Predatory Equity: Evolution of a Crisis

The threat to New York's affordable rental housing: 2005-2009

November 2009

ASSOCIATION FOR NEIGHBORHOOD & HOUSING DEVELOPMENT, INC.

Predatory Equity: Evolution of a Crisis

The threat to New York's affordable rental housing: 2005-2009

November 2009

The Association for Neighborhood and Housing Development

50 Broad Street, Suite 1125

New York, NY 10004

212-747-1117

www.ANHD.org

The Association for Neighborhood and Housing Development (ANHD) is a membership organization of 98 New York City nonprofit neighborhood housing groups. Our mission is to ensure flourishing neighborhoods and decent, affordable housing for all New Yorkers. We pursue this mission by supporting the programs and advancing the priorities of our member organizations engaged in community development and community organizing in low- and moderate-income neighborhoods throughout the city. ANHD's core programs include: housing policy research and advocacy, support for community organizing, and training and technical assistance. More information is available at our website, www.anhd.org.

ANHD gratefully acknowledges the Altman Foundation, the Surdna Foundation, and the New York Community Trust for their support of our work to preserve New York City's affordable apartment housing.

ANHD would also like to acknowledge the work done by Urban Homestead Assistance Board, the Community Service Society and the Citizens Housing and Planning Council to address the issue of predatory equity. ANHD would like to thank Greg Jost of University Neighborhood Housing Partners for producing the maps used in this report.

Contents

Summary

Section I – Predatory Equity: Tenant Harassment as a Business Model

- Neighborhoods around New York City saw a dramatic rise in harassment of tenants in recent years as landlords forced out working families so they could raise the rent. This increase in harassment was driven by the rise of a new type of buyer of New York City real estate: those raising money from Wall Street-type investors who demanded profit levels that could only be achieved in rent-regulated buildings by displacing tenants and undermining affordable rents.

- Many of the lending institutions that provided huge loans for the purchase of these buildings packaged the funds into mortgage-backed securities. This *securitization* was one of the core issue that led to the subprime crisis, and has also encouraged a similar destabilization of decent multifamily housing by encouraging investors to engage in very risky deals. Both the private-equity funders and the lending institutions were aware, or should have been, that harassment and displacement of tenants was a necessary element in their financial model.

- Private equity-backed developers, in the past four years, purchased an estimated 100,000 units of affordable, rent-regulated housing. This is a almost 10 percent of New York City's rent-regulated housing and represented a major threat to affordable housing and stable communities. This overly aggressive private equity investment has become known as "predatory equity" and has undermined the best efforts of New York City and State elected officials to slow the loss of affordable rental housing.

Section II – The Default Crisis: Predatory Equity Underwriting Unravels

- Although the harassment of tenants between 2005 and 2007 was highly effective in creating high tenant turnover and quickly driving up building income, by 2008 intervention and education by community organizers had made tenants more aware of their legal rights. As a result, although harassment has continued, it has been somewhat less effective. At the same time, ANHD analysis suggests that much of the loan underwriting was so speculative and badly overleveraged that even aggressive tenant turnover could not have supported the mortgage debt the owners incurred.

- This investment strategy has created a growing danger of default and poses a crisis for New York City apartment buildings. As of June 2009, 10 out of 10 predatory equity loans that ANHD is tracking are on a finance industry watchlist for being in danger of default. These loans are far more likely to be on the default watchlist then nonpredatory equity loans in the same mortgage-backed security pools, and could place up to 100,000 apartments at risk.

- A primary indicator of default danger is the *debt service coverage ratio*. ANHD's analysis of loan servicer reports on mortgage-backed securities in which some predatory equity mortgages are held reveals that, as of December 2008, the average debt service coverage ratio of predatory equity financing is .55/1. This means that only 55 cent in income is available for every dollar of debt owed.

- This new commercial loan subprime crisis could have a destructive, destabilizing effect on tenants, affordable housing and communities in New York City because when an owner defaults on financing, the property often falls into physical distress. These distressed buildings in turn depress the block in which they are located and the neighborhoods where they are concentrated. This crisis may also have a destabilizing impact on local real estate lending markets, reducing the availability of healthy investment in affordable housing.

- Responsibility for this crisis falls on many parties, including the developers and their private equity partners, the bank lenders, the mortgage-backed security underwriters and the credit rating agencies.

Section III – The Crisis Continued: Vulture Investors and Banks Maintain the Speculative Investment Model

- As of the writing of this report, banks are aware that some form of deleveraging must take place. A number of distressed-asset investment funds, better known as vulture funds, have been set up and capitalized specifically to take advantage of investment opportunities in New York City. These vulture funds are continuing the speculative investment model and, while they expect to be able to purchase properties and debt at less then their current face value, they also expect to quickly raise building income and profits by pushing out existing tenants. As of the writing of this report, there has been relatively little actual transfer of buildings or debt to the vulture funds because banks are trying to establish the actual market value of the buildings and loans, being careful not to sell for less than the assets might shortly be worth if the real estate market recovers.

- There is cause for great concern because some properties that have been deleveraged demonstrate that, even as debt is being reduced, a speculative investment model is being maintained. While the 2005-2008 model of grossly overleveraging rent-regulated buildings may be on the wane, there is evidence that the crisis is being continued by a new group of speculative investors who are less overleveraged, but are nonetheless using a speculative investment model based on high tenant turnover and harassment.

- One example is the Orbach Group, which recently purchased mortgage debt held by Deutsche Bank on a highly overleveraged portfolio of buildings owned by the well-known predatory equity developer Pinnacle Group. The Orbach Group has been accused of acting as a predatory equity-type developer in a portfolio of buildings it owns in Manhattan, where local legal services providers have documented a pattern of harassment.

Section IV – Policy Recommendations for Community and Government Action

- Local policymakers must take an active role in defusing the impact of this crisis by pro-actively protecting the rights of tenants in these buildings. They can use the legal tools at their disposal to stop tenant harassment, monitor building conditions and owner financials, and commit resources to ensure that this hard-to-replace affordable housing does not fall into abandonment and disrepair, dragging down tenants and communities.

- Some strategies have already proven effective in countering the impact of predatory equity, including tenant education and organizing that has slowed the impact of harassment, as well as public and legal pressure on the most abusive owners.

- It is also critical to close the legal loopholes that allow dramatic rent increases on vacant apartments, and so provide the fuel for harassment and speculative financing. Legislation is currently pending in the State legislature to tighten the 1/40th rent increase loophole and to repeal vacancy de-control. Both steps are critical to stopping the predatory equity model, and this legislation must be passed.

- There may be an opportunity created by the coming default crisis to transfer buildings away from defaulting predatory owners to purchasers who will preserve the affordable housing. However, to achieve a significant preservation purchase solution for the most at-risk properties, banks must be willing to move away from the speculative model and reduce the sale price of the asset to its true income-based value. Strong government and community pressure will be necessary to bring the banks to the table.

Introduction

Jose Ricardo Aquaiza moved into his building in Woodside, Queens, in 1994. The neighborhood was a stable, mixed-income community with a diverse ethnic mix and easy public transportation access to the major job centers of Manhattan. Jose's landlord was sometimes slow in providing repairs and services, but the rent was affordable, and overall the building and the community were a good, safe, stable place for Jose and his family. In 2006, a new owner named Vantage Properties, backed by financing from Apollo Real Estate Advisors, a private equity fund, bought Jose's building in a deal that included 2,124 apartments in Northeast Queens. It was quickly apparent that the new owner and its financing partners were operating with a new business model. Jose and many of his neighbors were immediately sued by the landlord and faced eviction in housing court based on frivolous allegations.

In Jose's case, the owner sued him three times in one year, once frivolously claiming that he had never been the legal occupant of the apartment, and twice on baseless claims that he owed rent. Jose was confident in asserting his rights in housing court, and each time the landlord's case quickly fell apart. But many of his neighbors were not so lucky. Most were immigrants for whom English was not their first language. They did not have legal representation and the landlord's aggressive attorney intimidated them into signing away the rights to their apartments. Within one year, almost 40 percent of Jose's neighbors had been displaced from their apartments.

With each vacancy, the new landlord made superficial improvements in the vacant apartment in order to take advantage of a loophole in the rent regulation system that allowed him to quickly raise the rent (although very few repairs were made to apartments occupied by tenants paying moderate rents). The landlord then moved in new tenants who were able to pay the much higher rents. The building had been physically improved, but at the expense of Jose and his neighbors, many of whom had been illegally bullied out.

Jose may be confronting further trouble because his landlord is facing a financial crisis. When the loan was underwritten in 2006, the owner and lender overleveraged the building using dangerous, speculative assumptions and financing tools. As a result, by December 2008, the buildings had only 69 cents to pay every dollar of debt service owed, and the loan had been placed on a default watchlist by the loan servicer. Jose's building is caught between a rock and a hard place: the current owner is harassing tenants because he bought the building with a speculative financing model, but, if the loan goes into default, repairs and services will likely languish. Alternately, the bank may keep the speculative model going by renegotiating the loan to keep the building in the hands of the current abusive landlord, or the bank may transfer the loan and building to a new landlord at the highest possible price in order to continue the speculative model of investment.

This exact scenario, based on a business model that has become known as predatory equity, is being acted out on a dramatic scale in dozens of neighborhoods around the city, threatening the stability of an estimated 100,000 affordable apartments that make up a critical part of the supply of affordable housing in New York's stable, working-class neighborhoods.

Section I – Predatory Equity: Tenant Harassment as a Business Model

In recent years, neighborhoods around New York City have seen a dramatic rise in the harassment of tenants as landlords tried to illegally remove low- and moderate-income families so they could raise the rent. This increase in harassment stemmed in large part from the rise of a new type of buyer of New York City real estate. These new owners partnered with Wall Street-type investors to raise money from private equity funds that created a pressure for profit levels that, in rent-regulated buildings, could only be achieved by illegally displacing tenants and undermining affordable rents. The private equity model of these new investors created an approach to and a model of building ownership that was substantially different from the traditional real estate owner model:

This “predatory equity” is undermining the best attempts of New York City and State elected officials to slow the loss of affordable housing.

- Residential real estate in working-class neighborhoods of New York City has typically been a financial backwater, a relatively non-liquid asset that returned a standard profit of 7 percent to 8 percent a year. Profits are taken by owners as income, as opposed to capital gains, and the non-liquid nature of the asset encourages the owner to hang onto the building for the long term. There is relatively little pressure and competition.

- In contrast, residential real estate-based private equity investment funds bring a very different set of pressures. A private equity fund attracts investors by proposing an investment strategy that will offer a competitive rate of return, competing with other Wall Street-type investment vehicles to attract and retain those investors. In the private equity funds that we have examined, a 14 percent to 20 percent annual rate of return is commonly proposed as the target profit level. In residential real estate in working-class neighborhoods, the primary strategy to increase the rate of return to such atypical levels is pushing out low-rent paying tenants.

Private equity-backed developers have purchased an estimated 100,000 units of affordable, rent-regulated housing in New York City over the past four years. This is a significant percentage – almost 10 percent – of our rent-regulated housing and represents a major threat to affordable housing and stable communities. This “predatory equity” is undermining the best attempts of New York City and State elected officials to slow the loss of affordable housing.

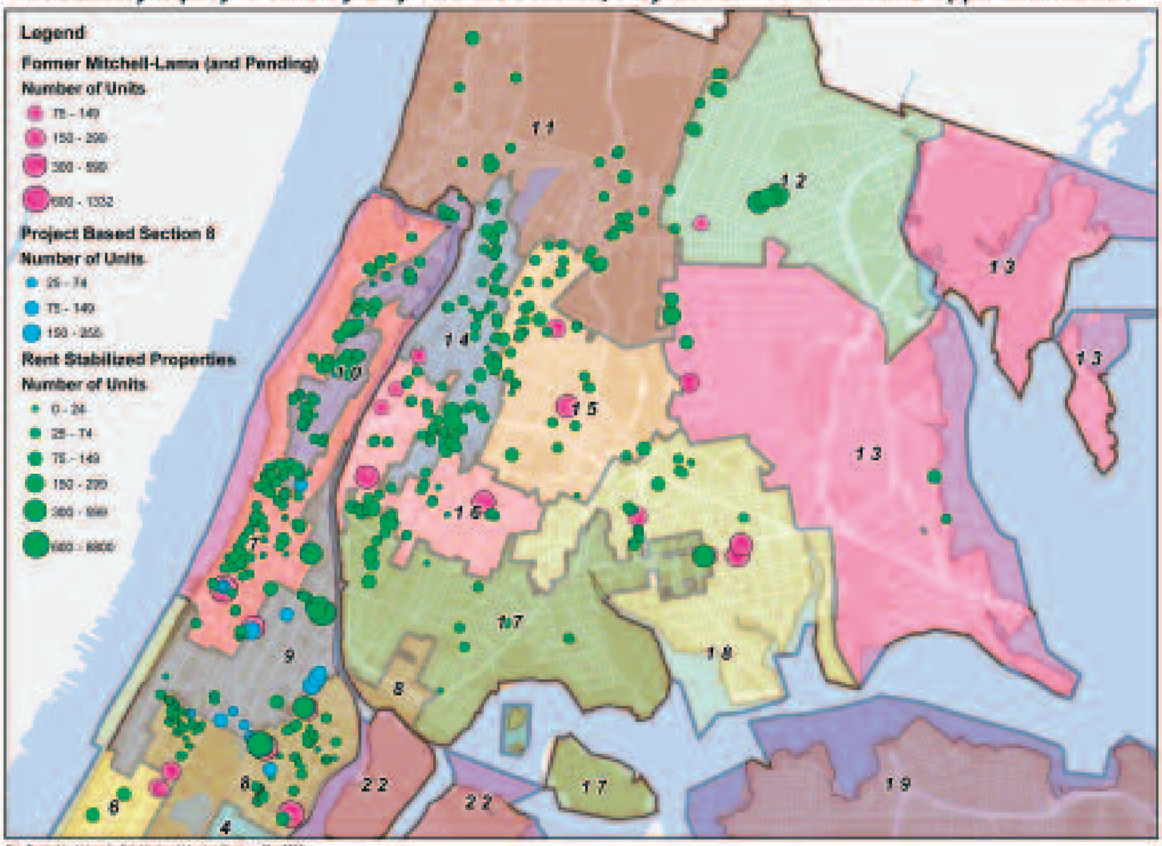
Attached as an addendum to this report is a chart of major predatory equity deals around the city. The communities targeted by predatory equity developers were generally stable, working-class neighborhoods where there was a supply of affordable, rental housing, including:

- West Harlem, with developers such as The Pinnacle Group, Vantage Properties and Stellar Management;
- East Harlem, with developers such as the Dawnay, Day Group;
- Washington Heights, with developers such as The Pinnacle Group, Vantage Properties and Perseus Investment Group;
- Lower East Side, with developers such as Westbrook Partners;
- Manhattan’s Turtle Bay, with developers such as Tishman-Speyer;
- Grand Concourse Corridor of the Bronx, with developers such as SG2 Properties;
- North-Central Bronx with developers such as Normandy Partners and Ocelot Group;
- Sunnyside, with developers such as Vantage Properties;
- Corona, with developers such as Urban American and Vantage Properties;
- Jamaica, with developers such as Vantage Properties;
- Ft. Greene, with developers such as the Dermot Group; and
- Many other working-class communities throughout New York City.

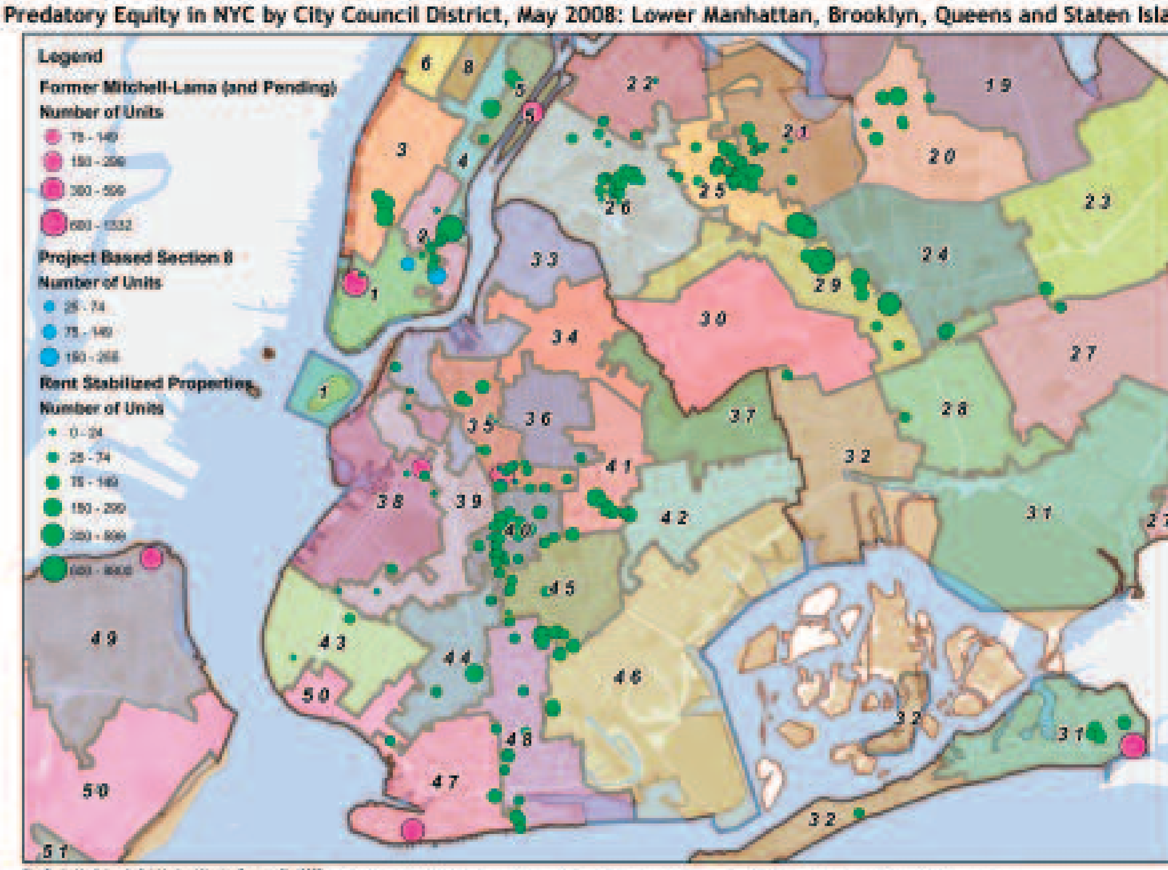
Documenting the Harassment

The most common form of harassment included bringing repeated, baseless legal actions against the tenant in Housing Court. In Housing Court, it is estimated that 90 percent of tenants do not have a lawyer, while 90 percent of landlords have legal representation. Tenants can thus be intimidated into signing away their rights without cause or making a procedural error that costs them their apartment. This intimidation strategy relied on the quantity, not quality, of legal actions filed. Research by community groups suggests that an aggressive landlord who brings baseless legal actions against 10 tenants can expect four to sign away their rights. This strategy was especially effective in buildings with an immigrant population. Combined with denial of repairs and basic servic-

Predatory Equity in NYC by City Council District, May 2008: The Bronx and Upper Manhattan



Predatory Equity in NYC by City Council District, May 2008: Lower Manhattan, Brooklyn, Queens and Staten Island



In a typical Queens building, there was a 23 percent turnover rate in the one year after Vantage bought the portfolio, driven by a Housing Court strategy employing baseless and frivolous cases to harass tenants.

es, aggressive buyout offers, threats to call the immigration authorities and numerous other tactics, this strategy was very effective in forcing low- and moderate -income families out of their apartments.

In early 2008, community advocates conducted door-to-door research in some of the buildings where they suspected that systematic harassment was taking place. Advocates looked for two indicators of harassment:

- An “unnatural” tenant turnover rate under the new landlord that is in excess of the 5.6 percent turnover rate that Housing and Vacancy Survey (HVS) data shows is the expected annual turnover for apartments renting for less than $800, which is an affordable rent for households earning $32,000.[1]”
- Specific experiences of harassment by current tenants, such as repeated baseless legal actions, lack of repairs and services, and repeated aggressive buy-out offers.

The results of the survey were striking in predatory equity-owned buildings across the city. Some particularly egregious examples of harassment were documented in buildings owned by Vantage Properties, a private equity developer backed by Apollo C apital and Credit Suisse. In the past few years, Vantage and their private equity partners purchased over 9,500 units of affordable, rent-regulated housing in Queens, Harlem and Upper Manhattan. Door-to-door surveys and other research found that Vantage engaged in a systematic pattern of harassment, primarily using the tactic of filing repeated, baseless cases in housing court.

In one portfolio of its buildings in Queens, Vantage brought 965 separate court proceedings against 2,124 apartments in the 16 months after it bought the building, suing almost one in every two tenants. This is a remarkable number, especially compared to just 50 court proceedings brought by the prior owner in the year before he sold the buildings to Vantage. In fact, Vantage filed so many eviction cases in Queens that it often monopolized one entire courtroom in Queens Housing Court for its exclusive use.

Door-to-door surveys of tenants living in Vantage buildings in Sunnyside, Queens, and Washington Heights, Manhattan, showed:

- In a typical Queens building, there was a 23 percent turnover rate in the one year after Vantage bought the portfolio, driven by a Housing C ourt strategy employing baseless and frivolous cases to harass tenants;

- In a typical Washington Heights building, 12 percent of the apartments were recaptured within nine months of Vantage’s purchase of the building. Of the tenants who remained at the time the survey was conducted, 25 percent were experiencing harassment, including 12 percent who were facing baseless and frivolous legal cases.

Harassment strategies used by Vantage in one Queens building included:

- In the most common examples of harassment, tenants received notices canceling their leases, claiming that they were illegally subletting their apartments, even though the tenants had lived in these apartments, and no where else, for years;

- Other tenants were sued multiple times for unpaid rent despite having fully paid with money orders. Although the tenants are able to prove in Housing Court that they have paid the rent in full, Vantage was often not deterred and sued them again a few months later;

- Vantage falsely claimed that the tenants had never paid their original security deposits, even though most of the tenants had been in the building for decades. Vantage often used this claim to say that the tenants owed back rent, giving Vantage an excuse to not cash any of the tenants' current rent payments because they were not "full payment." Vantage then took the tenants to court for many months' unpaid rent, even though the rent was unpaid because Vantage itself had refused to cash the checks.

Tenants in Vantage-owned buildings filed a class action lawsuit in New York State Supreme Court alleging illegal harassment under Local Law 7 (Aguaiza v . Vantage Properties LLC, Index # 8105197/08) Although the case has not yet been adjudicated, the judge hearing the case recently ruled that the acts alleged by the tenants constituted harassment and the case should go forward.

The fact that this harassment is rooted in a systematic business model is made clear in a prospectus filed with the SEC as part of a mortgage-backed security offering for a group of buildings in Washington Heights that Vantage Properties purchased in 2007.

Community advocates conducted similar door-to-door surveys and other research in buildings owned by Normandy Partners in the Bronx; Westbrook Partners in the Lower East Side; The Dermot Company in Ft. Greene, Brooklyn; the Dawnay Day Group in East Harlem; and the Pinnacle Group in Harlem. In each case, the surveys found an extraordinary high rate of eviction, and specific strategies of harassment that were similar to those used in the Vantage buildings.

In March 2008, in part as a response to the epidemic of harassment, Mayor Bloomberg signed Local Law 7, "The Tenant Protection Act," which gives tenants a *right of action* to claim harassment in Housing Court when the landlord has engaged in activities that cause or are intended to cause tenants to give up their legal rights or vacate their apartments. The new law specifically includes bringing repeated, baseless court proceedings and denying repairs and services as prohibited forms of harassment. This definition of illegal harassment has long existed in New York State law, but prior to the passage of Local Law 7, tenants did not have a right to raise the issue in Housing Court.

Evidence of Harassment as a Business Model

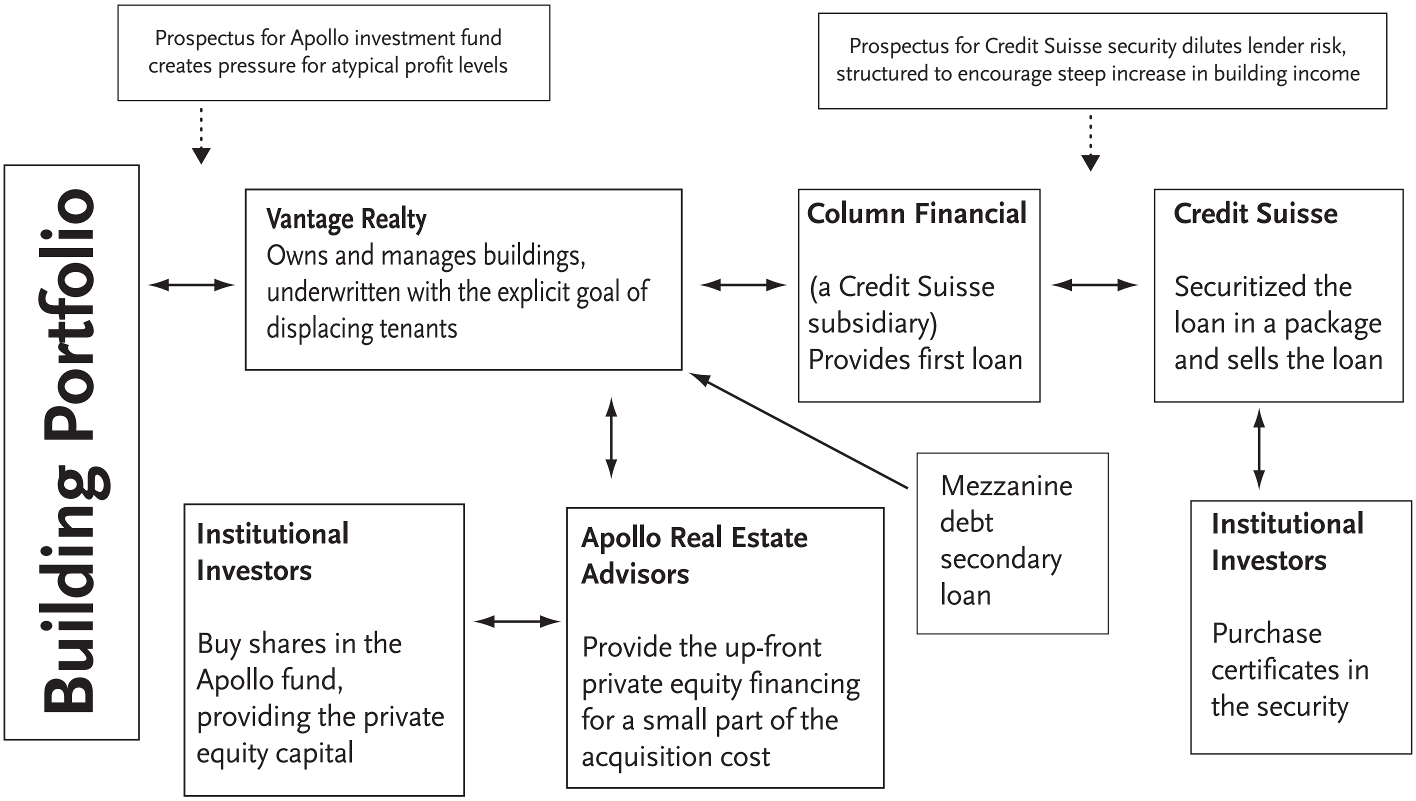
The fact that this harassment is rooted in a systematic business model is made clear in a prospectus filed with the Securities and Exchange Commission (SEC) as part of a mortgage-backed security offering for a group of buildings in Washington Heights that Vantage Properties purchased in 2007. This deal, known as the Broadway Portfolio, was financed by private equity partner Apollo Real Estate Advisors, and had a primary mortgage from Column Financial (a subsidiary of Credit Suisse). In the prospectus, the underwriting terms state that the owner would be able to pay the high debt-service costs because:

"The sponsors plan to improve the subject's performance by making capital improvements to individual units as the leases expire and raising rents to market levels. The borrower anticipates to recapture approximately 20-30% of the units [within the first year], and 10% a year thereafter[2]"

This is a clear statement of harassment because in rent-regulated buildings tenants have a right to renew their leases, and rents on occupied apartments can only be raised by a limited amount. The rent on a vacant apartment, however, can be increased dramatically. These 20 to 30 percent apartment recapture targets should be unattainable because only 1 percent of the apartments in these buildings were vacant at the time the loan was made, according to SEC documents, and the annual turnover rate for apartmentsrenting at less than $800 is only 5.6 percent, according to HVS data obtained from the Rent Guidelines Board.

Anatomy of a Deal

Why Private Equity-Backed and Securitized Deals Threaten Tenants and Affordable Housing



Without an aggressive and explicit strategy of harassment to push tenants out, the numbers simply do not work. The attached flow-chart *Anatomy of a Deal* illustrates the structure and problems of a typical predatory equity deal; in this case, one involving Vantage/Apollo/Credit Suisse.

These underwriting terms, and the systematic harassment they compel, were typical in financing and mortgages of predatory equity deals. The principal mortgage loan was packaged into a mortgage-backed security for about 30 percent of the 100,000 private equity-backed units that advocates are tracking. ANHD analyzed the underwriting terms for each of the mortgage-backed securities, and two things are clear from our analysis of the loan underwriting terms:

1. These risky loans were underwritten outside industry standards, including reliance on inflated income projections based on unnaturally high tenant turnover projections, use of high-cost and short-term balloon financing, layered excessive mezzanine debt, overly aggressive appraisals, and understatement of the buildings' maintenance and operating costs. (See Section II of this report for a full discussion of these issues).

2. All of the term sheets specifically state or imply that, in order to be able to make the debt service payments, the landlords would have to push out a significant percentage of the current regulated tenants so they could be replaced with tenants paying higher rents.

Vantage was unusual in specifically stating their tenant turnover goal in plain English in their underwriting documents. But when ANHD examined the SEC-filed underwriting term sheets for 10 other major predatory equity portfolio loans, we found clear indications of similar plans to force a high tenant turnover rate. In each case, mortgage loans were taken out with high debt beyond the buildings' capacity to support those payments. The underwriting terms for each loan explicitly projected a growth in rental income that would, over a few years, quickly rise to meet the debt service costs. Given the predictability of increases under rent regulation, we were able to analyze what the tenant turnover rate would have to be in order to meet the projected growth in rental income. For example:

- The underwriting in a loan for the Riverton building in Harlem owned by Stellar management and Larry Gluck assumed a 20 percent tenant turnover rate in the first year;
- The underwriting for the Esquire Portfolio of buildings in Washington Heights owned by Vantage assumed a 30 percent tenant turnover in the first year;
- The underwriting for Stuyvesant Town/Peter Cooper Village, owned by Tishman Speyer, assumed a 33 percent tenant turnover rate;
- The underwriting for a portfolio of buildings in Upper Manhattan owned by the Pinnacle Group assumed a 30 percent tenant turnover rate.

The Role of Mortgage-Backed Securities

One factor in the predatory equity model is resale by banks of the mortgages for the properties through investment instruments called mortgage-backed securities. This process is called *securitization*, and refers to the process by which a mortgage lender sells a mortgage to an underwriter, usually an investment bank, that bundles together a large group of mortgages and sells certificates in that group of mortgages to investors. Although ANHD is focusing on the role of securitization in destabilizing New York City's affordable rental housing, securitization has recently become infamous because it lies at the heart of the current subprime lending crisis that is costing so many small homeowners their homes and has driven the economy into recession.

To understand how securitization works and why it led to the subprime crisis, take the small-home lender Countrywide Financial as an example. Countrywide (which nearly went bankrupt last year) was a major player in the subprime mortgage market. As a lender, it was in its interest to make as many subprime loans as possible because subprime loans are very profitable, paying the lender high fees up front. However, Countrywide's desire to make highly profitable, but risky subprime loans should have been be tempered by its fear of those loans going bad. No lender, not even Countrywide, wants to be holding nonpaying loans. But through securitization, Countrywide worked with an investment bank to bundle the loans into an investment security and sell certificates in that security to investors. This allowed Countrywide to immediately recoup the value of the loan, while passing the risk that the loan would not be paid to the investor who bought the security. In this way, securitization threw off the balance of greed and risk that should keep a lender from encouraging unstable and risky loans.

The destruction created in the U.S. and world economy by *single-family* residential subprime loans and the investment instruments backed by those loans is now well understood. Lenders made expensive loans based on unjustified assumptions or outright falsehoods about the borrowers' ability to repay the loans. Borrowers are now defaulting at a rate that threatens the future of countless families and communities. Lenders sold those loans to back various investment instruments, including residential mortgage-backed securities and other collateralized debt obligations, in order to raise more capital to lend and to hedge the risk of aggressive lending. This has turned out to be a failure of historic proportions. Rather then hedging risk, the multiple layers of mortgage-backed securities, collateralized debt obligations, credit default swaps and other complex financial instruments spread the risk around like a virus. When mortgage default rates rose beyond analysts' expectations, investors who bought any of the multiple layers of the instruments lost billions and credit markets collapsed.

In the case of private equity investment in New York's *multifamily* rental housing, securitizing loans encouraged many financial institutions to do highly risky lending that was either predicated on harassment or financially unsupportable. This practice was both destructive to the buildings and dangerous to investors who bought into the securities.

In the case of private equity investment in New York's *multifamily* rental housing, securitizing loans encouraged many financial institutions to do highly risky lending that was either predicated on harassment or financially unsupportable.

Section II – The Default Crisis: Predatory Equity Underwriting Unravels

As with the single-family home residential subprime crisis, the speculative nature of the multifamily building predatory equity investment model is proving highly unstable, and a default crisis of predatory equity mortgages is poised to further undermine affordable housing and communities throughout New York City.

ANHD has analyzed the underwriting terms and actual performance of 10 major predatory equity portfolio loans that were packaged into commercial mortgage-backed securities. Because the loans were securitized, the borrower is required to report revenue, expenses and vacancies to their loan servicer, and this information is tracked by the loan servicer against the underwriting assumptions stated in the prospectus filed with the Securities and Exchange Commission. The loan servicer information is published in an industry data service called Trepp. Access to these Trepp loan servicer reports has allowed ANHD to determine whether a loan is performing and meeting its underwriting targets. The servicer reports also indicate if the servicer has placed the loan on a "default watchlist" because the underwriting and performance of the loan indicates that it may be approaching default.

The results of ANHD's analysis are dramatic. We found that as of June 2009, a remarkable 10 out of 10 predatory equity loans that we are closely tracking were either on a finance industry watchlist as in danger of default, in workout with a finance industry loan servicer for being in danger of default, or actually in default. This compared to a watchlist average of 20 percent of all other loans that were pooled in commercial mortgage-backed securities in the same year.[3] This makes predatory equity loans far more likely to be on a default watchlist than other commercial loans in the same security pool.

Another dramatic indicator of default danger is the *debt service coverage ratio*, the ratio of building income available to pay the debt owed on the building. Analysis by ANHD of loan servicer reports reveals that as of December 2008, the average debt service coverage ratio of predatory equity financing is .55/1. This means that only 55 cents in income is available for every dollar of debt owed.

ANHD only has access to detailed underwriting and servicer's watch list information for the predatory equity loans that were pooled into securities, covering 27,000 affordable rental units. Available loan information suggests, however, that the financing model is similar among most of the 100,000 rental units that we classify as having been purchased by predatory equity developers.

This default crisis is likely to have a destructive, destabilizing effect on tenants, affordable housing and communities in New York City. When an owner defaults on financing, a property typically falls into physical distress. These distressed projects in turn depress the block where they are located and the neighborhoods in which they are concentrated. Another very real consequence of a default crisis is that local real estate lending markets will be destabilized, with financial institutions unwilling to make the healthy investments that are necessary in affordable rental housing. Investors in collateralized debt obligations will also be affected if the default rate of predatory equity loans is high enough and if the commercial mortgage-backed securities that they back are highly exposed. Although this scenario has been disastrous in the subprime single-family home loan market, it is not yet clear what will occur in the multifamily building loan market.

> The danger of default in these predatory equity loans was not an unforeseeable accident.

The danger of default in these predatory equity loans was not an unforeseeable accident. As in the single-family home subprime crisis, these loans would not have been made if long-accepted underwriting standards had not been ignored by a chain of parties, including the developer, the private equity partner, the first loan lender, the mezzanine debt lender, the security pool underwriter and the credit rating agency.

ANHD examined the underwriting for 10 rent-stabilized multifamily residential building portfolios, covering over 27,000 apartments, that were purchased by private equity firms and financed with mortgages that were subsequently securitized in commercial mortgage-backed securities. This underwriting information divulges financing terms and underwriting assumptions that cannot be obtained from public records for non-securitized loans. These securitized loans have many similarities:

- **Inflating Income Projections:** Projected income was based on wildly aggressive tenant turnover assumptions, not actual income, and was used to justify inflated loan amounts. The growth in rental income from a well-managed rent-regulated building should be expected to rise in a steady, but moderate line because leases under rent regulation must be renewed and rents can only be increased by a moderate amount with each lease renewal. Although dramatic increases in rent can be taken on vacant apartments, the average annual turnover rate for tenants in affordable rent-regulated apartments averages 5.6 percent a year, which does not translate to the huge jump in rental income that speculative purchasers need to satisfy their debt obligations. All the predatory equity mortgage underwriting that ANHD examined posits a substantial increase in operating income that will support repaying the interest on the project financing. All have substantial debt service reserves that are intended to cover the interest shortfall while the portfolio is transitioned to a higher-income building with higher rents, as well as capital improvement reserves. All the owners state that they will achieve these higher rents by pushing a high tenant turnover rate in order to raise rents through the Individual Apartment Improvement Program and Major Capital Improvement Program.

- **Relying on Balloon Short-Term Financing:** None of the loans used to purchase these buildings amortize any of the purchase price, and most have terms of five or seven years. Reliance on 100 percent non-amortizing debt, while often seen in commercial and coop conversion loans, has not, until recently, been common practice in residential loans. Non-amortizing debt supports inflated pricing of real estate.

- **Using Mezzanine Debt:** Mezzanine debt is unsecured, non-amortizing "subordinate" debt that has a higher interest rate than the first position loan. Hedge funds and private equity funds are typical lenders. In almost every deal analyzed, mezzanine debt was used as operating support to paper over the fact that the property could not sustain its own costs, or to allow the developer to take out profits from nonperforming deals.

- **Using Aggressive Appraisals:** The appraised values presented in the underwriting information are often questionable. Appraisers use a combination of comparable sales, replacement values and multiples of gross income (Gross Rent Multiplier) to derive estimates of current market value. In many of these loans, the Gross Rent Multiplier is excessively high.

- **Understating the costs of Maintaining and Operating Buildings.** In many of the projects, reported or imputed operating costs were deceptively low and bore little relation to the reality of operating multifamily rental housing in New York City.

Analyzing the Default Risk of Specific Predatory Equity Deals

In the following Default Risk Summary Chart, ANHD analyzes five critical indicators of speculative underwriting and financial distress for each of the 10 major portfolio loans:

1. Was the loan reasonable at underwriting?
    a. *What was the appraised value at sale of the building?* Standard underwriting practice in New Y ork City suggests that the value of the building should be no more then 10 times the building's income. That income is determined by the building's rent roll, a number called the "gross rent multiplier ." A gross rent multiplier of more then 10 indicates an overly frothy appraisal.

    b. *What is the relationship between building income and building debt?* In standard underwriting, there should be at least one dollar in income for every dollar of debt owed. This relationship is called the "debt service coverage ratio." A debt service coverage ratio at underwriting of less then 1/1 indicates that the loan was based on speculative assumptions.

2. Were the underwriting assumptions honest?
    a. *How did the building's projected rental income when the loan was underwritten compare to the actual rental income once the owner was actually managing the building?* In many cases, the owner grossly overestimated income at underwriting, which can put enormous stress on the building's finances and place the loan in danger of default.

    b. *How did the building's projected operating expenses when the loan was underwritten compare to the operating expenses once the owner was actually managing the building?* In many cases, the owner grossly underestimated expenses at underwriting, which can put enormous stress on the building's finances and place the loan in danger of default.

3. How is the loan currently performing according to the loan servicer?
    a. What *is the actual debt service coverage ratio?* Is it less then 1/1? For this critical metric, ANHD is comparing six-month loan servicer reports from June 2008 and December 2008 to show the trend of debt service coverage ratio over a year. Astonishingly, the average debt service coverage ratio in June 2008 was .71/1, and in December 2008 was .55/1. That is, on average for these 10 portfolio loans, there was 55 cents in income available for every dollar of debt owed.

    a. *Is the building on the loan servicer's default watchlist?* An astounding 10 out of 10 of these loans have been placed on a default watchlist by the loan servicer, are in default workout with the loan servicer, or are actually in default. Extrapolating from these 10 loans to the full universe of predatory equity buildings suggests that as many as 100,000 units of affordable rental housing bought by predatory equity developers may be at risk of financial default.

Predatory Equity Default Risk

Portfolio Information	Queens Multifamily Portfolio	Savoy Park	Broadway Portfolio	Esquire Portfolio	Three Borough Portfolio
Residential Dwelling Units	2,124	1,802	455	214	1,646
Neighborhood	11 submarkets of Queens	Harlem	Washington Heights Manhattan	Hamilton Heights Manhattan	Manhattan, Bronx & Queens
Owner	Vantage/Apollo	Vantage/Apollo	Vantage/Apollo	Vantage/Apollo	Westbrook, Normandy, and others
Lender	Column Financial	Column Financial	Column Financial	Column Financial	Barclays Capital
Underwriter	Credit Suisse, etc.	Credit Suisse, etc.	Credit Suisse, etc.	Credit Suisse, etc.	Wachovia
Master Servicer	Key Corp	CapMark	Key Corp	KeyBank, Wachovia, and others	Wachovia
Special Servicer	LNR Partners, Inc.	Midland	ING Clarion Ptrs, LLC	ING Clarion Ptrs, LLC	LNR Partners, Inc.
I. Was Loan Reasonable?					
Appraised Value Per Dwelling Unit	$142,797	$233,074	$241,099	$196,729	$96,233
Gross Rent Multiplier	13.05	24. 37	26. 72	19. 54	9.32
Debt Service Coverage Ratio at Purchase (Primary Mortgage Only)	1.06	0.60	0.57	0.54	1.15
II. Were Underwriting Assumptions Honest?					
Underwritten Revenues (per Dwelling Unit per Month)	$825	$1,323	$1,741	$1,976	$910
Last Reported Revenues (per Dwelling Unit per Month)	$989	$857	$1,049	$893	$0
Underwritten Expenses - total	$9,020,053	$9,027,067	$3,388,038	$1,651,084	$7,489,818
Underwritten Expenses (per Dwelling Unit per Month)	$354	$417	$621	$643	$379
Last Reported Expenses (per Dwelling Unit per Month)	$629	$488	$678	$794	Not available
III. Performance Report Data					
Net Operating Income - 06/08	$23,653,849	$4,288,698	$1,589,953	$684,167	$10,068,950
Debt Service Coverage Ratio (Primary mortgage only) - 06/08	1.68	0.33	0.28	0.41	Not Available
Net Operating Income - 11/08	$8,185,160	7,528,260	$1,908,604	$1,813,632	
Debt Service Coverage Ratio (Primary mortgage only) - 11/08	0.69	0.57	0.43	0.11	0.66 (as of 06/09)
Loan Servicer Status	Watchlisted - 11/08	Watchlisted - 04/08	Watchlisted - 10/08	Watchlisted - 07/08	Watchlisted – 02/09
IV. Reserve Status Trend	Much worse	Toward default, but stabilizing	Toward default	Toward default	Probably OK
V. Time Remaining to Default "BURN RATE"	Only 26% of Debt Service Reserve remaining, but likely to stabilize	Debt Service Reserve likely depleted. Should default in 2009	13% of Debt Service Reserve reported remaining, but ANHD analysis indicates it is likely gone. Should default in 2009	35% of Debt Service Reserve reported remaining, but ANHD analysis indicates it is likely gone. Should default in 2009.	Little information is available

Portfolio Information	Riverton Apartments	Manhattan Apartment Portfolio/Pinnacle	NYC Portfolio Roll-up Dawney Day	Mayberry	Peter Cooper Village & Stuyvesant Town
Residential Dwelling Units	1,230	1,083	1,142	180	11,227
Neighborhood	Harlem	East Harlem	East Harlem	Upper East Side	East Side
Owner	Gluck & Rockport Group	Pinnacle / Praedium Group	Dawnay Day	Atlas, Goldberger & A. Cohen	Tishman Speyer, Blackrock
Lender	German American	German American	La Salle	Column Financial	Multiple
Underwriter	Citigroup, etc.	GE Cap Corp	La Salle, Morg Stan, and others	Credit Suisse, etc.	Multiple
Master Servicer	Midland	Key Corp	Capmark Finance	KeyBank/Wachovia, etc.	Wachovia
Special Servicer	CWCapital Asset	LNR Partners, Inc.	Centerline Servicing	ING Clarion Ptrs, LLC	CW Capital Asst Mgmt
I. Was Loan Reasonable?					
Appraised Value Per Dwelling Unit	$96,233	$142,797	$233,074	$241,099	$196,729
Gross Rent Multiplier	19. 70	22.14	18.76	25.53	23.48
Debt Service Coverage Ratio at Purchase (Primary Mortgage Only)	0.39	0.42	N/A	0.50	0.58
II. Were Underwriting Assumptions Honest?					
Underwritten Revenues (per Dwelling Unit per Month)	$825	$1,323	$1,741	$1,976	$910
Last Reported Revenues (per Dwelling Unit per Month)	$989	$857	$1,049	$893	$0
Underwritten Expenses - total	$9,021,766	$6,489,037	$5,588,797	$2,767,091	$145,569,012
Underwritten Expenses (per Dwelling Unit per Month)	$611	$499	$408	$1,281	$1,080
Last Reported Expenses (per Dwelling Unit per Month)	$629	$488	$678	$794	N/A
III. Performance Report Data					
Net Operating Income - 11/08	$3,846,361	$5,179,007	N/A	$3,097,396	$106,024,910
Debt Service Coverage Ratio (Primary mortgage only) - 06/08	0.28	0.40	N/A	0.62	0.55
Net Operating Income - 11/08	4,031,421	N/A	$10,009,575	$1,971,269	$132,413,333
Debt Service Coverage Ratio (Primary mortgage only) - 11/08	0.29	0.35	0.87	0.39	0.67
Loan Servicer Status	In Default	Watchlisted - 12/07	Off Watchlist to Spec. Servicer	Off Watchlist to Spec. Servicer	Watchlisted - 04/08
IV. Reserve Status Trend	Little information, likely heading toward default	Getting worse	Getting worse	Toward default	Restructuring ahead
V. Time Remaining to Default "BURN RATE"	Little information reported. Rumored near default	Collateral Reserve balance almost depleted. Should default in 2009	Reserve balances not reported. Dawney Day has folded.	Reserve balance not reported.	Stabilizing, but still depleting reserves at a rapid rate

4. What is the status of the operating reserve and debt service reserve?
    a. *Are the reserve funds being used up at a faster rate then expected?* Because the underwriting assumptions were so aggressive, these buildings took on large amounts of extra debt to act as a reserve fund for operating expenses and debt service payments. But, that reserve is not unlimited. F or eight of the 10 loans, the reserve funds are being used up far too quickly .

5. What is the "burn rate" of the debt and operating reserve?
    a. *How much time is remaining before the reserves are fully used up and the loan is likely to go into default?*

One example of speculative underwriting assumptions based on tenant harassment and current financial distress is The Manhattan Apartment Portfolio deal, which covers 1,083 apartments in Harlem and is owned by the developer The Pinnacle Group. This deal had private equity backing from The Praedium Group, a first mortgage loan from German American Bank, and was pooled into a mortgage-backed security underwritten by GE C apital Corporation. ANHD's analysis reveals the following:

1. Was the Pinnacle loan reasonable at underwriting?
    a. The appraised value of the buildings was based on a gross rent multiplier of 22.14, far in excess of the industry standard of 10.

    b. At the moment the mortgage was underwritten, the debt service coverage ratio (the amount of build - ing income available to pay debt service costs) was a dangerously low .42/1, although this number was projected to rise as high tenant turnover enabled the owner to quickly raise rents.

2. Were the underwriting assumptions for the Pinnacle loan honest?
    a. The buildings' finances have performed far below what was projected at underwriting. A verage rents were supposed to rise to $1,884 as thee buildings "transitioned" to market rate, but as of December 2008, average rents were only $948.

    b. Operating costs were projected at $499 month per apartment, but as of December 2008, the average per-apartment monthly operating cost was $599.

3. How is the Pinnacle loan currently performing according to the loan servicer?
    a. In June 2008, the loan servicer reported that the buildings had a debt service coverage ratio of .40/1. That is, only 40 cents of income was available to pay every dollar of debt owed. By December 2008, the debt service coverage ratio had fallen to .35/1.

    b. The loan covering these buildings was placed on a default watchlist by the loan servicer in December 2008.

4. What is the status of Pinnacle's operating reserve and debt service reserve?
    a. Because of the above indicators, the debt service reserve and operating reserve are being used up at a far faster rate then anticipated when the loan was underwritten.

5. What is the "burn rate" of Pinnacle's debt and operating reserve?
    a. The debt service and operating reserves are likely to be used up by the end of 2009, and the loan is likely to go into default.

Stuyvesant Town and the Role of the Credit Rating Agencies

There is a long chain of responsibility for the predatory equity crisis, including the developer , the private equity partner, the first loan lender, the mezzanine debt lender, and the security pool underwriter. One additional responsible party stands out – the investment rating agency . The three major credit rating agencies – Standard and Poor's, Fitch, and Moody's – play a central role in creating marketable investments by offering an "objective" analysis of the credit worthiness of the investment. Most importantly, the credit rating agencies are supposed to determine for investors whether the investment is "credit-grade" (rated on a scale from AAA to BBB), or "speculative" (rated below BBB). The failure of the credit rating agencies to behave responsibly in the lead-up to the single-family residential subprime crisis is now well understood. A recent, scathing report by the Securities and Exchange Commission states, "The rating agencies' performance in rating these [residential subprime] structured finance products raises questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole."[4]

Few of these assumptions were realistic when the deal was underwritten, even in the most optimistic market conditions, making the deal speculative and raising serious questions about the "investment grade" BBB-rating.

We believe this assessment may be equally true for the commercial lending markets. A prime example is the rating for the high-profile $5.4 billion deal for Stuyvesant Town-Peter Cooper Village, an 11,000 unit housing complex on Manhattan's East Side. The finances for this deal were rated BBB- by Standard & Poor's and Moody's, declaring the deal "investment-grade."

ANHD analysis of the Stuyvesant Town-Peter Cooper Village deal suggests, however , that it was clearly speculative and based on unsustainable assumptions, including:

- The housing complex was assessed with a gross rent multiplier of 23.48, more then double the underwriting standard gross rent multiplier of 10;

- The debt service coverage ratio at underwriting was .58/1, but this number was planned to quickly rise to a more acceptable level as the new owner raised rents by driving rapid tenant turnover in the lower-rent apartments;

- Owner Tishman-Speyer and their lenders projected at underwriting that approximately 3,000 rent-regulated units would be deregulated within five years, a 33 percent tenant turnover rate that could only be achieved using illegal harassment;

- The complex has not performing as planned. Tishman-Speyer projected average rents of $3,576 as rents rose to market level because of high tenant turnover; however , turnover and the market have lagged, and as of the last loan servicer reporting, the average rents were only $2,058. Operating expanses for the building have also been higher then projected.

- In June 2008, the loans for Stuyvesant Town/Peter Cooper Village were placed on the default watchlist by the loan servicer, primarily because the debt service coverage ratio had fallen to .55/1. In December 2008, the housing complex was kept on the watchlist by the loan servicer because the debt service coverage ratio had only risen to .67/1, far less of a rise then needed to sustain the debt service payments.

Few of these assumptions were realistic when the deal was underwritten, even in the most optimistic market conditions, making the deal speculative and raising serious questions about the "investment grade" BBB-rating.

The finances of the deal are actually performing terribly, as should have been expected if the developer, lenders and credit rating agencies involved had followed acceptable underwriting standards. A May 2009 research report by Bank of America/Merrill Lynch analyzing the state of the financing for Stuyvesant Town/Peter Cooper Village finds:

> *"As of April 27, 2009, the replacement reserve and debt service reserve was essentially depleted. The only remaining reserve is the debt service reserve…The total reserve burn was faster during the last part of 2009 with reserves paying down faster than $21 million a month. Even if we assume a debt service burn rate of $15 million per month the reserve would be depleted by November 2009.[5]"*

The other predatory equity deals we have examined do not have an individual rating for the loan (called a "shadow rating"). Instead, only the loan pool as a whole is rated. In each case, the loan security pool was given an AAA rating. Any danger to the investor in the security was expected to be hedged by various forms of "credit enhancements" that are structured into the security pool. These credit enhancements included tranching and over-collateralization. These same types of credit enhancements were expected to shield investors from losses in single-family home loan-based investments, but failed when the loan default rate exceeded the levels that had been initially projected by the rating agencies. The projected default rate of the predatory equity loans and the failure of the agencies to accurately rate the Stuyvesant Town-Peter Cooper Village deal may well present a similar danger in the multifamily building loan market, calling the role of the credit rating agencies into serious question.

Section III – The Crisis Continued: Vulture Investors and Banks Maintain the Speculative Investment Model

The predatory equity model in New York City is now entering a new phase as banks decide how they will deleverage these financially unsustainable deals. The banks will determine whether to continue the speculative model or restructure the deals in a way that is healthy for affordable housing and communities. Unfortunately, there is reason for concern.

ANHD research of industry news sources suggests that, as of the writing of this report:

- Banks and mortgage-backed security underwriters are aware that they have grossly overleveraged predatory equity deals, and that some form of de-leveraging must take place;

- A number of distressed-asset investment funds, better known as vulture funds, have been set up and capitalized specifically to take advantage of investment opportunities in New York City multifamily housing as banks sell off predatory equity debt and assets at a discount;

- These vulture funds are continuing the speculative investment model, and while they expect to be able to purchase properties and debt at less then their current face value, they also expect to quickly raise building income to achieve unusually high profits by pushing out existing tenants.

- There has been relatively little actual transfer of buildings or debt to vulture funds as of the writing of this report because banks are trying to establish the actual market value of the buildings and loans, being careful not to sell for less than the assets might shortly be worth if the real estate market recovers;

- The banks may also have an incentive to favor restructuring the debt with the existing predatory equity owner because the current market crisis may seem so bad that their best option is remain with the current building owner by extending the terms of the financing. The banks' hope would be, as one analyst put it, to "gun the engine and hope they can jump far enough to make it to the other side of the economic chasm:"

- Another reason for the slowness of the deleveraging may be that Treasury Department policy is encouraging banks to keep the loans on their books without restructuring the debt because holding on to distressed debt allows the banks to maintain the appearance of value. Once the debt is sold or restructured, the bank's books must be adjusted down and investors and government regulators informed of the loss of value. This same problem seems to be responsible for slowing the rate at which banks are restructuring single-family home mortgages that are approaching default;

- There is cause for great concern because some properties that have been deleveraged demonstrate that, even as debt is being reduced, a speculative investment model is being continued. While the 2005-2008 model of grossly overleveraging rent-regulated buildings may be on the wane, there is evidence that the crisis is being continued by a new group of speculative investors who are less overleveraged, but are nonetheless using a speculative investment model based on high tenant turnover and harassment.

One example of this new speculative wave is the Orbach Group, which recently purchased debt held by Deutsche Bank on a highly overleveraged portfolio of buildings owned by the well-known predatory equity developer The Pinnacle Group. In this case, Deutsche Bank sold the loan to Orbach in a whole-note sale. Evidence gathered by legal services attorneys working in a different portfolio of buildings owned by the Orbach Group suggests that Orbach has a history of acting as a predatory equity developer, engaging in a campaign of harassment and displacement in order to achieve high tenant turnover.

In 2005, a partnership of the Praedium Group and The Pinnacle Group purchased a portfolio of 22 rent-regulated apartment buildings on West 109th Street totaling 384 units. In 2007, Deutsche Bank originated a $75 million mortgage for the properties. Pinnacle is well known as a predatory equity investor, with a well-documented history of harassing tenants by filing unsupportable legal papers, such as frivolous court cases, to press tenants, the majority of whom are not represented by counsel, to give up the rights to their apartments. Reporting by the *New York Times* in 2007 revealed that Pinnacle sued a remarkable 40 percent of the tenants within one year of purchasing many of their properties.[6]

While we do not have performance data on the West 109th Street portfolio loan because it is not a mortgage-backed security, a different Pinnacle portfolio loan that is in a commercial mortgage-backed security (The Manhattan Apartment Portfolio) is among the worst performers, with a Debt Service Coverage Ratio of .35/1.

In March, 2009, published reports suggested that Deutsche Bank planned a whole-note sale of the mortgage on the West 109th Street Portfolio to the Orbach Group at a discount of 40 percent of the original value.[7] ANHD has done an underwriting analysis of the West 109th Street portfolio and it is our assessment that a 40 percent discount would leave the building far less overleveraged, although still somewhat in excess of the building's actual income-based value. This suggests that the lender, Deutsche Bank, now has a more realistic model of how rent-regulated buildings in New York City should be underwritten.

However, there are grave concerns about the Orbach Group as purchaser of the mortgage, as evidence suggests that it has a history of managing buildings with the same speculative approach and harassing tactics as the worst of the predatory equity developers. In 2008, the Orbach Group (also know as the Lighthouse Group) purchased and began to manage 13 buildings in the Hell's Kitchen neighborhood of Manhattan. Local tenant organizers and legal service providers have documented that Orbach quickly moved to bring legal action in Housing Court

There must be a pro-active, strategic local government response to this growing crisis that anticipates where the problems will occur and develops the resources and policy tools to deal with the crisis.

against some 37 percent of the rent-regulated tenants. Legal services providers report that many of these cases are frivolous, and clearly designed to intimidate tenants into giving up the legal rights to their apartments. This pattern is consistent with the worst behavior of predatory equity developers.

Another deleveraging that indicates the risk of a continued speculative investment model is a group of buildings in the Bronx owned by the Ocelot Group, with a first mortgage from Deutsche Bank. The Ocelot Group defaulted on the debt and F annie Mae, which had taken most of the debt from Deutsche Bank, was set to foreclose and sell the buildings at auction. Tenant advocates from the Urban Homestead Assistance Board together with the New Y ork Department of Housing Preservation and Development (HPD) were aware that vulture investors were interested in the building portfolio, even though the buildings suffered extremely severe distress because of lack of maintenance. Pressure by advocates and HPD led to a positive outcome in this case, and as of the writing of this report the buildings have been kept away from vulture investors at open public auction. HPD is instead working with F annie Mae to pre-approve a purchaser who will commit to preserving the affordability and physical condition of the buildings.[8]

While the 2005-2008 model of grossly overleveraging rent-regulated buildings may be on the wane, the Orbach purchase indicates that a new model of speculative investment is taking its place. The debt load is lower, but the owner has still purchased the building with an expectation that harassment of tenants, in clear violation of city law, can produce a rapid turnover and outsized profit expectations. If banks continue to deleverage unsupportable predatory equity loans by selling to the highest purchaser, even if that purchaser has a destructive and speculative model, instead of reducing the price of the asset to its true income-based value and selling to a stable, preservation purchaser, affordable housing and communities will continue to suffer.

Section IV – Policy Recommendations for Community and Government Action

This paper suggests that tenants and communities around New York City face a serious crisis stemming from the scale of the predatory equity model and the pending default crisis. New protections and strategies must be put in place to safeguard the tenants, affordable housing, communities and investors who may be damaged. Over the past two years, tenants, community organizers and government officials have developed some strategies that have been successful in countering the destructive impact of predatory equity on tenants and affordable housing:

- Tenant education and organizing by ANHD member groups and others has had a positive impact by giving tenants information and tools to dampen the effectiveness of harassment and slow the rate of tenant displacement.

- Public pressure and legal action has sometimes helped discourage predatory equity owners from engaging in the worst behavior.

- In one important example, concerted pressure by government and community groups successfully encouraged a bank to agree to sell a distressed predatory equity portfolio owned by the Ocelot Group to a preservation purchaser. In this case the holder of the debt, F annie Mae, is a government-sponsored entity that was more susceptible to pressure than an ordinary bank to value the public benefit over their balance sheet in their actions.

There is no silver bullet for the problems that distressed predatory equity deals will cause and no single governmental agency can be responsible for the solution. But there must be a pro-active, strategic local government response to this growing crisis that anticipates where the problems will occur and develops the resources and policy tools to deal with the crisis.

Steps to address the predatory equity harassment and default crisis include:

Enforce Existing Tenant Protections in Strategically Targeted At-Risk Buildings:

- **Educate and Support At-Risk Tenants.** Predatory equity investments are based on the assumption that tenants can be pushed out and rents increased beyond historically reasonable levels, using illegal harassment as the means. The first line of defense must be assisting tenants to understand their rights so they can stay in their homes. Resources must be committed so that community groups can pro-actively reach out to buildings and educate tenants to protect their rights in buildings targeted by a predatory equity investment strategy;

- **Focus Anti-Harassment Enforcement in At-Risk Buildings.** Anti-harassment protections for tenants, including the recently signed Tenant Protection Act (Local Law 7) and state anti-harassment provisions in the Rent Stabilization Code, must be energetically enforced by city and state agencies. The New York City Department of Housing Preservation and Development (HPD) must commit anti-harassment enforcement resources from their litigation unit to pro-actively target predatory equity buildings where the risk of harassment is greatest;

- **Focus Code Enforcement in Affected Buildings.** As buildings with a predatory equity investment strategy begin to face increasing financial pressure, as this white paper suggests they will, tenants will likely face deteriorating conditions as the building owner tries to save money by reducing necessary repairs and services, or as the building is neglected while ownership is in doubt. HPD must commit code enforcement resources, including inspections, litigation and emergency repairs, to help avoid building deterioration. HPD should pro-actively target these buildings before the crisis becomes more severe.

Tighten the 1/40th Rent Increase Loophole that is Central to the Predatory Equity Model:

The specific mechanism that developers use to raise rents on vacant, rent-regulated apartments after the tenant has been moved out is an Individual Apartment Improvement Increase, also known as a 1/40th increase. Under this rule, a landlord is allowed to raise the monthly rent on a vacant apartment by 1/40th of total cost of any improvement made to that apartment, but the loophole is often subject to fraud because it relies entirely on landlord self-certification with no government oversight. This leaves tenants vulnerable and the rules virtually unenforced. The loophole's formula is also excessively generous: instead of providing a reasonable incentive for owners to invest and make improvements, the loophole offers owners a quick and cheap path to take the apartment out of affordability. The New York State Assembly has already passed legislation to tighten the 1/40th loophole and the bill is awaiting action by the State Senate and governor.[11]

Repeal Vacancy De-Control:

The ability of developers to remove apartments from rent regulation when they raise the rent on a vacant apartment to above a $2,000 threshold (vacancy de-control) has been an enormous incentive for illegal harassment, and a central part of the predatory equity financing model. Often combined with a 1/40th rent increase as the actual mechanism to raise the rent above the threshold, vacancy de-control has allowed a speculative financing model to run amuck and fueled the loss of thousands of units of affordable rental housing. Legislation to repeal vacancy de-control has been passed by the New York State Assembly, and is awaiting action by the State Senate and governor.

Create a Preservation Purchase Solution for Buildings at Risk of Default

Many of the multifamily buildings bought by predatory equity developers will fall into financial distress. This will have destructive, destabilizing effect on tenants, affordable housing, and communities in New York City because when an owner defaults on financing, a property very often falls into physical distress, and these distressed projects, in turn, depress the neighborhoods where they are concentrated. V ulture investors may also purchase distressed predatory equity buildings with an explicit strategy of continuing the speculative ownership model, with the harassment that implies, at the expense of tenants rights and affordable housing. Because of these threats, city and state authorities must develop a plan and commit resources to protect this hard-to-replace affordable housing.

A true solution to the crisis must include a public/private strategy to deleverage and preserve affordability by restructuring the building and transferring it to a preservation purchaser . There are a relatively small number of banks and financial institutions that hold the first-position loans, either through origination or underwriting the mortgage-backed security, on the majority of predatory equity buildings that are in danger of default. With political pressure and limited public financing or access to tax abatements, the buildings could be transferred to a preservation purchaser.

There will be no preservation purchase solution at the scale necessary to stabilize our neighborhoods unless the banks are willing to move away from a speculative model and adjust the value of the building and debt down to its true income-based value. If, for example, the bank writes down a loan to 80 cents on the dollar, but the rental income only supports debt at 50 cents on the dollar , the building may continue to deteriorate, with tenants still likely to face harassment or displacement. At that same 80 cents on the dollar, any purchaser will likely employ a speculative ownership model, with all the tenant harassment that implies.

The deleveraging of these building loans and investments will be complicated and unlikely to happen in a uniform manner. The bank that originated the first-position loan may be in the best position to negotiate, given its numerous leverage points. That bank can restructure the loan so the current owner can afford the debt service payments, initiate a foreclosure proceeding on the loan, or write down the value of the loan to an amount that is more sustainable and sell it to a new buyer That bank can also negotiate to reduce the value of the loan and transfer it to a new owner. Mezzanine lenders, in general, are in a junior position in the debt stack and cannot force a transfer of the building or primary debt.

Securitized loans can also be included in this process because the underwriter of a commercial mortgage-backed security generally retains the right to foreclose on or renegotiate the loans. The specific entity that is given acting authority over the mortgage is generally the *special servicer,* but the holder of a particular portion of the security known as the *equity tranch* controls the special servicer. Generally, the underwriting institution holds the equity tranch of the security. The specifics of these relationships are complex and vary in each security. (In this respect, commercial mortgage-backed securities based on multifamily building loans are different then residential mortgage-backed securities based on single-family home mortgages, which are made of an enormous number of loans and where the underwriter may not have immediate control to restructure the debt of any of the mortgage assets in the security.)

A pro-active strategy that seeks deleveraging and transfer of ownership to a preservation purchaser should feature the following:

- Political and community organizing pressure that is applied on those limited number of banks and financial institutions that hold defaulting predatory equity loans, bringing them to the table *before* the building has been transferred to vulture investors or the loan inadequately restructured with the current owner .

- Financing tools that can facilitate quick action by preservation-minded financiers and purchasers.

- The development of a pre-approved list of preservation purchasers, including both for-profit and nonprofit groups.

This strategy should engage each bank or underwriter on an institution-by-institution basis. The strategy must move quickly because it relies on the premise that, because of market conditions, the financial institutions are already expecting to take significant write-downs on many loans, and may therefore be open to taking a slightly deeper loss in return for political gain.

Because bank have, as discussed in Section III, been slow to deleverage the assets and resistant to pressure to consider the impact on the local community in their restructuring of the debt, it is necessary to develop additional tools and strategies to achieve a preservation purchase solution for a meaningful number of at-risk buildings. Some possible new tools include:

- Federal TARP, TARP for Main Street, or Public Private Investment Program funds could be used to provide resources for preservation purchases, or used to purchase predatory equity assets in distressed mortgage-backed securities, with the requirement that the financing require the preservation of the affordable housing and tenants' rights.

- Bank supervision under the Community Reinvestment Act (CRA) could encourage banks to transfer distressed predatory equity assets to preservation purchasers in return for CRA credit.

- A report from the Citizens Housing and Planning Commission proposes that banks could be encouraged to consider preservation transfers of predatory equity assets with the following approach: HPD and HUD could create a list of pre-approved buyers who could then purchase the debt of distressed predatory equity assets for the fair market value, with that value based on current building income and expenses. In order to protect the bank against too great a loss on their balance sheet, an agency such as the the Federal Deposit Insurance Corporation (FDIC) could issue a subordinate note for the difference between the fair market value and the book value of the debt. The bank could then write-down the debt over a 10-year period, in that way reducing the impact of the loss on the bank's balance sheet.[9]

- The Citizens Housing and Planning Commission also proposes changes to New York State foreclosure law that would give a greater ability to protect at-risk predatory equity buildings. These changes include: giving HPD the exclusive right to select receivers (court-appointed managers) for large multifamily buildings in foreclosure, limiting bidders on foreclosed large multifamily buildings to those pre-approved by HPD; and, giving HPD the right to intervene in foreclosure proceedings to monitor building conditions.[10]

While the damage done to the city's affordable housing stock by speculative and predatory lending cannot be undone in some cases, the current decline in market values may allow coordinated intervention and deleveraging to preserve affordability of defaulting predatory equity buildings, with only a very moderate infusion of public resources.

Stronger Regulation of Credit Rating Agencies:

New regulations and oversight must be developed for the credit rating agencies. This new oversight can include more explicit SEC standards or legal action by state law enforcement authorities such as the attorney general to hold the credit rating agencies accountable.

Appendix A
Resources for Combating Predatory Equity

Citywide Policy and Tenant Organizing Support Groups

Association for Neighborhood and Housing Development
212-747-1117 www.anhd.org

Urban Homestead Assistance Board
212-479-3302 www.uhab.org

New York State Tenants and Neighbors
212-608-4320 www.tandn.org

Community Service Society
212-614-5483 www.cssny.org

Citizens Housing and Policy Council
212-286-9214 www.chpcny.org

Neighborhood-Based Tenant Organizing Support Organizations

Lower East Side:

Good Old Lower East Side
212-533-2541 www.goles.org

Cooper Square Committee
212-228-8210 www.coopersquare.org

Upper West Side:

Goddard Riverside Community Center SRO Law Project
212-873-6600 www.goddard.org/srolawproject

Washington Heights:

Mirabal Sisters Community Center
212-234-3002 www.mirabalcenter.org

Northern Manhattan Improvement Corp.
212-822-8300 www.nmic.org

Bronx:

New Settlement Apartments
718-716-8000

North West Bronx Community and Clergy Committee
718-584-0515 www.northwestbronx.org

Queens:

Queens Vantage Tenants Council c/o Catholic Migration Services
347-472-3500

Immigrant Tenant Advocacy Project, Catholic Migration Services
347-472-3500

Chhaya Community Development Corp.
718-478-3848   www.chhayacdc.org

Make the Road New York
718-418-7690   www.maketheroad.org

Woodside on the Move
718-476-8449   www.woodsideonthemove.org

Queens Community House
718-592-5757   www.queenscommunityhouse.org

Centro Hispano Cuzcatlan
718-298-5083   www.chcuzcatlan.org

Brooklyn:

Pratt Area Community Council
718-522-2613   www.prattarea.org

Fifth Avenue Committee
718-237-2017   www.fifthave.org

Flatbush Development Corp.
718-859-4897   www.fdconline.org

Make the Road New York
718-418-7690   www.maketheroad.org

Cypress Hills Local Development Corporation
718-647-2800   www.cypresshills.org

Appendix B

Chart of Major Predatory Equity Deals (non-comprehensive)

Developer	Portfolio Name	Neighborhood(s)
Vantage	Broadway Portfolio	Washington Heights
	Queens Portfolio I - Katz	Flushing, Sunnyside, Rego Park
	Queens Portfolio II - Haros	Jackson Heights, Astoria, Kew Gardens
	Aries Portfolio	Woodhaven, Hollis, Woodside, Elmhurst
	Amsterdam Apartments	Sunnyside, Jackson Heights, Corona
	Savoy Park/Delano	
	Esquire Portfolio	Harlem
	Saxon Hall	Hamilton Heights
		Rego Park
Pinnacle	Manhattan Apartment Portfolio	Washington Heights, Harlem
	Various Large Portfolios	Washington Heights, Harlem, Brooklyn
Normandy Partners	Three Borough Pool	Bronx, Wash. Heights, Harlem, Sunnyside
	East Village Portfolio	East Villiage
Westbrook Partners	East Village	East Villiage
Dawnay, Day Group	New York City Apt. Portfolio	El Barrio
SG2	Various	Bronx, Wash. Heights
Prana Growth Fund	Variou	Washington Heights, Bronx
Dermot	Various	Brooklyn, Astoria
Taconic Investment	Eastchester Heights	Bronx
	Farfield Towers	Brooklyn
Cronus Capital	Upper Manhattan	Upper Manhattan, Harlem
Urban American	Eastchester Heights	
	Tennis Court	Brooklyn
	Prospect Park South/Flatbush	Brooklyn
	Fordham/Manhattan	Bronx, Manhattan
	Kinsbridge, University Heights	Bronx, Manhattan
	5 Large Complexes	Various
Ocelot Holdings	Various	Bronx, Northern Manhattan
Atlas Capital Group	Mayberry House	Upper East Side
Bronstein Properties	Bassuk Portfolio	Brooklyn, Queens
Northbrook Partners	Various	West Village, Upper West Side
Tahl-Propp Equities	Various	Harlem
Tishman-Speyer	Peter Cooper/Stuyvesant Town	Manhattan
Cammeby's International	Various	Brooklyn, Various
Stellar Management	Rivington, Various	Harlem, Various
Tahl-Propp	Various	Harlem, Various
Karasick	Robert Fulton Terrace, various	Harlem, Various

Equity Partner	First Loan	CMBS Underwriter
Apollo	Column/Credit Suisse	Credit Suisse
Apollo	Column	Credit Suisse
Apollo	Prudential	
Apollo	Column	
Apollo	Column	
Apollo	Column	Credit Suisse
Apollo	Column	Credit Suisse
Apollo	Prudential	
Praedium Capital	Column	GE Commercial Mortgage Corp
Praedium Capital	Column	
Vantage - Westbrook	Barclays	Wachovia
Westbrook	Barclays	
Dawnay, Day	Lasalle	Morgan Stanley Capital I
BlackRock Realty	Morgan Stanley	
Canyon/Johnson Funds	NY Community Bank	
ING Clarion		
Apollo		
Perseus Capital	WaMu	
City Investment Fund		
RCG Urban American/		
Ramius Capital Group		
Ocelot Capital	Deutchebank	
Lehman Brothers		Credit Suisse
JP Morgan Investment Management		
Blackrock		
Blackrock,	Various Pari Pasou	Wachovia, Cobalt, Merrill Lynch
Various		
Apollo, various		Royal Bank of Canada
	JP Morgan Chase	

End Notes

[1] Housing and Vacancy Survey (HVS) data that detailed turnover rates for apartments renting at different levels was obtained from the Rent Guidelines Board.

[2] Free Writing Prospectus filed with Securities and Exchange Commission for mortgage-backed security underwritten by Credit Suisse Mortgage Corporation known as CSMC 2007 C2, P. 78.

[3] Commercial Mortgage Alert, July 18, 2008. "Spreads Rise on Deals Flagged by Servicers", p. 10.

[4] *Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies*, United States Securities and Exchange Commission, July, 2008, p. 2.

[5] Bank of America/Merrill Lynch Research Report, "2008 Financials Released for Peter Cooper Village & Stuyvesant Town", May 18, 2009.

[6] New York Times, "As Landlord Grows, So Does Criticism", Timothy Williams, September 3, 2006.

[7] Commercial Mortgage Alert, "Deutsche to Sell Loan at Discount, March 27, 2009.

[8] New York Times, "Struggling Landlord Leaves Repairs Undone", Manny Fernandez and Jennifer 8. Lee, July 14, 2009

[9] *Debt Threat: Saving Multifamily Rental Housing from Zombie Mortgages*, a 2009 report by the Citizens Housing and Planning Council, P. 24.

[10] *Debt Threat: Saving Multifamily Rental Housing from Zombie Mortgages*, a 2009 report by the Citizens Housing and Planning Council, P. 29.

[11] *The $20,000 Stove: How Fraudulent Rent Increases Undermine New York's Affordable rental Housing*, A 2008 report by the Association for Neighborhood and Housing Development.

The Association for Neighborhood and Housing Development

The Association for Neighborhood and Housing Development (ANHD) is a membership organization of New Y ork City not-for-profit neighborhood housing groups. Our mission is to ensure flourishing neighborhoods and decent, affordable housing for all New Yorkers. We pursue this mission by supporting the programs and advancing the priorities of our member organizations engaged in community development and community organizing is low- and moderate-income neighborhoods throughout the city.

We have 98 member organizations composed of CDCs, community organizing groups and supportive housing providers. Our members have successfully rebuilt blighted neighborhoods and have preserved poor and working-class communities as safe and decent places to live. The New Y ork City not-for-profit housing sector has developed over 100,000 units of low-and moderate-income housing; the ANHD membership directly operates over 35,000 units, providing housing for over 100,000 people. In addition to housing programs, our membership has also sponsored exciting and innovative commercial revitalization projects, engaged in workforce development initiatives and obtained substantial improvements in quality of life in the areas of public safety, education, child care, and open spaces for the neighborhood people they serve.

Visit www.anhd.org for more information about ANHD and our Permanent Affordability campaign.

anhd

ASSOCIATION FOR NEIGHBORHOOD & HOUSING DEVELOPMENT, INC.

50 Broad Street, Suite 1125
New York, NY 10004-2376
Tel: 212-747-1117
Fax: 212-747-1114
www.anhd.org