apartment renting at 80% of AMI. Converting apartments that are renting for less than 80% of AMI could offer some additional affordability for homeownership but increases displacement risk for existing tenants of naturally occurring affordable housing (affordable at between 60% and 80% of AMI) and would likely require additional improvement costs to conform with code requirements and a standard of finish that would be attractive to potential buyers.

Currently, the cost of condo conversion makes affordability for households earning less than 80% of AMI challenging without policy interventions or subsidies. Market volatility regarding interest rates, the impact of inflation, and changing valuation metrics for apartments (cap rates) make it challenging to forecast condo conversion feasibility in the near term. As current market conditions/volatility change in the future, the affordability impact of conversion could improve, at which point they can be explored as an option to provide affordable homeownership.

Appendix

Study Project Committee

In addition to representatives from ECONorthwest, BDS Planning, and the Washington State Department of Commerce, the Affordable Housing Advisory Board Condo Conversion Study Project Committee included:

- Paul Trautman, Senior Housing Developer, Community Frameworks, Affordable Housing Advisory Board Chair
- Ann Campbell, Homeownership Unit Managing Director, Washington State Department of Commerce
- Jeanette McKague, Assistant Director of Housing and Community Development, Washington Realtors
- Michael Orbino, Managing Broker, Team Foster Building + Developer Services at Compass
- Steve Walker, Executive Director, Washington State Housing Finance Commission
- Patrick Johansen, Chairman of Housing Justice Committee, RiseUpWA
- Raelene Schifano, non-profit advocate, HOA Fightclub
- Michael Brandt, real estate lawyer, Principal, Brandt Law Group

Study engagement

Study Project Committee meetings

Three study project committee meetings were held to cover the following topics:

1. Project goals and preliminary findings
2. Project updates and additional results
3. Committee feedback and guidance

Condominium Conversions Study meeting materials are available online:
https://www.commerce.wa.gov/about-us/boards-and-commissions/affordable-housing-advisory-board/condominium-conversions-study/

Informational interviews with Committee members and stakeholders

In addition to project committee meetings, ECONorthwest conducted individual informational interviews with project committee members. ECONorthwest also held additional key informant interviews with relevant stakeholders, including:

- Real estate lawyers
- Insurance lawyers
- Tenants' rights advocates
- City staff focused on homeownership and anti-displacement
- Nonprofit housing development organizations