



THE NEXT SUB-PRIME LOAN CRISIS: How Predatory Equity Investment is Undermining New York's Affordable Multi-Family Rental Housing

Summary

- Neighborhoods around New York City have, in recent years, seen a dramatic rise in harassment of tenants as landlords try to remove working families so they can raise the rent. Mayor Bloomberg recently signed a landmark new anti-harassment law, Local Law 7, in part as a response to this problem.
- There is a direct connection between this increase in harassment and the rise of a new type of buyer of New York City real estate. These new buyers are raising money from Wall Street-type funds that create a pressure for profit levels that, in rent regulated buildings, can only be achieved by displacing tenants and undermining affordable rents.
- At the same time, many of the lending institutions that are providing the huge loans for the purchase of these buildings are “securitizing” the loans. This “securitization” is the core issue that led to the sub-prime crisis and is creating a similar destabilization of decent multi-family housing while encouraging investors to engage in very risky deals.
- Both the private-equity funders and the lending institutions are aware, or should be aware, that harassment of tenants is taking place as a result of their financial model.
- Private equity-backed developers have, in the past four years, purchased an estimated 90,000 units of affordable, rent regulated housing. This is a significant percentage of our rent-regulated housing and represents a significant threat to affordable housing and stable communities.
- This over-aggressive private equity, what we are calling “predatory equity”, is undermining the best efforts of New York City and State elected officials to slow the loss of affordable housing, including both private, rent-regulated buildings and publicly-subsidized Mitchell-Lama and Section 8 projects.

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Introduction

Residential real estate in working class neighborhoods has not typically been a competitive investment strategy. However, private equity managers have dramatically changed this landscape as they are able to tap into the world's biggest pools of investment capital and pay unheard of and often speculative prices for New York City apartment buildings occupied by low- and moderate-income tenants. In order to get access to capital and ensure investors are attracted to their fund in the future, they must promise a higher rate of return. Unfortunately, the only way they can deliver on their promise is by using harassing tactics to obtain vacancies in order to raise rents to levels that current tenants cannot afford.

Private equity-backed developers have, in the past four years, purchased an estimated 90,000 units of affordable, rent regulated housing. This is a significant percentage of our rent-regulated housing, and represents a major threat to affordable housing and stable communities. This crisis is most pressing in neighborhoods where there is still a supply of affordable, rental housing, including West Harlem, East Harlem, Washington Heights, the Lower East Side, North and Central Bronx, Sunnyside, Corona, Jamaica, Rego Park, Bedford Stuyvesant, Ft. Greene, and many other communities.

The New Harassment Crisis

The most common form of harassment includes bringing repeated, baseless legal actions against the tenant in housing court. The intention of this approach is to intimidate tenants, 90% of whom are not represented by counsel, into signing away their rights without cause or making a procedural error that causes them to lose their apartment. This strategy relies on the quantity, not quality, of legal actions filed. Our research suggests that an aggressive landlord who brings baseless legal actions against ten tenants can expect four to sign away their rights. This strategy is especially effective in buildings with an immigrant population. This strategy, combined with denial of repairs and basic services, aggressive buy-out offers, threats to call the immigration authorities, and numerous other tactics are very effective in forcing low-income tenants out of their apartments.

This behavior is clearly a violation of City and State law. In March 2008, in part as a response to the epidemic of harassment, Mayor Bloomberg signed Local Law 7, which makes it illegal for an owner to engage in activities that cause, or are intended to cause a tenant to give up their legal rights or vacate their apartment. The new law specifically includes bringing repeated, baseless court proceedings and denying repairs and services as a prohibited form of harassment. This definition of illegal harassment has long existed in New York State law.

In early 2008, community advocates began conducting 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:

- 1) An “unnatural” turnover rate under the new landlord, understanding that data from the New York City Rent Guidelines Board suggests that the “natural” turnover rate should be 5.6%, and
- 2) 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 particularly striking in buildings owned by Vantage Properties, a private equity developer backed by Apollo Capital and Credit Suisse. In the past few years, Vantage and their private equity partners have purchased over 9,500 units of affordable, rent-regulated housing in Queens, Harlem, and Upper Manhattan. The door-to-door surveys and other research found that Vantage engages in a systematic pattern of harassment, primarily using the tactic of filing repeated, baseless cases in housing court.

In one portfolio of buildings owned by Vantage in Queens, Vantage has brought 965 separate court proceedings against the 2,124 apartments in the portfolio in the 16 months after Vantage bought the building, suing almost one in every two tenants. This is a remarkable number, especially compared to the only 50 court proceedings brought by the prior owner in the year before he sold the buildings to Vantage. In fact, Vantage files so many eviction cases in Queens that it often monopolize 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, have produced the following data:

- In a typical Queens building, there has been a 23% turnover rate since Vantage bought the portfolio a little over a year ago, driven by a housing court strategy so clearly designed to harass tenants that many of the eviction cases filed by Vantage are facially insufficient.
- In a typical Washington Heights building, 12% of the apartments have been recaptured by Vantage since they bought the building nine months ago. Of the remaining tenants, 25% are experiencing harassment, including 12% who are facing baseless and frivolous legal cases.

Here is a sample of the harassing tactics Vantage is using in this one Queens building:

- In the most common examples of harassment, tenants received notices canceling their leases, claiming that they were illegally subletting the apartment, even though the tenants have lived in the apartment, and no where else, for years.
- Other tenants have been sued multiple times for unpaid rent despite paying with money orders. Although the tenants are able to prove in housing court that they have paid the rent in full, Vantage is not deterred and sues them again a few months later. These cases are unfortunately very common.
- For many tenants, Vantage claimed that the tenants had never paid their security deposits, even though most of the tenants had been in the building for decades. Furthermore, if there is any question about those original security deposits, it is

the responsibility of Vantage to get the information from the landlord from whom they purchased the building. Nonetheless, Vantage then used this claim of no security deposits to say that the tenants owed back rent, giving Vantage an excuse to not cash any of the tenant's current rent payments because they were not "full payment." Vantage then takes the tenants to court for many months' unpaid rent, even though the rent is unpaid because Vantage itself has been refusing to cash the checks.

Community advocates have 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, we found an extraordinary high rate of evictions, and specific strategies of harassment that are similar to those used in the Vantage buildings.

Why Wall Street-Type Funding Threatens Affordable Housing

The private equity fund-model of these new investors creates an approach to and a model of building ownership that is substantially different from the traditional real estate owner model:

- Residential real estate in working-class neighborhoods of New York City has traditionally been a financial backwater, a relatively non-liquid asset that returned a rate of profit of about 8.5% 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 and have a long time horizon. 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, and must compete with other Wall Street-type investment vehicles to attract and retain those investors. In the private equity funds that we have examined, a 14% - 20% annual rate of return is commonly proposed as the target profit level. In residential real estate in working class neighborhoods, the major way you increase your rate of return to atypical levels, such as those pledged by private equity funds, is by pushing out low-rent paying tenants.

Why “Securitization” is Creating a New Sub-Prime Crisis

There is a direct connection between the new financial model of “securitization” and the buildings where the worst harassment is taking place. In fact, the practice of securitization by the lending institutions is leading directly to harassment.

Securitization (the creation of a mortgage-backed investment security) refers to the process by which a mortgage lender bundles together a large group of mortgages and sells certificates in that group of mortgages to investors. Although we are 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

sub-prime lending crisis that is costing so many small homeowners their homes and driving the economy into recession.

To understand how securitization works and why it led to the sub-prime crisis, take the small-home lender Countrywide Financial as an example. Countrywide (which nearly went bankrupt earlier this year) was a major player in the sub-prime mortgage market. As a lender, it is in their interest to make as many sub-prime loans as possible because sub-prime loans are very profitable, paying the lender high fees up front. However, Countrywide's desire to make highly-profitable, but risky sub-prime loans should be tempered by their fear of having those loans go bad. No lender, not even Countrywide, wants to be holding non-paying loans. But, through securitization, Countrywide works with an investment bank to bundle the loans into an investment security and sell certificates in that security to investors. This allows Countrywide to immediately recoup the value of the loan, but passes the risk that the loan will not be paid to the investor who buys the security. In this way, securitization throws off the balance of greed and risk that should keep a lender from encouraging unstable and risky loans.

In the case of private equity investment in New York's multi-family rental housing, the fact that many of the lending institutions are securitizing the loans is encouraging the lenders to make loans that are highly risky, and are either predicated on harassment, or are unsupportable in a way that is destructive to the building and dangerous to the investor who bought into the security.

A promise of harassment is made clear in a prospectus filed with the Securities and Exchange Commission (SEC) for a group of buildings in Washington Heights owned by Vantage Properties, financed by private equity partner Apollo Real Estate Advisors, and with a primary mortgage from Column Financial (a subsidiary of Credit Suisse). 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. However, the rent on a vacant apartment can be increased dramatically. In the prospectus, the underwriting terms state that Vantage "anticipates to recapture approximately 20-30% of the units [within the first year], and 10% a year thereafter" in order to pay the debt service on their loan. These targets are unjustifiable since only 1% of the apartments in these buildings were vacant at the time the loan was made, according to the SEC documents, and the annual rate of turnover for rent-regulated buildings is only 5.6%, according to the Rent Guidelines Board. Without an aggressive strategy 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 Vantage/Apollo/Credit Suisse deal.

These underwriting terms, and the systematic harassment that they compel, are typical in the 90,000 affordable, rent-regulated units that have been purchased by private-equity backed landlords over the past few years. The principal mortgage loan has been securitized in about 40% of the 90,000 private-equity backed units that advocates are tracking. Advocates have studied the underwriting terms for each of the mortgage-

backed securities (also called Collateralized Mortgage Obligations), and two things are clear from our detailed analysis of the loan underwriting terms:

1. These loans are incredibly risky and are underwritten outside industry standards. Most are interest-only first loans, with additional “mezzanine” debt layered on top. According to many of the term sheets, the rental income from the buildings will have to be increased by a factor of two or three to cover the debt service. Because the apartments are rent regulated and the rent increases limited by law, this is an almost impossible assumption to make.
2. All of the term sheets imply that, in order to be able to make the debt service, the landlord will have to push out a significant percentage of the current regulated tenants so they can be replaced with higher-rent paying tenants. In some cases, the term sheets explicitly state this in plain English, stating that the landlord must “recapture” 20-30% of the apartments in order to pay the debt service. Where this is not stated in plain English, the numbers tell the exact same story. If this were a hollow estimates used to justify the loan, we would be concerned about the investors, but less concerned about the impact on the city. In fact, we are seeing these landlords moving very aggressively to “recapture” these apartments.

In addition to passing along the risk of unreasonable loans to someone else, securitization in these multi-family rental buildings also encourages harassment because it creates a system where it is doubly profitable for the lending institution to make loans that are based on grossly inflated rent rolls. This is because the specific structure of a “collateralized mortgage obligation” bases the price of the security which is sold to an investor on the income generated by the mortgage asset, that is, the estimated rent roll of the building. Thus, the lender profits two times if they encourage bad behavior by the developer and agree to underwrite a loan based on an inflated estimate of a rent roll:

- The lender first profits more on the front-end by making a larger loan, which comes with higher fees.
- The lender profits far more on the back-end by selling the loan for an even higher price (based on the inflated rent roll) to the investor in the security.

This pressure/incentive to base the mortgage on an inflated estimate of a rent roll has two possible outcomes, both bad:

1. Either the assumptions are correct, and the landlord actually can harass out enough of the tenants and increase the rent roll in the building enough to pay the debt service, in which case the investment security is good but tenant protection laws are broken and affordable housing destroyed. Or,
2. The landlord cannot remove enough of the tenants to raise the rent roll and pay the debt service, in which case the building is financially unstable and likely to fall into dangerous disrepair, which is a difficult process for residents to endure. And, whoever bought certificates in the investment security stands to lose.

For the thousands of working class households who are victims of this business model, no outcome is favorable, and it is clear that the legal and financial structure of the mortgage-backed security exacerbates, and even requires harassment, placing both the lender and the underwriting entity in the middle of the problem.

Conclusion

Tenants and affordable housing across New York City are threatened as private-equity backed developers are purchasing a significant percentage of our affordable, multi-family rental housing. The Wall Street-type level of competition of private equity financing, and the unbalanced structure of loan securitization, is causing an epidemic of tenant harassment and destabilizing buildings. These landlords and financiers are jeopardizing the economic diversity and long-term stability of our neighborhoods, and undermining the best efforts of New York City and State elected officials to slow the loss of affordable housing. These elected officials and government agencies must act to address this crisis.

Anatomy of a Deal

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

